

# **Good Governance and Social Responsibility**

## **Lecture 12: Foreign Direct Investment, Privatization, and Insolvency Regimes**

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## Lecture Learning Objectives:

At the end of the lecture, you will be able to:

1. Define foreign direct investment
2. Identify the types of FDI
3. Show what the Philippine government (GPH) is doing to attract FDI
4. Enumerate and explain the key features of a favorable investment climate
5. Explain the idea of privatization
6. Understand the different arguments for and against privatization
7. Explain the concept of insolvency
8. Understand insolvency law and illustrate how the rehabilitation is done
9. Discuss the openness to and restrictions upon foreign investment of the GPH

“ Anything that makes your attempt to buy an asset more risky can have a material effect on the amount of investment we get. These days, we’d be lucky if we get lots of foreign direct investment. We should not restrict it. We should make it easier.”

-Nouriel Roubini

## INTRODUCTION

**Foreign direct investment** refers to the direct investment in productive assets by a company incorporated or un-incorporated in a foreign country to the host country, a system entirely different from the investments in shares of local companies by foreign entities.

**Economic theory** suggests that foreign direct investment (FDI) can generate positive spillovers to domestic firms in the host country. Since **multinational corporations (MNCs)** are an important source of international capital and technology, their entry can facilitate the transfer of technical and business know-how resulting in productivity gains and competitiveness among local firms. These spillover effects develop through best practices demonstration and diffusion, or through the creation of linkages with foreign and domestic firms becoming either suppliers or customers, or through the movement of experienced workers from foreign to local firms. The entry of MNCs may also increase competition and force domestic firms to imitate and innovate.

**Domestic firms** also benefit from spillovers and externalities associated with FDI through exports and/or international integration (Costa and de Queiroz 2002). **MNCs** have established global or regional production bases where domestic firms, particularly small and medium enterprises, can participate by serving as potential suppliers of outsourced parts or services. Participation in these networks can also provide domestic firms with

access to export markets. **Global/regional production networks** have increasingly grown in sectors such as automotive, machinery, electronics and garments.

There are two broad classifications of technological spillovers from FDI to domestic firms: **horizontal (within or intra-industry)** and **vertical (inter-industry) spillover** effects. **Horizontal spill over** refers to the effect the presence of MNCs has on domestic firms in the same sector. **Vertical spillovers** from FDI occur as a result of the interaction between domestic and foreign firms that are not in the same industry. This may take place through backward or forward trade linkages between foreign and domestic firms. **Backward linkages** are created when MNCs source raw materials and intermediate products from domestic firms. **Forward linkages** are created through contacts between domestic and foreign firms.

The existing FDI literature shows an increasing number of studies examining the technology spillovers from FDI to domestic firms. However, the evidence that foreign presence generates positive productivity externalities remains limited since the empirical literature indicates mixed results. Many show significant positive spillover effects from FDI while some find no or statistically insignificant result from technology spillover. The diverse results may be attributed to differences in countries' ability to benefit from foreign investment reflecting varying levels of absorptive capacity and market structure.

To attract FDI inflows and generate the positive spillover effects from the presence of foreign firms, the Philippines liberalized its FDI policy and offered various foreign investment incentive measures. To date, however, there are only a few studies that examine the productivity spillovers to domestic firms. Most studies focus on the impact of FDI on economic growth and on the determinants of FDI to the Philippines. There are hardly any empirical studies that explicitly apply quantitative analysis in evaluating whether FDI generates technology spillover from foreign to domestic firms. Due to the paucity of FDI firm-level panel data, it is difficult to measure or disentangle the contribution and different effects of FDI.

**Foreign direct investment (FDI)** has grown steadily in volume and is a major source of development finance. Recognizing that FDI can contribute to economic development, all governments want to attract it. However, the experience has been mixed.

A country's development depends on domestic and external financing. Developing countries have many developmental needs, and they often have a savings or trade gap. In an economy in equilibrium, it is an accepted identity that savings equals investment ( $S = I$ ). However, economies are seldom in equilibrium, and in a developing economy, a shortfall normally exists between savings and the desired level of investment, which countries seek to fill by capital inflows. As such, external financing is important for economic and social development.

Since the Bretton Woods Institutions and the United Nations system were established, official development assistance (ODA) has grown steadily and played a lead

role as a source of external capital for economic growth and development of less developed countries around the world (Amerasinghe & Espejo 2006). However, since the early 1980s, private capital flows, particularly foreign direct investment (FDI), have grown at a phenomenal rate. FDI has become an important source of private external finance for developing countries. It is different from other major types of external private flows in that it is motivated largely by investors' long-term prospects of making profits from production activities that they control. Foreign bank lending and portfolio investment, in contrast, are invested in activities which are often motivated by short-term profit considerations. These investments can be influenced by a variety of factors (e.g. interest rates) and they are prone to herd behavior.

## **FOREIGN DIRECT INVESTMENT IN DEVELOPING COUNTRIES**

Increasing foreign investment can be one of the indicators that the host country's economy is growing and in general, opening its windows on globalization. **FDI** is more than merely moving capital across borders; it has certain advantages to both the host country and the investor. Dunning (1980, 1988) argues that a firm's foreign investment decisions are mainly influenced by firm and location specific advantages. Open door economic policy (Singh & Jun 1975; Walder 1996), market size (Lardy 1995; Milner & Pentecost 1996; Fittock & Edwards 1998), political stability (Tesai 1994) and host countries' macroeconomic policy, tax regime and regulatory practices are considered as major determinants that attract FDI to developing countries. **FDI** inflows generate jobs through new establishments and expanded business and other economic activities, and indirectly increase competition within domestic markets and facilitate the transfer of improved technology and management techniques.

For the **investor**, the potential benefits lie in penetrating a market, gaining access to low-cost raw materials, diversifying business activity, reduction of cost in production processes and defeating some of the disadvantages of exporting, such as trade barriers and transport costs. **FDI** also enables companies to learn about the host market and how to compete in it. **Multinational enterprises (MNEs)** own and control operations abroad to benefit from diverse production locations and globalization of market.

**MNES** undertake production in different countries to minimize production costs and expand globally. Firms therefore choose the lowest cost locations for their production activities that the propensity of a firm to get involved in international production depends on three conditions: ownership advantages, location advantages and internalization advantages.

Internal factors in host countries are also important determinants. There are elements of a host country that are considered location-related factors; **First**, there are Ricardian type endowments, which mainly comprise natural resources, most kinds of labor and proximity to markets. **Second**, there are environmental variables that act as a function of political, economic, legal and infrastructural factors of a host country.

These factors play a crucial role in a firm's decision to enter a host country. There are **four types of FDI**:

- Resource seeking (motivated by access to local, natural or human resources).
- Import substituting (substituting for exports to the local market).
- Export platform (a basis for exporting to a regional market).
- Rationalized or vertically disintegrated (locating each stage of production according to local costs). A particular investment may be motivated by several of the above factors simultaneously.

An economy that offers long-term business prospects could influence an FDI decision but needs to be directly relevant to the profitability of the venture. The inflow of FDI to a host country depends on the availability of location specific factors and the opportunity to effectively utilize those resources. Overall, the factors that influence FDI decisions can include the size and growth of the host country market, factor prices (labor, raw materials etc.), economic policies (interest rates, exchange rates, tax etc.), profitability and the protection afforded to investing firms by tariffs and/or other measures.

### **FDI POLICY SHIFT IN THE 1990S**

In the last two decades, the Philippines has considerably liberalized its FDI policies. Through the legislation of the Republic Act 7042 or the Foreign Investment Act (FIA) in June 1991, the country allowed foreign equity participation up to 100% in all areas not specified in the Foreign Investment Negative List. At the same time, the Philippines pursued changes in its investment incentive schemes in order to encourage FDI inflows.

Various investment incentive measures were granted through the different investment regimes administered by the **Board of Investments (BOI)**, **Philippine Economic Zone Authority (PEZA)**, **Subic Bay Metropolitan Authority (SBMA)**, **Clark Development Corporation (CDC)** and other bodies mandated by various laws to establish, maintain and manage special economic or free port zones. BOI-registered enterprises, depending on their status, are allowed income tax holiday between 3 to 6 years, tax- and duty-free importation of spare parts, and tax credit on raw materials. **PEZA** grants the most generous incentives including income tax holiday, basic income tax rate of 5% of gross income earned, and tax and duty-free importation of capital equipment, spare parts and raw material inputs. Except for the income tax holiday, Clark and Subic enterprises enjoy the same incentives available to PEZA enterprises.

### **FDI PERFORMANCE**

The 1980s witnessed fluctuating FDI inflows but with the liberalization efforts in the early 1990s, steady increases in FDI inflows were registered from 1991 to 1994. Although substantial declines were observed in 2001 and 2003, some recovery was felt as FDI increased from 2004 to 2007. In terms of FDI sectoral distribution, a structural shift seems to be taking place as inflows to the manufacturing sector slowed down while inflows to the services sector particularly finance and telecommunications continued to rise.

Within manufacturing, FDI inflows have been dominated by the food and beverage sector with a share of 12.7% from 2000 to 2007. The share of chemicals and chemical products fell to 4.2% in the 2000s from 12.2% in the 1980s. Coke, refined petroleum and other fuel products also dropped to only 3.3% in the 2000s from 9% in the 1990s. Similarly, FDI inflows in machinery, apparatus and supplies fell to 2% from a share of 9% in the 1990s. There is also a decline in the share of transport equipment from 3.7% in the 1980s to 2.6% in the 2000s. Only paper and paper products witnessed an increase from 0.31% in the 1990s to 1.25% in the 2000s.

In terms of FDI sources, the US was the country's largest source of FDI inflows up to the 1980s. However, its share dropped from 56% in the 1980s to only 13% in the 1990s and 2000s. US dominance has been substantially diluted by the increasing presence of Japan, Netherlands, UK and Singapore. Japan's share increased from 13% in the 1980s to 24% in the 1990s, although this fell to 18% in the 2000s.

While the investment policy reforms and opening up of more sectors to foreign investors in the past decade resulted in improvements in FDI inflows to the country, on the overall, FDI inflows to the Philippines have been limited and the country's FDI performance has lagged behind its neighbors in East and Southeast Asia. Compared with FDI inflows to the ASEAN countries, the Philippines received the lowest level of FDI inflows particularly in the 1990s and the 2000s. In terms of cumulative FDI inflows, for instance, Vietnam's total soared to US\$40 billion while the Philippines barely increased at US\$18.96 billion in 2007.

## **KEY FEATURES OF THE INVESTMENT CLIMATE**

The following are some of the **major factors that influence firms to decision to locate their investment in any particular developing country:**

### **ACCESS TO FINANCE AND INTERNATIONAL INTEGRATION**

Access to finance considerably influences a firm's tendency to invest. Businesses invest in projects where the expected benefits exceed the cost of investment. However, this can only be achieved where businesses do not face credit constraints unrelated to their own performance. Credit constraints are less likely in countries with well-developed and well-functioning financial systems. Research has shown the importance of financial sector development for growth (Levine, 1997). A healthy financial system allows them to expand according to their expected potential, rather than their current stock of cash. Thus, countries with well-developed financial systems comprises of banks, financing institutions and securities market have the greater tendency to grow faster than countries with less developed systems (World Bank, 2003).

According to World Bank in its 2003 report, countries that aggressively pursued integration with the global economy such as Brazil, China, India, Malaysia, Mexico, the Philippines and Thailand grew more quickly in the 1990s than those that did not. This will send us back to the basic idea that openness to trade and foreign direct investment accelerates economic growth.

## **GOVERNANCE**

A country's general makeup of governance and the body that govern interactions between business and government determine the burden that firms face in complying with government regulations, the quality of government services, and the degree to which corruption is associated with the procurement of these services. Modern experiential research confirms, for example, that measures of corruption are significantly and negatively related to inflows of foreign direct investment (Smarzynska and Wei 2000; Wei 2000). Regulations in developing countries may tend to be more complex and bureaucratic than necessary, associated with corruption, and often are not intended to correct market failures or protect consumers (World Bank, 2004). Djankov et al. (2002) state that more regulations are generally not associated with better societal outcomes in developing countries. They also find a correlation between strict regulation and increased corruption.

## **INFRASTRUCTURE**

The better the infrastructure of the host economy, the more attractive it is to foreign investors. For example, the quality of transport and communications system can be estimated from expenditure on road transport (Hill and Munday, 1991). Ernst and Young identified the following **infrastructure factors** as important in attracting FDI. These include:

- Good base of related and supporting industries like suppliers, sub- contractors, university research center, business services and raw materials.
- Good transport facilities, roads as well as port system for both sea and air.
- Low cost and availability of utilities such telecommunications, energy and water.
- Environmental regulations and procedures.
- Availability of sites and premises.

In countries with inferior infrastructure, businesses must dedicate more resources to acquiring information, procuring inputs, and delivering their products to the market. This undermines the competitiveness of firms, at best, and at worst, deters them from entering markets where they could otherwise operate efficiently.

## **SKILLED LABOR FORCE**

knowledge infrastructure and the level of human development. Education, training, one of the essential requirements for economic growth of a country is its health and social services are tools for human capital development. Realizing this importance, governments in developing countries need to deploy resources for human capital development. Systematic assessment of availability of human capital is therefore necessary before formulating any policy for attracting FDI. Such **policies should be designed to:**

- Identify critical shortages of skilled manpower in the various sectors of the economy and take measures to address the reasons for the shortage.
- Develop knowledge development strategies for creating a skilled labor force that foreign investors find advantageous for future growth.
- Set targets for human resource development based on reasonable expectations of growth.

## **MACROECONOMIC FACTORS**

Investment is motivated by profit, and foreign investors will always choose a country with an optimistic business sector which is measured in terms of Gross Domestic Product (GDP) growth rate, inflation rate, level of industrialization, etc. There is an existence of herd mentality among foreign investors the tends to create a band wagon effect in a particular country; China and some other East Asian countries are recent examples of this. India now exhibits a similar attraction. By contrast, Nepal, Bangladesh and many other slow growths third world economies have so far received very negligible amounts of FDI.

## **POLITICAL STABILITY**

Political certainty and transparency are a very important determinant for developing countries to attract DFI. Political uncertainty in a potential host country may unexpectedly change the 'rules of the game' under which businesses operate.

Instability in a host country's government or monetary and fiscal policies results in more uncertain investment results and may depreciate firm's value/ The following **political factors** are the most seriously considered by investors in pre-investment decision making:

- Frequent changes of government
- Critical attitudes of opposition political parties towards FDI
- Lack of transparency in the public service
- Degree of nationalism
- Incidence of corruption
- Possibilities of terrorism

Business and political risks are credible determinants of FDI location variables such as regulatory environment, inflation, incidence of violent or peaceful power transitions and host country relationships with other countries are among the factors identified.

## **TECHNOLOGY FACTOR**

Technological progress casts an important role in economic growth, which encourages innovation and attracts FDI. A well-developed technology infrastructure assists the implementation of better business processes. It also involves lots of adaptation. To support innovation, the public sector can undertake research and development activities directly on its own or with private partners to provide complementary services.

## **PRIVATIZATION**

In the ordinary context, **privatization** is a stage or course of action of transferring in whole or in part the ownership of a business enterprise, agency or public service from the public sector to the private sector. In a wider perspective, **privatization** means the transfer of any government tasks and functions to the private sectors which may include providing important services like power, water and transportation. Other functions may

include revenue collection, law enforcement, and in some advanced countries, this may even include running a prison.

## **PRO-PRIVATIZATION**

Proponents of privatization believed that private entities can more efficiently deliver goods and/or service than government due to free market rivalry. This is based on the premise that government should be more on the regulatory aspect, that being, it has no "business in business." Besides, government is not generally known as a good provider of goods and services, especially in less developed and developing countries. In general, it is argued that overtime privatization will lead to lower prices, better quality, more options, less corruption, less red tape and faster delivery of both goods and services.

From the business economic standpoint, the argument for privatization is that the **government has few incentives** to make certain that they can run well the enterprises they own. In a state-run business, for instance, there is difficulty in determining how well it is being run considering that the absence of basis for comparisons since most deals in state monopolies. Another is that **the government administration does not have the fullest technical competence in evaluating the effectiveness and efficiency of diverse industries that governments are engaging into.**

Another argument is that when a **government experiences an insufficiency of funds** it can have easier ways of covering it either by borrowing or taxation, unlike private enterprise. There is therefore a clear undue advantage by the state-run enterprises because they can borrow money at cheaper cost compared to private enterprises. When it is privatized, the taxpayers' money will not be used to cover losses.

### **Accountability**

Managers of privately-owned enterprises are answerable to their shareholders and to the consumers. Decision makers and managers of publicly owned companies on the other hand are required to be more accountable to the broader community and more of it actually will be to the "political stakeholders."

### **Funds**

Private companies have easy access of investment capital in the financial markets more especially when the said markets are appropriately liquid. This fluidity characteristic will make private companies capable of maneuvering swiftly to respond to the market and to the overall business environment.

### **Dispersion of Resources**

There are more tendencies that the resources, profits and incentives will be dispersed and "diversified" in a highly privatized environment, this would give more opportunities to more entities. Availability of investment to a good number of entities will ignite the capital market, promotes activities, and adds more spin to the economy in the process.

## **Corruption**

A government monopoly is prone to corruption considering that some decisions are made primarily on the basis of decision-maker's personal gain. Dishonesty would definitely compromise resources which would lead to poor performance.

## **Tainted Purpose**

A company or an industry may be run or used by the government mainly as vehicles in satisfying political goals. And the government may put off development and improvements due to its political implications rather than addressing valid economic concerns.

## **No More Subsidies**

Efficiency can bring in profits. With profits, none or minimized subsidies will be needed so taxpayers' money will be saved.

## **Natural Monopolies**

The existence of natural monopolies does not mean that these sectors must be state-owned. Governments can enact anti-trust legislation and bodies to deal with anti-competitive behaviors.

## **Political Influence**

Nationalized industries are prone to interference from politicians for political or populist reasons. Examples include making an industry buy supplies from local producers (when that may be more expensive than buying from abroad), forcing an industry to freeze its prices/fares to satisfy the electorate or control inflation, increasing its staffing to reduce unemployment, or moving its operations to marginal constituencies.

## **Profits**

Corporations exist to generate profits for their shareholders. Private companies are poised to earn profits by being in the best position to serve the needs of their targeted consumers. Competition brings improvements on quality.

## **Security**

Governments have had the tendency to "bailout" poorly run businesses, often due to the sensitivity of job losses, when economically, it may be better to let the business fold.

## **ANTI-PRIVATIZATION**

Those who oppose privatization argue the claims that governments are ultimately accountable to the people, so they have to make certain that the enterprises they own are well managed. Nationalized enterprises run poorly will cause government to lose public support and votes. Thus, democratic governments do have an incentive to maximize efficiency in nationalized companies, due to the pressure of future elections.

Opponents of certain privatization believe certain parts of the social terrain should remain closed to market forces in order to protect them from the unpredictability and

ruthlessness of the market (such as private prisons, basic health care and basic education). Another view is that some of the utilities which government provides benefit society at large and are indirect and difficult to measure or unable to produce a profit, such as defense. Still another is that natural monopolies are by definition not subject to competition and better administered by the state.

The controlling ethical issue in the anti-privatization perspective is the need for responsible stewardship of social support missions. Market interactions are all guided by self-interest, and successful actors in a healthy market must be committed to charging the maximum price that the market will bear. Privatization opponents believe that this model is not compatible with government mission for social support, whose primary aim is delivering affordability and quality of service to society.

Some would also point out that privatizing certain functions of government might hamper coordination, and charge firms with specialized and limited capabilities to perform functions which they are not suited for. In rebuilding a war torn nation's infrastructure, for example, a private firm would, in order to provide security, either have to hire security, which would be both necessarily limited and complicate their functions, or coordinate with government, which, due to a lack of command structure shared between firm and government, might be difficult. A government agency, on the other hand, would have the entire military of a nation to draw upon for security, whose chain of command is clearly defined.

Furthermore, opponents of privatization argue that it is undesirable to transfer state-owned assets into private hands for the **following reasons**:

### **Accountability**

The public does not have any control or oversight of private companies.

### **Capital**

Governments can raise money in the financial markets more cheaply to re-lend to state-owned enterprises.

### **Concentration of Wealth**

Profits from successful enterprises end up in private, often foreign, hands instead of being available for the common good.

### **Cuts in Essential Services**

Governments have chosen to keep certain companies/industries under public ownership because of their strategic importance or sensitive nature. If a government-owned company providing an essential service (such as water supply) to all citizens is privatized, its new owners could lead to the abandoning of the social obligations to those who are less able to pay or from regions where this service is unprofitable.

## **Downsizing**

Private companies often face a conflict between profitability and service levels and could overreact to short-term events. A state-owned company might have a longer-term view, and thus be less likely to cut back on maintenance or staff costs, training, etc., to stem short-term losses. Many private companies have downsized while making record profits.

## **Goals**

The government may seek to use state companies as instruments to further social goals for the benefit of the nation as a whole.

## **Job Loss**

Due to the additional financial burden placed on privatized companies to succeed without any government help, unlike the public companies, jobs could be lost to keep more money in the company.

## **Natural Monopolies**

Privatization will not result in true competition if a natural monopoly exists.

## **Political Influence**

Governments can easily exert pressure on state-owned firms to help implement a government policy.

## **Privatization and Poverty**

It is acknowledged by many studies that there are winners and losers with privatization. Lack of transparency leading to state-owned assets being appropriated at minuscule amounts by those with political connections, absence of regulatory institutions, improper design and inadequate control of the privatization process leading to asset stripping, are some of the major concerns.

## **Profit**

Private companies do not have any goal other than to maximize profits. A private company will serve the needs of those who are most willing (and able) to pay, as opposed to the needs of the majority, and are thus anti-democratic.

# **INSOLVENCY REGIMES**

## **INSOLVENCY**

**Insolvency** refers to the inability of a person or an entity to pay its debts as they fall due. There are **two (2) aspects** from which insolvency can be defined, first, **cash flow liquidity** which is the inability to pay debts when they fall due; second, **asset insolvency**, a state where the entity's asset is lesser than its liabilities.

A business can be cash flow illiquid (or temporarily "insolvent") but "balance sheet solvent" if it holds fixed illiquid assets, particularly against short term debt that it cannot be straight away realize when needed. Conversely, a business can have negative net

assets showing on its balance sheet, but its cash flow is healthy by reason of steady revenue streams that is able to serve debt obligations as they fall due.

**Insolvency** is commonly confused with bankruptcy. The two, however, are not entirely similar. The only similarity these two have is that these two deals deal with troubled debt. Insolvency is a state of being and bankruptcy is a matter of law. There has to be bankruptcy proceedings in court, and it is the court that will declare that, and entity is bankrupt. Companies can be insolvent but not legally bankrupt. Insolvency can lead to bankruptcy, but the condition may also be a temporary insolvency and fixable without legal protection from creditors.

Companies facing the possibility of insolvency can take measures to keep themselves financially afloat at least. Using existing lines of credit to borrow money is one way to avoid insolvency; however, this creates more liability and new payment deadlines; an option that will bury down the company deeper into financial trouble if not checked. Selling off assets to other companies is also a common hedge against insolvency. Consumers may notice a local grocery store changing hands, for example.

Another option for avoiding insolvency is by allowing a takeover from a larger corporation. It is normal for major conglomerates to seek out small but commercially viable companies for acquisition or takeover proceedings. Even if the smaller company is currently flirting with insolvency, the rights to its signature product lines may prove valuable enough to save it from financial ruin on the one hand and give the acquiring company operational leverage on another. This happens quite often in the wholesale food industry. Struggling or insolvent manufacturers of a popular product may agree to sell off all of their assets to a corporation with better financing.

**Insolvency** does not necessarily lead to bankruptcy, but all bankrupt companies are also considered insolvent. Once an announcement of insolvency is made, stockholders may have to decide whether or not to sell off their shares or remain with the company until it can regain its financial footing.

## **CONSEQUENCE OF INSOLVENCY**

The main heart of modern insolvency legislation and debt restructuring practices is no longer on the easiest solution, which is liquidation and the consequent elimination of insolvent entities. Laws and trends now are on the remodeling of the financial and organizational structure of the corporation experiencing financial distress so as to permit the rehabilitation and continuation of their business. This is known as a **business turnaround or business recovery**. In some jurisdictions, it is a violation under the insolvency laws for a corporation to continue in business while insolvent. In others, the business may continue under a declared protective arrangement while alternative options to achieve recovery are being worked out.

## **INSOLVENCY LAW AND BUSINESS REHABILITATION**

The Philippine insolvency law which was enacted in 1909 has **three (3) principal subjects:**

1. Suspension of payments
2. Voluntary insolvency
3. Involuntary insolvency

### **FEATURES OF INSOLVENCY LAW**

#### **Rehabilitative**

It is considered rehabilitative because of its suspension of payment provision which allows the restructuring of debtor's obligation to enable it to continue its operation.

#### **Distributive**

On the other hand, it also considered distributive since the purpose of the insolvency provision of the law is to affect an equitable distribution of properties among the creditors and to benefit the debtor by discharging him of his obligation for him to have a new start.

### **REHABILITATION LAW (THE PROCESS)**

The basic rehabilitation law can be found in P.D. 902-A as amended which contained the **following process:**

#### **Stay Order**

The rehabilitation rules authorize both debtor-initiated and creditor-initiated petitions. Any creditor or creditors holding at least 25% of the debtor's total liabilities, can petition the appropriate Regional Trial Court (RTC) to place the debtor under rehabilitation. If the court finds the petition to be sufficient in form and in substance, it issues a stay order which among others, suspends enforcement claims of whatever nature against the debtor.

#### **Adequate Protection**

The stay concept is not an absolute rule. During the effectiveness of the stay order, creditors may seek relief from its effects. In this regard, the rehabilitation rules will adopt the concept of adequate protection. A secured creditor, for example, may ask relief from the stay order if he lacks adequate protection. A creditor is considered as lacking adequate protection if it can be shown that-

1. the debtor is not honoring a pre-existing agreement to keep the property insured.
2. the debtor is failing to take commercially reasonable steps to maintain the property; or
3. the depreciation of the property increases to the extent that the creditor becomes under-secured.

Upon showing a lack of adequate protection, the court shall take steps to protect the creditor's interest such as ordering the rehabilitation receiver to make payments or

give replacement security. The court may, however, refuse to give the creditor this relief if it would prevent the continuation of the debtor as a going concern or otherwise prevent the approval and implementation of the rehabilitation plan.

### **Rehabilitation Receiver**

The rehabilitation rules authorize the appointment of a duly qualified person as a rehabilitation receiver for the debtor under rehabilitation. The rehabilitation receiver, who is considered an officer of the court, does not take over the management and control of the debtor. His primary role is to oversee and monitor the operations of the debtor pending proceedings. He is also tasked to recommend to the court whether the rehabilitation of the debtor is feasible as well as to implement the rehabilitation plan if approved. To protect the rehabilitation receiver, the rehabilitation rules give him immunity from suit for any act done or omitted by him in good faith in the exercise of his function and powers.

### **"Equality is Equity" Principle**

The rehabilitation rule adopts the "equality is equity" principle prescribed by the Supreme Court for rehabilitation cases. This principle basically states that once a company goes under rehabilitation, all creditors, whether secured or unsecured, should be placed on equal footing. Consequently, unlike SEC Rules on Corporate Recovery, The rehabilitation rules do not classify creditors into secured and unsecured creditors. Neither do they give creditors the right to vote against the rehabilitation of the debtor. What the rehabilitation rules grant or give the creditors is the right to oppose or comment on the petition and rehabilitation plan. The court may, however, approve the rehabilitation plan even over the objection of the majority of the creditors if, in its judgment, the rehabilitation of the debtor is feasible, and the opposition of the creditor is manifestly unreasonable.

In deciding whether the opposition of creditor is manifestly unreasonable, the court may consider the following:

1. the plan would likely provide the objecting class of creditors with compensation greater than that which they would have received if the assets of the debtor were sold by a liquidator within a three-month period.
2. the shareholder or owners of the debtor lose at least their controlling interest as a result of the plan; and
3. rehabilitation receiver has recommended approval of the plan.

### **Cram Down**

The rehabilitation rules provides that in approving a rehabilitation plan, the court may impose such terms, conditions or restrictions as may be required for its effective implementation or for the protection and preservation for creditors if the plan fails. Once the plan is approved, it is binding upon the debtor and all persons who may be affected by it, including the creditors, whether or not they participated in the proceedings or opposed the plan. Payments to the creditors shall be allowed only to the extent called for by the plan.

An approved rehabilitation plan may be modified or altered only on motion and if the Court determines that such is necessary to achieve the desired targets or goals set forth therein.

In case of the failure of the rehabilitation plan, the court, *motu proprio* or upon recommendation of the rehabilitation receiver, may terminate the proceedings.

## **PROPOSED CORPORATE RECOVERY AND INSOLVENCY ACT**

There are several proposed laws now pending with the Philippines Congress to update the antiquated insolvency law regime. The proposed Corporate Recovery Act, which has been renamed the Corporate Recovery and Insolvency Act ("CRIA"), contains the usual provisions of a modern bankruptcy statute. It generally follows the world's best insolvency practices. There are provisions on voluntary and involuntary initiation of proceedings, effect of commencement of proceedings, duration of stay order and adequate protection. The proposed legislation also deals with administrative expenses, payment of post-commencement interest, rescission of pre-commencement transactions, new money and cram down. The CRIA also takes into consideration existing local context such as the effect of a stay order on government financial institutions which enjoy special protection under Philippine law. Unlike the rehabilitation rules, the CRIA provides for a classification of creditors and grants them separate voting rights. It even addresses the interplay between good corporate governance and insolvency. In response to bankruptcies with international repercussions, the CRIA contains provisions on cross-border insolvency.

Unlike the Insolvency Act and the Rehabilitation Law, the proposed Corporate Recovery Act expressly categories **different forms of debt** relief available to a corporate debtor in financial distress. They are as follows:

### **Suspension of Payments**

This limited remedy provides a company with a moratorium on debt payments while it negotiates an out-of-court arrangement with its creditors. To prevent abuse, the moratorium is limited to three months under the watch of a conservator. Further, if a debtor chooses this remedy, it is precluded from obtaining relief under court-supervised rehabilitation or pre-negotiated rehabilitation for an entire year thereafter. This "election of remedies" is designed to prevent debtors from delaying the enforcement of creditors' claims by first suspension of payments and then seeking rehabilitation.

### **Fast-Track Rehabilitation**

This is the default relief under the proposed legislation. A debtor is limited to this remedy, unless (a) it has initiated a pre-negotiated rehabilitation proceeding; (b) the debtor is a non-stock corporation or partnership; and (c) a majority of the creditors have requested conversion of the proceeding to court-supervised rehabilitation proceeding.

This remedy involves the transfer of the assets of the debtor into a new company which will be owned by creditors of the debtor in exchange for their credit. The objective

is to continue the old business under a new corporation with minimum or no debts at all. This involves quite an intricate procedure. Involved in the process is the setting up of a new company that will initially be fully owned by the old debtor in exchange for its assets, issuance of bonds, auctioning off of the shares of the new company to the creditors of the debtor company in exchange for their credit and the eventual ownership of the new company by the creditors of the debtor.

This relief has encountered a lot of criticism as statutory relief. It will most likely be deleted as a form of statutory relief, without prejudice to it being part of a court-supervised or pre-negotiated rehabilitation plan.

### **Court-Supervised Rehabilitation**

This is the counterpart of the rehabilitation proceeding under the present regime. Unlike the present rehabilitation process which is court-driven, the CRIA makes court-supervised rehabilitation creditor-driven.

The remedy contemplates the formulation of a plan under the supervision of the court. The legislation establishes minimum standards for the plan to maintain transparency and fairness. The creditors vote on the plan according to specific classes (secured creditors, for instance would usually be a separate class). If the vote of the majority of each of the creditor classes (voting on the basis of size of claim) is obtained, the court shall approve the rehabilitation plan.

If support from all the voting creditor classes is not obtained, the court may nevertheless approve the plan if evidence is shown that eighty percent of all the voting creditors support it.

If the court approves the plan, it becomes binding on all creditors, even those who voted against it. The proceeding that is converted to liquidation is case of (a) late submission of the plan, (b) the court's failure to approve the plan, or (c) the debtor's breach of plan.

### **Pre-Negotiated Rehabilitation**

Experience in the Philippines has shown that the informal workout process or out-of-court restructurings are quite common. This process, however, suffers from the need for near unanimity among the creditors. Dissenting or "maverick" creditors can frustrate the whole process. Accordingly, there is a need for accelerated court approval of the restructuring agreement.

The pre-negotiated rehabilitation process allows for summary judicial proceedings for debtors seeking ratification of a rehabilitation that was approved by a majority of the creditors before the debtor sought relief from the court. It allows a debtor to establish a comprehensive plan without needing to obtain unanimity, so long as the minimal standards in the legislation are met, and a majority of the creditors support the plan. Once the court approves the plan, the pre-negotiated plan is crammed down on non-

participating or dissenting creditors. This relief, therefore, combines the benefit of an accelerated court process and cram down concept in insolvency law.

### **Dissolution and Liquidation**

This is the final resort under the legislation. The proposed law calls for the appointment of a liquidator and formulation of a liquidation plan. The provisions are envisioned to ensure that the debtor's assets are sold quickly. It also seeks to amend existing legal provisions on preference of credits. For example, under the proposed law, the proceeds from the sale of mortgaged properties are distributed to the secured creditors. Proceeds remaining from such sales, and from sales of non-mortgaged properties, are distributed as follows:

1. first, to meet unpaid administrative expenses.
2. second, to workers for back wages.
3. third, to the government for back taxes.
4. fourth, to all creditors not specifically mentioned; and
5. fifth, to creditors whose claims are subordinated by law or agreement.

There are encouraging developments in the insolvency law regime of the Philippines. While there was no statutory movement in this area for a significant number of years, our Supreme Court has responded to the need of the times by quickly adopting the Rehabilitation Rules that gave meat to our rehabilitation law. Call it judicial activism but the reality of the situation is that this singular act of the Supreme Court has contributed, in no insignificant part, to the restoration of public confidence and order in this area of law.

More importantly, the Philippine Congress is now responding to insolvency law developments more than it ever did before. Several legislative bills have been filed in the present Congress. The House Committee on Economic Affairs is conducting several hearings on the proposed legislation more than any other congressional committee had done before. Practitioners, academicians and experts-both from the private and government sectors-are actively participating in the deliberations.

It is hoped that the insolvency law of the Philippines will come to par with the world's best insolvency law practices in the not-so-distant future (Adapted from the Article: Recent Developments on Insolvency Laws and Business Rehabilitation in the Philippines, by Francis Lim).

### **OPENNESS TO AND RESTRICTIONS UPON FOREIGN INVESTMENT**

The Government of the Philippines (GPH) actively seeks foreign investment to promote economic development. The Philippine investment landscape has some noteworthy advantages such as its free trade zones, including the Philippine Economic Zone Authority (PEZA) (<http://www.peza.gov.ph>). Certain industries have experienced impressive growth in recent years, especially those that leverage educated, English speaking Philippine labor.

Despite these strengths, legal restrictions, regulatory inconsistency, inadequate public investment in social and physical infrastructure and a lack of transparency hinder foreign investment. In many sectors of the economy, GPH regulatory authority remains ambiguous, and corruption is a significant factor. In addition, a complex and slow judicial system inhibits the timely and fair resolution of commercial disputes.

Philippine law generally treats foreign investors the same as their domestic counterparts, with important exceptions outlined in the Foreign Investment Act (detailed below). Corporations or partnerships must register with the Securities and Exchange Commission (SEC) (<http://www.sec.gov.ph>) and sole proprietorships must be registered with the Bureau of Trade Regulation and Consumer Protection (BTRCP) in the Department of Trade and Industry (DTI) (<http://www.dti.gov.ph>). Investors generally report that the Philippine bureaucracy is non-discriminatory but slow to process these requirements. To streamline business registration process, the GPH is implementing the Philippine Business Registry (PBR), a single, web-based business registration system that integrates business registration processes now handled by five government agencies.

The 1991 Foreign Investment Act (FIA) requires the GPH to publish the Foreign Investment Negative List (FINL), which outlines sectors in which foreign investment is restricted or limited. The GPH is required by the FIA to update the FINL every two years. The 9th FINL was published in October 2012. The broad scope of the FINL contributes to the poor Philippine record in attracting foreign investment, particularly compared to its ASEAN counterparts. The FINL is comprised of two parts. Part A details sectors in which foreign equity participation is restricted by the Constitution or laws. Part B lists areas in which foreign ownership is limited (generally to 40%) for reasons of national security defense, public health, morals and the protection of small and medium enterprises (SMEs). There is no procedural mechanism to request a waiver from the negative lists.

The 1987 Constitution prohibits foreign nationals from owning land in the Philippines. The Investors' Lease Act of 1994 (ILA) allows foreign investors to lease a contiguous parcel up to 1,000 hectares for 50 years, renewable once for 25 additional years. The 2003 Dual-Citizenship Act, which allows natural-born Filipinos who became naturalized citizens of a foreign country to re-acquire Philippine citizenship, gave Philippine dual citizens full rights to possess land. Ownership deeds continue to be difficult to establish and are poorly reported and regulated. The court system is slow to resolve land disputes.

Only Philippine citizens can practice licensed professions such as engineering, medicine and allied professions, accountancy, architecture, interior design, chemistry, environmental planning, social work, teaching, law, real estate services, respiratory therapy and psychology. There are changes brought about in the ASEAN through Mutual Recognition Agreements (MRA). Companies that register with the Board of Investments (BOI) (<http://www.boi.gov.ph>) may employ foreign nationals in supervisory, technical, or advisory positions for five years from the date of registration, extendable by BOI upon request. Top positions and elective officers of majority foreign-owned BOI-registered

enterprises (i.e., president, general manager and treasurer, or their equivalents) are exempt from the five-year limitation. Other investment areas reserved for Filipinos include mass media (except recording), small-scale mining, private security, utilization of marine resources including small-scale utilization of natural resources in rivers, lakes, and lagoons, and the manufacture of firecrackers and pyrotechnic devices.

Foreign investment is highly restricted in the retail trade industry. Retail trade enterprises with paid-up capital of less than US\$2.5 million, or less than US\$250,000 for retailers of luxury goods, are reserved for Filipinos. Foreign investors are prohibited from owning stock in lending, financing or investment companies unless the investor's home country affords the same reciprocal rights to Filipino investors. Foreign ownership in enterprises engaged in financing and securities underwriting that are regulated by the SEC is limited to 60%. Changes in the 9th FINL cap foreign ownership at 49% for lending companies.

Other specific limits on foreign investment include: private radio communications networks (20%), employee recruitment and locally-funded public works construction and repair (25%), advertising agencies (30%), natural resource exploration, development, and utilization (40%, with exceptions), educational institutions (40%), operation and management of public utilities (40%), operation of commercial deep sea fishing vessels (40%), Philippine government procurement contracts (40% for supply of goods and commodities, 25% for construction of locally-funded public works, with some exceptions), adjustment companies (40%), operations of Build-Operate-Transfer (BOT) projects in public utilities (40%), ownership of private lands (40%), rice and corn processing (40%, with some exceptions), financing companies and investment houses (60%).

The Philippines limits foreign ownership for reasons of national security, defense and public health. Industries such as the manufacturing of explosives, firearms, and military hardware, as well as the operation of massage clinics, are generally limited to 40% foreign equity. Foreign ownership in SMEs is also limited to 40% in non-export firms. The SEC has implemented rules and regulations that will enable it to monitor, investigate, and impose penalties on corporations that do not comply with foreign ownership equity requirements of sectors covered by the FINL.

Foreign ownership in the banking sector is restricted by the 1994 Foreign Bank Liberalization Act. The Act limits at 10 the number of new foreign banks that could open full-service branches in the Philippines, and those licenses have already been issued. The banks are limited to six branch offices, each. In addition, each of the four foreign banks operating in the Philippines prior to 1948 is allowed to open up to six branches each. Publicly listed foreign banks with national or global rankings may own up to 60% of a locally incorporated subsidiary. Foreign banks that do not meet these requirements are limited to a 40% stake. Since 1999, the Bangko Sentral ng Pilipinas (Philippine Central Bank) (<http://www.bsp.gov.ph>) has imposed a moratorium on the issuance of new bank licenses. Micro-finance institutions are exempt. Philippine law also requires that majority Filipino-owned banks must control at least 70% of the total banking resources in the country.

The insurance industry is open to 100% foreign ownership, subject to a sliding scale of minimum capital requirements depending on the level of foreign equity. As a general rule, government agencies, including government-owned and controlled corporations, must secure insurance protection from the state-owned Government Service Insurance System (GSIS) (<http://www.gsis.gov.ph>). This policy extends to the government's interests in projects implemented under the BOT law, but BOT regulations also allow proponents/operators to secure bid security and performance bonds from surety or insurance companies accredited by the Philippine Insurance Commission.

Offshore companies not incorporated in the Philippines may underwrite Philippine issues for foreign markets but not the domestic market. Current law also restricts membership on boards of directors for mutual fund companies to Philippine citizens.

The Lending Company Regulation Act of 2007 which established a regulatory framework for credit enterprises that do not clearly fall under the scope of existing laws, requires majority Philippine ownership for such enterprises.

In addition to the restrictions detailed in the FINL, firms with more than 40% foreign equity that qualify for BOI incentives must divest to the 40% level within 30 years from registration date or within a longer period as determined by the BOI. Foreign- controlled companies that export 100% of production are exempt from this requirement. Certain non-luxury retail establishments must offer at least 30% of their equity to the public within eight years from the start of operation.

In July 2012, President Benigno Aquino III issued an executive order closing 78 areas to new mining. The order imposes a moratorium on the new mining agreements until the Philippine Congress defines a revenue-sharing scheme. It additionally confines small-scale mining to designated areas, requires the government to review and renegotiate existing contracts, requires reserves to be rewarded through a public bidding process, provides state ownership of mine wastes upon the expiration of a contract, creates the Mining Industry Coordinating Council to implement reforms, and bans the use of mercury in small-scale mining.

The BOT Law provides the legal framework for private sector participation in large infrastructure projects. Franchises in public utilities-railways, urban rail mass transit systems, electricity and water distribution, and telephone systems-may only be awarded to enterprises with at least 60% Philippine ownership. While US firms have won contracts under the law, mostly in the power generation sector, more active foreign participation under BOT is often frustrated by legal and administrative problems, including weaknesses in planning, tendering, and executing private sector infrastructure projects; regulatory and legal challenges to collecting and/or increasing tolls and fees; and lingering ambiguities about guarantees and other support provided by the government.

The Aquino administration has established the "Public Private Partnership (PPP) Center" (<http://ppp.gov.ph>) to promote transparency and oversee project development and approval. Resources for right-of-way and land acquisition have been allocated and

single borrower (SB) limits for Philippine banks that finance PPP arrangements have been relaxed. PPP infrastructure projects costing more than P1 billion (about US\$25 million) undertaken through contractual arrangements authorized under the BOT Law may register with BOI to be entitled to incentives under the Omnibus Investment Code.

## **FDI AND REGIONAL PRODUCTION NETWORKS**

Participation in regional/global production networks provides domestic firms not only access to export markets but to newer technologies as well. These can generate substantial positive spillovers and externalities. The current regional economic integration process is important in facilitating the establishment and development of regional production networks.

The Philippines is host to affiliates of foreign automakers and electronics companies and has participated in their production networks. However, given the country's narrow participation in the production networks of MNCs in these industries, opportunities for spillovers into the local economy become limited. While the Philippines' largest exports are high technology products such as electronics and auto parts, these are mainly concentrated in labor-intensive, highly import-dependent, and low value-added segments like semi-conductors and wiring harnesses. Hence, the backward linkages to the domestic economy created by these high-tech exports have remained limited.

## **ASSESSMENT OF FDI SPILLOVER EFFECTS**

The empirical analysis done by Prof. Rafaelita Aldaba and Prof. Fernando Aldaba from the Philippine Institute for Developmental Studies (Nov. 2010) shows that based on the full sample, productivity spillovers take place horizontally from multinational corporations to domestic firms within the same industry at the five-digit level. There is no evidence that productivity or employment spillovers take place between foreign and domestic firms either through backward linkages (where domestic firms supply intermediate inputs to foreign firms) or through forward linkages (where foreign firms supply intermediate inputs to domestic firms). Though these results may be attributed partly to the data aggregation and other limitations of the dataset, these are consistent with the present condition of the manufacturing industry characterized by the weakness of forward and backward linkages between firms. Given these limited linkages between domestic firms and MNCs, it would be difficult for productivity spillovers from foreign affiliates to take place through forward or backward linkages channels.

## **POLICY RECOMMENDATIONS**

The experience of the Philippines shows that FDI spillover effects are not automatically generated. Opening up the economy to FDI has contributed to the country's exports of high technology products and overall economic growth. However, the spillover effects of FDI to domestic firms has remained limited due to the domestic firms' weak competitiveness and inability to absorb the technology or knowledge being transferred.

This implies that for spillovers to take place, the absorptive capacity of domestic firms must be strengthened.

To deepen the firm linkages within the economy, the development of domestic parts and suppliers would be crucial. With the increasing regional economic integration in East and Southeast Asia, potential opportunities could arise from the growth of regional production networks where domestic parts and supplier firms could act as subcontractors of outsourced parts and components. To improve the competitiveness of domestic parts and suppliers and strengthen their linkages with foreign affiliates, the government needs to adopt a more comprehensive approach that would combine industrial policy to improve and develop domestic parts and supplier firms with measures to create an environment conducive to the creation and expansion of FDI-related spillovers as well as increase participation in higher segments of industry value chain. The **following policies are suggested:**

#### **Human Resource Development and Training.**

The government must implement substantial reforms in all stages of education and training systems to raise the learning capabilities of firms and upgrade labor skills.

#### **Industrial and Technology Upgrading.**

For the Philippines to move up the technology scale, design and development skills and technological capabilities must be improved. Industrial upgrading would necessitate a strong base of domestic knowledge. This would require the development of specialized skills and technological capabilities, particularly in electronics and auto parts.

#### **SME Finance Support Programs.**

In the country, the lack of access to financing has severely constrained the growth of SMEs. Private banks were able to overcome these challenges by providing assistance in preparing accounting records, business advice, simplifying loan documentation and tailor fitting loans to match the borrower's cash flow.

#### **Linkages Improvement and Promotion of Subcontracting and Outsourcing Activities.**

It is important to develop a program to provide information exchange to local firms to make strategic linkages with MNCs. Supplier development and linkage programs can be developed to improve linkages between domestic firms, especially SMEs, with foreign affiliates of MNCs.

#### **Improvement of Infrastructure and Logistics and Overall Investment Climate.**

Good infrastructure and logistics that lower production cost and facilitate the easy supply chain management from the procurement of inputs to the export of outputs are important for the operations of production networks. The government must continue to pursue policies to lower power and communication costs, provide sufficient port systems, reduce travel time, and offer travel and shipment options. To improve the country's investment climate, it is important that the government immediately focus not only on

inadequate infrastructure but also on the country's low institutional quality, corruption and inefficient bureaucracy that continue to constrain doing business in the country.

### **Capacity Building and Adequate Funding for the Department of Trade and Industry and Board of Investments' Competitiveness and Linkages Program.**

Strengthen the capacity of the staff and provide adequate resources for the effective implementation of the programs to be designed to improve industry competitiveness and linkages between domestic firms and MNCs.

### **Conversion and Transfer Policies**

The Central Bank has worked since 2007 to relax and streamline the Philippine foreign exchange (forex) regulatory framework. There are no restrictions on the full and immediate transfer of funds associated with foreign investments, foreign debt servicing, or payment of royalties, lease payments and similar fees.

Central Bank regulations provide specific requirements for foreign exchange purchases from banks and their subsidiary foreign exchange corporations and from non-bank foreign exchange dealers, money changers, and remittance agents. There is no mandatory foreign exchange surrender requirement imposed on export earners or other foreign currency earners such as overseas workers. The Central Bank follows a market-determined exchange rate policy, with scope for intervention targeted mainly at smoothing excessive foreign exchange volatility. To curb foreign exchange speculation and temper the Peso's rapid appreciation from surges in foreign portfolio capital, the monetary authority announced in late 2012 that it would impose ceilings on non-deliverable forward transactions relative to bank's capital.

### **Expropriation and Compensation**

Philippine law allows for expropriation of private property for public use or in the interest of national welfare or defense. In such cases, the Philippine government offers compensation for the affected property. In the event of expropriation, foreign investors have the right under Philippine law to remit sums received as compensation in the currency in which the investment was originally made and at the exchange rate at the time of remittance. However, agreeing on a mutually acceptable price can be a protracted process.

There are no recent cases of actual expropriation involving US companies in the Philippines. Since the implementation of the BOT law in 1990, some BOT contractors in the energy sector, including US firms, have reported disputes with local government units (LGUs) on real property tax assessments. Some LGUs initiated auction and/or confiscation proceedings on the contractors' assets, which the companies have challenged in the courts.

### **Dispute Settlement**

Many foreign investors describe the inefficiency and uncertainty of the judicial system as a significant disincentive for investment. Investment disputes can take years to resolve. While the judiciary is constitutionally independent of the executive and

legislative branches, it faces many problems including understaffing and corruption. In addition, a number of Philippine government actions in recent years have raised questions over the sanctity of contracts in the Philippines. High-profile cases include the government-initiated review and renegotiation of contracts with independent power producers, court decisions voiding disadvantageous and allegedly tainted BOT agreements, and challenges to foreign participation in large-scale natural resource exploration activities. The GPH has received foreign donor support for judicial reform projects through the Asian Development Bank, the World Bank and USAID.

In July 2012, President Aquino signed an executive order requiring all government contracts involving PPP, BOT and joint ventures with the private sector, to include provisions for alternative dispute resolution. According to the order, the goal is to make resolving disputes less expensive, tedious, and time-consuming, particularly for large-scale capital-intensive infrastructure and development contracts.

The Philippines is a member of the International Center for the Settlement of Investment Disputes (ICSID) and has adopted the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the "New York Convention"). However, Philippine courts have shown a reluctance to abide by the arbitral process or its resulting decisions. Enforcing an arbitral award in the Philippines can take years.

In July 2010, the Philippine Congress passed a new bankruptcy and insolvency law that provides a more predictable framework for the rehabilitation and liquidation of distressed companies. Rehabilitation may be initiated by debtors or creditors under court-supervised, pre-negotiated, or out-of-court proceedings. The law also sets the conditions for voluntary (debtor-initiated) and involuntary (creditor-initiated) liquidation. The law recognizes cross-border insolvency proceedings in accordance with the United Nations Center for International Trade and Development's Model Law on Cross-Border Insolvency, allowing the courts to recognize proceedings in a foreign jurisdiction involving a foreign entity with assets in the Philippines. Regional trial courts designated by the Supreme Court have jurisdiction over insolvency and bankruptcy cases. According to the International Finance Corporation's 2013 Ease of Doing Business report, the Philippines ranks 65th of the 85 economies studied in resolving insolvency and bankruptcy cases.

## **PERFORMANCE REQUIREMENTS AND INCENTIVES**

### **Performance Requirements**

Performance requirements are established by the BOI for investors who are granted incentives and are usually based on the approved project proposal. BOI-registered companies provide a projected yearly production schedule and export performance targets. Registered projects must maintain at least 25% of total project cost in the form of equity and comply with the 25% local value-added sourcing requirement. As of March 2010, foreign retailers are no longer subject to local sourcing requirements.

The Philippines is not a signatory to the WTO Agreement on Government Procurement. The Government Procurement Reform Act of 2003 requires the public

sector to procure goods, supplies, and consulting services from enterprises that are at least 60% Filipino-owned and infrastructure services from enterprises with at least 75% Filipino interest. Although Philippine law outlines objective criteria for selection of a single portal electronic procurement system, US and other foreign companies continue to raise concerns about irregularities in government procurement and inconsistent implementation.

Philippine law also gives preference to local products and/or Filipino-controlled enterprises in the bid evaluation process for public sector purchases of goods and supplies. When the lowest bid is from a supplier of imported goods and/or from a foreign-owned enterprise, the lowest domestic bidder can claim preference and match the offer provided its original bid was no more than 15% higher than that of the foreign bidder or foreign entity.

Filipino consultants also enjoy preferential treatment in government projects. If Filipino consultants work for foreigners on such projects due to technical need, the law requires that they are the lead consultants. Where foreign funding is indispensable, foreign consultants must enter into joint ventures with Filipinos. Multilateral donor agencies report that their implementing partners have thus far been able to comply with both donors' internal procurement guidelines and Philippine law. Foreign bidders may participate in foreign-funded development assistance projects provided the foreign assistance agreement expressly provides for use of the foreign government or international financing institution's procurement procedures and guidelines. The Official Development Assistance Act further authorizes the President to waive statutory preferences for local suppliers for foreign-funded projects.

The Government Procurement Reform Act does not cover projects under the BOT Law, which allows investors in qualifying projects to engage the services of Philippine and/or foreign firms for the construction of infrastructure projects. Procurement by government agencies and government-owned or controlled corporations is subject to a countertrade requirement entailing the payment of at least US\$1 million in foreign currency. Implementing regulations set the level of countertrade obligations at a minimum of 50% of the import price and set penalties for nonperformance of countertrade obligations.

### **Incentives**

According to the Senate Tax Study and Research Office, there are about 180 fiscal incentives laws and issuances in the Philippines as of December 2012. President Aquino has stated his support for fiscal incentives rationalization publicly and listed fiscal incentives reform as a priority legislative measure. A number of bills have been filed in the Philippine Congress, but the scope and detail of reform remain contentious.

Every year, the Investment Priorities Plan (IPP) outlines the list of investment areas entitled to incentives.

Screening for the legitimacy and regulatory compliance of companies seeking investment incentives appears to be non-discriminatory, but the application process can be complicated. Incentives granted by the BOI often depend on action by other agencies such as the Department of Finance (DOF) (<http://www.dof.gov.ph>), including its Bureau of Customs (BOC) (<http://customs.gov.ph>). Significant incentives offered to BOI-registered companies currently include a 4 to 6 years income tax holiday (ITH) (depending on whether the project is non-pioneer or pioneer), which may be extended for another three years upon compliance of certain criteria, with the aggregate benefit not to exceed eight years; additional deduction from taxable income of 50% of the wages corresponding to the increment in number of direct labor as against the previous year for the first five years from date of registration, but not simultaneously with ITH; duty-free importation of capital equipment, spare parts, and accessories for five years from date of registration; tax and duty exemptions on imported breeding stocks and genetic materials for ten years; exemption from wharfage dues and any export tax, duty, impost, and fees on non-traditional export products for ten years; the ability to employ foreign nationals in supervisory, technical, or advisory positions; and the simplification of customs procedures. A project study is required when applying for BOI registration and enterprises must adhere with the representations they submitted to the Board during its application. Registered projects must maintain the 75/25 debt-equity ratio.

To encourage wider distribution of industry across the Philippines, BOI-registered enterprises that locate in less-developed areas are entitled to "pioneer" incentives. Such enterprises can deduct from taxable income 100% of the cost of the necessary and major infrastructure works. BOI-registered enterprises may also deduct from its taxable income 100% of its incremental labor expenses for five years, which is double the rate that is allowed for BOI-registered projects not located in less-developed areas.

Incentives also apply specifically to export-oriented firms. An enterprise with more than 40% foreign equity that exports at least 70% of its production may be entitled to incentives even if the activity is not listed in the IPP. Aside from ITH and duty-free importation of capital equipment, registered enterprises may also be entitled to tax credit for taxes and duties paid on imported raw materials used in the processing of export products for ten years and may have exemption from taxes and duties on imported spare parts, and access to customs bonded manufacturing warehouses.

Generally, the export commitment for export-oriented BOI-registered enterprises is 50% of total production if Filipino-owned (i.e. with 60% or more Filipino equity) and 70% if foreign-owned (i.e. less than 60% Filipino equity). BOI-registered, foreign-owned firms must divest to the 40% level within 30 years from registration date or within a longer period determined by BOI. BOI-registered, foreign-owned firms that export 100% of production are exempt from this requirement.

Export-oriented firms with at least 50% of their revenues derived from exports may register for additional incentives under the Export Development Act of 1994. Registered exporters may be eligible for both these and BOI incentives, provided the exporters are registered according to BOI rules and regulations and the exporter does not take

advantage of the same or similar incentives twice. Specific export incentives include a tax credit ranging from 2.5% to 10% of annual incremental export revenue.

Philippine law also provides incentives for multinational enterprises to establish regional or area headquarters and regional operating headquarters in the Philippines. Regional headquarters are defined as branches of multinational companies that do not earn or derive income from the country, and which act as centers for supervision, communications, or coordination. Incentives include exemption from income tax, exemption from branch profits remittance tax, exemption from value-added tax, sale or lease of goods and property and rendition of services to the regional headquarters subject to 0% value-added tax, exemption from all taxes, fees, or charges imposed by a local government unit (except real property taxes), and value-added tax and duty-free importation of training and conference materials and equipment solely used for the headquarters functions.

Regional operating headquarters enjoy many of the same incentives as regional headquarters but are subject to the standard 12% value-added tax, applicable branch profits remittance tax, and 10% corporate income tax. Foreign executives working at regional operating headquarters may import personal and household effects duty free and may obtain immigration benefits. Eligible multinationals establishing regional operating headquarters must spend at least US\$200,000 yearly to cover operations.

Multinationals entities that establish regional warehouses for the supply of spare parts, manufactured components, or raw materials for foreign markets also enjoy incentives on imports that are re-exported, including exemption from customs duties, internal revenue taxes, and local taxes. Imported merchandise intended for the Philippine market is subject to applicable duties and taxes.

### **Right to Private Ownership and Establishment**

Philippine law recognizes the private right to acquire and dispose of property or business interests, subject to foreign nationality caps specified in the Philippine Constitution and other laws. The 1987 Constitution grants the government authority to regulate competition and prohibit monopoly, but there is no implementing law. The Aquino administration has prioritized the enactment of an anti-trust law. Congress is considering several anti-trust bills. In June 2011, President Aquino issued an executive order designating the Department of Justice (DOJ) as the government's competition authority until anti-trust legislation is passed.

A few sectors are closed to private enterprise, generally on grounds of security, health or public morals. For example, the Philippine government operates or licenses all casinos through the Philippine Amusement and Gaming Corporation (PAGCOR) (<http://www.pagcor.ph>) and runs lottery operations through the Philippine Charity Sweepstakes Office (PCSO) (<http://www.pcsso.gov.ph>).

Generally, only the state-owned GSIS may insure government-funded projects. BOT projects and partially privatized government corporations must meet GSIS insurance

and bonding requirements in proportion to Philippine government interests. In addition, government funds are usually deposited in the Central Bank or in government-owned banks.

### **Protection of Property Rights**

The Philippines has established procedures for registering claims on property, but delays and uncertainty caused by the judicial system remain a problem. Questions regarding the general sanctity of contracts, and the property rights they support, have also clouded the investment climate.

Of particular concern in the Philippines is the challenge of intellectual property rights protection, for which the Philippines is listed on United States Trade Representative (USTR) Special 301 Watch List. US distributors continue to report pirated optical discs of cinematographic, musical works, computer games, and business software, as well as widespread unauthorized transmissions of motion pictures and other programming on cable television systems. Furthermore, trademark infringement of a variety of product lines remains prevalent.

The Intellectual Property (IP) Code provides the legal framework for intellectual property rights protection in the Philippines, especially in the key areas of patents, trademarks, and copyright. The Electronic Commerce Act extends the legal framework established by the IP Code to the Internet. Investor concerns include deficiencies in the IP Code and other IP laws that have unclear provisions relating to the rights of copyright owners over broadcast, rebroadcast, cable retransmission or satellite retransmission of their works, and burdensome restrictions affecting contracts to license software and other technology.

The Philippines has generally strong patent and trademark laws. Its first-to-file patent system grants patents valid for 20 years from the date of filing. The holder of a patent is guaranteed an additional right of exclusive importation of his invention. The United States announced its Patent Prosecution Highway (PPH) partnership with the Philippines starting in January 2013. The PPH is a global program that streamlines the examination process for patent applications filed in participating countries. However, the Cheaper Medicines Act limits patent protection for pharmaceuticals and significantly liberalizes the grounds for the compulsory licensing of pharmaceuticals. The Philippine Intellectual Property Office (IPOPHL) (<http://www.ipophil.gov.ph>) reported it has not received any application for licensing since the law passed in 2008.

Trademark law protects well-known marks, which do not need to be in actual use or registered to be protected under the law, and prior use of a trademark in the Philippines is not required to file a trademark application. In July 2012, the Philippines acceded to the Madrid Protocol, an agreement that facilitates the protection of trademarks in a large number of countries by obtaining an international registration.

In the area of copyright law, legislation that would fully implement the World Intellectual Property Organization (WIPO) Copyright and Performances and Phonograms

treaties has been ratified by the Philippine Congress after being pending for more than a decade. Once enacted, a copyright bureau will be created under the IPOPHL to handle copyright matters. Philippine law also protects computer software as literary work, and exclusive rental rights may be offered in several categories of works and sound recordings. Terms of protection for sound recordings, audiovisual works, newspapers, and periodicals are compatible with the Agreement on the Trade-Related Aspects of Intellectual Property Rights (TRIPS). Further, the enactment of the Anti-Camcording Act in 2010 provided stringent penalties for illegal camcording of motion pictures in theaters. The Act has reportedly helped to significantly reduce unlawful camcording incidents in the Philippines.

The IP Code also recognizes industrial designs, performers' rights, and trade secrets. The registration of a qualifying industrial design is for a period of five years and may be renewed for two consecutive five-year periods. While Philippine law recognizes performers' rights for 50 years after death, the exercise of exclusive rights for copyright owners over broadcast and retransmission is ambiguous. While there are no codified rules on the protection of trade secrets, Philippine officials assert that existing civil and criminal statutes protect trade secrets and confidential information. Other important laws defining intellectual property rights are the Plant Variety Protection Act, which provides plant breeders intellectual property rights consistent with the 1991 Union for the Protection of New Varieties of Plants Convention, and the Integrated Circuit Act, providing WTO-consistent protection for the layout designs of integrated circuits.

Generally, the Philippine government enforcement agencies are most responsive to those copyright owners who actively work with them to target infringement. Agencies will not proactively target infringement unless the copyright owner brings it to their attention and works with them on surveillance and enforcement actions. The IPOPHL has jurisdiction to resolve certain disputes concerning alleged infringement and licensing. In June 2011, IPOPHL launched its IPR Arbitration and Mediation Center to receive and facilitate IP disputes presented to the center for review, resolution, and settlement through mediation and arbitral proceedings. Although intellectual property owners have sometimes used the IPOPHL's administrative complaint system as an alternative to the judicial system, the process can be slow-moving due to limited resources. Joint efforts between the private sector and the National Bureau of Investigation (NBI), Philippine National Police (PNP), Bureau of Customs (BOC), Optical Media Board (OMB) (<http://www.omb.gov.ph>), and several LGUs have resulted in successful enforcement actions.

Enforcement actions are not often followed by successful prosecutions. Intellectual property infringement is not considered a major crime within the Philippine judicial system and takes a lower precedence in court proceedings. In October 2011, the Philippine Supreme Court approved Rules of Procedure for Intellectual Property Rights Cases, a key judicial reform identified in several recent Special 301 reports. The special rules include streamlined procedures to expedite cases and rules of evidence for IPR cases; provisions for the speedy, summary destruction of seized goods; designation of four courts with national jurisdiction to issue search warrants; and regional IP commercial

courts. The special rules have the potential to improve IPR-related convictions as it shortens lengthy court action that led many cases to be settled out of court. Convicted intellectual property violators rarely spend time in jail, since the six-year penalty enables them to apply for probation immediately under Philippine law. As of November 2012, IPOPHL reported that 161 out of 231 IP violations cases filed in their office since 2001 have been dismissed, while the latest statistics on court convictions on IP violations are not yet available as of the reporting period.

### **Transparency of the Regulatory System.**

Philippine national agencies are required by law to develop regulations via a public consultation process, often involving public hearings. In most cases, this ensures some transparency in the rulemaking process. New regulations must be published in national newspapers of general circulation or in the GPH's official gazette before taking effect.

On the enforcement side, however, regulatory action is often weak, inconsistent, and unpredictable. Regulatory agencies in the Philippines are generally not statutorily independent but are attached to cabinet departments or the Office of the President and, therefore, subject to political pressure. Many US investors describe business registration, customs, immigration, and visa procedures as burdensome and a source of frustration. To counter this, some agencies, such as the SEC, BOI and the Department of Foreign Affairs (DFA) (<http://www.dfa.gov.ph>), have established express lanes or "one-stop shops" to reduce bureaucratic delays, with varying degrees of success.

### **Efficient Capital Markets and Portfolio Investment**

The Philippines is generally open to foreign portfolio capital investment. Non-residents may purchase domestically issued securities and invest in equities and money market instruments. They may also invest in bank deposits, although foreign exchange purchases from banks to remit profits and repatriate capital for peso time deposits with maturities of under 90 days face some restrictions.

The securities market is growing but remains dominated by government bills/bonds. Nevertheless, private sector issuances have been steadily increasing and now constitute an important source of financing for major Philippine enterprises. Between June 2011 and October 2012, Fitch, Standard & Poor's, and Moody's upgraded the Philippines' sovereign credit ratings to one notch below investment grade, contributing to robust expansion of the Philippine capital market.

### **Philippine Stock Exchange**

Membership in the Philippine Stock Exchange (PSE) is open to foreign-controlled stock brokerages incorporated under Philippine law. Although growing, the Philippine stock market lags many of its neighbors in size, product offerings, and trading activity. Investments in any publicly listed firm on the PSE are governed by foreign ownership ceilings stipulated in the Constitution and other laws.

There are less than 260 listed firms, and the ten most actively traded companies account for nearly 40% of trading value and about 35% of domestic market capitalization.

To encourage publicly listed companies to widen their investor base, the PSE introduced reforms in 2006 to include trading activity and free float criteria in the selection of companies comprising the stock exchange index. The 30 companies included in the benchmark index are subject to review every six months. In November 2010, the PSE reinstated a policy for listed companies to maintain at least 10% public ownership of their issued and outstanding shares to promote greater market liquidity and fairer and more transparent stock pricing. Listed firms were given up to the end of 2012 to comply with the minimum public float rule or face de-listing/suspension and higher taxes.

Hostile takeovers are not common because most companies' shares are not publicly listed and controlling interest tends to remain with a small group of parties. Cross-ownership and interlocking directorates among listed companies also lessen the likelihood of hostile takeovers.

The Securities Regulation Code of 2000 strengthened investor protection by requiring full disclosure in the regulation of public offerings, and implementing stricter rules on insider trading, mandatory tender offer requirements, and the segregation of broker-dealer functions. The Code also significantly increased sanctions for securities violations, and mandated steps to improve the internal management of the stock exchange and future securities exchanges. Moreover, the Code expressly prohibits any one industry group (including brokers) from controlling more than 20% of the stock exchange's voting rights, though the PSE has yet to fully comply.

The enforcement of these strengthened laws is mixed. While there has been some progress from the creation of special commercial courts, the prosecution of stock market irregularities can be subject to delays and uncertainties of the Philippine legal system.

## **Banking**

As of September 2012, the five largest commercial banks in the Philippines represented 47% of total commercial banking system resources, with estimated total assets the equivalent of about US\$162 billion. The Central Bank has worked to strengthen banks' capital bases, reporting requirements, corporate governance and risk management systems.

Commercial banks' published average capital adequacy ratio was 18.4% on a consolidated basis as of March 2012, well above the 10% statutory limit and the 8% internationally accepted benchmark. Time-bound fiscal and regulatory incentives to encourage the sale of non-performing assets to private special purpose vehicles and asset management companies promoted a resilient post-Asian crisis banking sector in the Philippines. Philippine banks also had limited direct exposure during the global financial crisis to investment products issued by troubled financial institutions overseas. As of September 2012, non-performing loans and non-performing asset ratios of commercial banks were estimated at 2.1% and 2.6%, respectively.

The General Banking Law of 2000 paved the way for the Philippine banking system to phase in internationally accepted, risk-based capital adequacy standards. Since 2011, the Central Bank has broadly revised its risk-based capital framework in step with

adjustments in the Basel capital adequacy rules. In July 2007, the Philippines adopted the Basel 2 capital adequacy framework for commercial banks and their bank/quasi-bank subsidiaries, expanding coverage from credit and market risks to include operational risks and enhancing the risk-weighting framework and disclosure of capital adequacy and risk management systems. The Central Bank began the staggered adoption of Basel 3 capital adequacy rules for commercial banks in January 2011. Full implementation is scheduled for January 2014-four years ahead of the timeline provided by the Basel Committee on Banking Supervision.

Thrift, rural, and cooperative banks that are not subsidiaries of commercial banks are covered by a modified, risk-based capital framework consisting of Basel 1 with some elements of Basel 2, such as new capital adequacy requirements for operational risks and enhanced disclosure.

Other important provisions of the General Banking Law strengthened transparency, bank supervision and bank management. However, some impediments remain to more effective bank supervision and prompt corrective action, including stringent bank deposit secrecy laws and inadequate liability protection for Central Bank officials and bank examiners.

Credit is generally granted on market terms and foreign firms are able to obtain credit from the domestic market. However, some laws require financial institutions to set aside loans for certain preferred sectors, which may translate into increased costs and/or credit risks. Banks must set aside 25% of loanable funds for agricultural credit, with at least 10% earmarked for agrarian reform programs and beneficiaries. In early 2010, a new law tightened alternative modes of compliance-which used to include low-cost housing, educational, and medical developmental loans-to those directly targeting the agricultural sectors. Recent investor experience with "agri-agra" eligible bonds raise questions about implied guarantees by the Philippine government and investors are cautioned to exercise due diligence.

Banks are also required to set aside 10% of their loans for micro-, small- and medium-sized (MSME) borrowers, 80% of which should be earmarked for micro and small enterprises. While most domestic banks are able to comply with these mandatory lending requirements, operating and branching restrictions make it more difficult for foreign bank branches to comply. To help incentivize lending to MSMEs with limited or non-existing collateral to guarantee their lending, the Philippine government seeks to enhance MSME access to finance through the Central Credit Information Corporation (CCIC). It would operationalize a system that collects and disseminates fair and accurate information about the track record of borrowers, as well as the credit activities of all entities participating in the financial system. The legal and regulatory framework for a centralized credit information system is in place but not yet operational. The Credit Information System Act was adopted in October 2008 (Republic Act No. 9510). The implementing rules and regulations were adopted in May 2009. Direct lending by non-financial government agencies is limited to the Department of Social Welfare and Development (DSWD), focusing on the poorest areas not being served by micro-finance institutions.

## **Anti-Money Laundering and Information Exchange**

The Paris-based Financial Action Task Force (FATF) continues to monitor implementation of the Philippine Anti-Money Laundering Act through the Anti-Money Laundering Council. Covered institutions include foreign exchange dealers and remittance agents, which are required to register with the Central Bank and must comply with various Central Bank regulations and requirements related to the implementation of the Philippines' anti-money laundering law. The Philippines is a member of the Egmont Group, the international network of financial intelligence units and the Asia Pacific Group on Money Laundering.

The Philippine government has been working to address "strategic deficiencies" that pose potential risks to the international financial system, as identified by the Asia Pacific Group on Money Laundering. In June 2012, the FATF moved the Philippines from its "dark gray" to "gray" list following the enactment of key laws allowing ex parte inquiry into bank deposits/investments and making terrorist financing a stand-alone crime. Legislation to address remaining major deficiencies is pending before the Philippine Congress. Bills include broadening the definition of the crime of money laundering and expanding predicate crimes and covered institutions. President Aquino has certified the matter as urgent.

Following the signing into law of the Exchange of Information on Tax Matters Act in March 2010, and the issuance of implementing rules and regulations in September 2010, the Organization for Economic Cooperation and Development (OECD) upgraded the Philippines from its tax standards "blacklist" to the list of jurisdictions that "have substantially implemented the internationally agreed tax standard" for the exchange of information.

## **Accounting Standards**

In 2005, the Philippines started to fully adopt the Philippine Financial Reporting Standards patterned after the International Financial Reporting Standards issued by the International Accounting Standards Board (IASB). Effective Jan. 1, 2010, the Philippines also adopted International Financial Reporting Standards for SMEs which except for limited circumstances, apply to enterprises which do not have public accountability and with total assets from P3 million to P350 million (about US\$75,000 to US\$8.75 million) or liabilities from P3 million to P250 million (about US\$75,000 to US\$6.25 million).

The Philippine SEC requires the corporations' president, chief executive officer and chief financial officer to assume management responsibility and accountability for financial statements. Financial statements are examined by independent auditors in accordance with the Philippine Standards on Auditing, which are based on International Auditing Standards. The SEC reviews and revises guidelines, as necessary, on the accreditation of auditing firms and external auditors to promote quality control and discipline in the financial reporting environment. Certain regulatory agencies, such as the Central Bank, Insurance Commission and Bureau of Internal Revenue, enforce separate accreditation rules. The SEC requires listed companies to disclose to the SEC its actions on any material external audit findings within five days of receipt. Material findings include

fraud or error, losses or potential losses aggregating 10% or more of a company's consolidated assets, indications of company insolvency, and internal control weaknesses that could result in financial reporting problems.

A number of local accountancy firms are affiliated with the "Big Four" international accounting firms, namely KPMG, PricewaterhouseCoopers, Ernst & Young, and Deloitte.

### **Outward Investments**

There are generally no restrictions on outward investments by Philippine residents, although foreign exchange purchases from banks and their foreign exchange subsidiaries/affiliates above US\$60 million per investor or per fund per year require prior approval from the Central Bank. As part of the US\$60 million ceiling, residents may also purchase foreign exchange from banks and their foreign exchange subsidiaries/affiliates to invest in foreign currency bonds/notes, as well as peso-denominated securities for settlement in foreign currency, issued offshore by the Philippine government or resident entities.

Qualified investors, such as mutual funds, pension or retirement funds, investment trust funds and insurance companies may apply with the Central Bank for higher annual outward investment limits. All outward investments of banks in subsidiaries and affiliates abroad require prior Central Bank approval.

Foreign exchange earnings and divestment proceeds from outward investments that were funded with foreign exchange purchased from banks or their subsidiary/affiliate foreign exchange corporations are not required to be inwardly remitted and sold for Pesos.

### **Competition From State-Owned Enterprises**

Private and state-owned enterprises generally compete equally, with some clear exceptions. In 2002, the government's National Food Authority (NFA) (<http://www.nfa.gov.ph>) allowed the private sector to import rice. Though, in 2012, the GPH ceded about 83% of all rice importation to the private sector, including minimum access volume (MAV) and country specific quota (CSQ) imports. With limited exceptions, only the state-owned GSIS may provide coverage for the government's insurance risks and interests, including those in BOT projects and privatized government corporations, at least in proportion to the Philippine government's interest.

The government has also intervened to directly cap or control pricing in some additional private markets. During heavy typhoons and flooding, the Philippine government may impose temporary price controls on gasoline and a basket of basic goods and services. Under Philippine law, the President may freeze prices on basic goods and services for a period of 90 days under a state of emergency.

The Philippine government's privatization program is managed by the Privatization Management Office under the DOF. Apart from restrictions under the FINL, there are no regulations that discriminate against foreign buyers. The bidding process appears to be

transparent, though the Supreme Court has twice overturned high-profile privatization transactions to foreign buyers. The Power Sector Assets and Liabilities Management Corporation is required to sell 70% of the government-owned National Power Corporation's (NPC) generating assets and to transfer 70% of NPC-Independent Power Producer contracts to private companies.

The Philippine government has opened access and retail competition through several measures, including unbundling rates, removing cross-subsidies, establishing the Wholesale Electricity Spot Market and privatizing 92% of the NPC's generation assets as of 2012.

### **Corporate Social Responsibility**

Corporate social responsibility (CSR) constitutes a basic aspect of most significant business operations in the Philippines. US companies report strong and favorable responses to CSR programs among employees and within local communities. Many CSR programs focus on poverty alleviation efforts, promoting the environment, health initiatives, and education. Under the 2012 IPP, registered enterprises are encouraged to undertake sustainable CSR projects in the locality where the projects are implemented. In some cases, the Philippine government has compelled its own entities to engage in CSR. For example, the Philippine Bases Conversion and Development Authority is mandated to declare portions of its property in Fort Bonifacio and surrounding areas as low-cost housing sites.

### **Political Violence**

Terrorist groups and criminal gangs operate in some regions of the country. The Department of State publishes a consular information sheet at <http://travel.state.gov> and advises all Americans living in or visiting the Philippines to review this information periodically. The Department strongly encourages visiting and resident Americans in the Philippines to register with the Consular Section of the US Embassy in Manila through <http://travelregistration.state.gov>, the State Department's travel registration website.

Arbitrary, unlawful, and extrajudicial killings by national, provincial, and local government actors continue to be a serious problem. The justice system is constrained by limited resources that results in limited investigations, few prosecutions, and lengthy trials. Corruption, impunity, and abuse of power remain endemic.

On May 10, 2010, approximately 75% of registered citizens voted in elections for president, both houses of congress, and provincial and local governments. The election was generally free and fair but was marked by some violence and allegations of vote buying and electoral fraud.

Peace talks between the government and the Mindanao-based insurgent group Moro Islamic Liberation Front (MILF) are ongoing. After years of negotiations, during which both sides generally adhered to a cease-fire, the government and the MILF signed a Framework Agreement in October 2012 that appears to outline the basis for a durable solution to the longstanding conflict between the parties, though much work remains to

be done. As of January 2013, the parties continued to negotiate the modalities for implementing a final peace accord.

The New People's Army (NPA), the military arm of the Communist Party of the Philippines, is responsible for general civil disturbance through assassinations of public officials, bombings, and other tactics. It frequently demands "revolutionary taxes" from local and, at times, foreign businesses, and businesspeople. To enforce its demands, the NPA sometimes attacks infrastructure such as power facilities, telecommunications towers, and bridges, mostly in Mindanao. The National Democratic Front (NDF), an umbrella organization that includes the Communist Party and its allies, has engaged in intermittent peace talks with the Philippine government. The NDF has not targeted foreigners in recent years but could threaten US citizens engaged in business or property management activities.

Terrorist groups, including the Abu Sayyaf Group and Jema'ah Islamiyah, periodically attack civilian targets in Mindanao, kidnap civilians for ransom and engage in armed skirmishes with the security forces.

## **Corruption**

Corruption is a pervasive and long-standing problem in the Philippines. Recent government efforts have improved the country's ranking in Transparency International's Corruption Perceptions Index from 129 in 2011 to 105 (out of 176 economies) in 2012. Nevertheless, corruption was still ranked as the most problematic factor for doing business in the 2012-2013 Global Competitiveness Report.

The current administration continues to implement the anti-corruption reforms outlined in the Philippine Development Plan 2011-2016. Its 2012-2016 Good Governance and Anti-Corruption Cluster Plan further identifies specific measures to curb corruption through greater transparency and accountability in government transactions. Since President Aquino took office in 2010, corruption charges have been filed against several high-profile public officials. In May 2012, the Philippine Senate removed the Chief Justice of the Supreme Court after he was impeached on charges of failing to fulfill wealth disclosure obligations. Efforts to reign in corruption have, in general, improved public perception, though achieving tangible change remains a serious challenge to the Aquino administration.

The Philippines is not a signatory to the OECD Anti-Bribery Convention. It ratified the UN Convention against Corruption in 2003. The Philippine Revised Penal Code, the Anti-Graft and Corrupt Practices Act, and the Code of Ethical Conduct for Public Officials aim to combat corruption and related anti-competitive business practices. The Office of the Ombudsman (<http://www.ombudsman.gov.ph>) investigates and prosecutes cases of alleged graft and corruption involving public officials. Cases against high-ranking officials are brought before the special anti-corruption court, the "Sandiganbayan". Cases against low-ranking officials are filed before regional trial courts. Several bills supporting anti-corruption efforts are currently filed in Congress, including freedom of information rights, whistle-blower protection, and strengthening the country's witness protection program.

President Aquino abolished the Presidential Anti-Graft Commission in November 2010 and transferred its investigative, adjudicatory, and recommendatory functions directly under his office. This enabled the Office of the President to directly investigate and hear administrative cases involving presidential appointees in the executive branch and government-owned and controlled corporations. Soliciting/accepting and offering/giving a bribe are criminal offenses, punishable by imprisonment (6 to 15 years), a fine, and/or disqualification from public office or business dealings with the government.

### **Bilateral Investment Agreements**

As of 2012, the Philippines had signed bilateral investment agreements with 40 partner countries (Argentina, Australia, Austria, Bahrain, Bangladesh, Belgium and Luxembourg, Burma, Cambodia, Canada, Chile, China, the Czech Republic, Denmark, Equatorial Guinea, Finland, France, Germany, India, Indonesia, Iran, Italy, Japan, Republic of Korea, Kuwait, Laos, Mongolia, Netherlands, Pakistan, Portugal, Romania, Russian Federation, Spain, Sweden, Switzerland, Syria, Taiwan, Thailand, Turkey, United Kingdom, and Vietnam). It has four regional free trade agreements that include an investment chapter (ASEAN Comprehensive Investment Agreement, ASEAN-Australia-New Zealand Free Trade Agreement, Agreement on Investment under the Framework Agreement on Comprehensive Economic Cooperation among Governments of ASEAN and Republic of Korea, and Agreement on Investment under the Framework Agreement on Comprehensive Economic Cooperation among Governments of ASEAN and China).

The Philippines does not have a bilateral investment agreement with the United States.

### **Taxes/Bilateral Tax Treaty**

The Philippines has a tax treaty with the United States for the purposes of avoiding double taxation, providing procedures for resolving interpretative disputes, and enforcing taxes of both countries. The treaty also encourages bilateral trade and investments by allowing the exchange of capital, goods and services under clearly defined tax rules and, in some cases, preferential tax rates or tax exemptions.

Pursuant to the most favored nation clause of the Philippine-United States tax treaty, US recipients of royalty income qualify for the preferential rate provided in the Philippine-United Arab Emirates tax treaty. Accordingly, a 10% tax rate applies with respect to most royalties. A 15% tax applies on the remittance of profits by Philippine branches of US companies to their head offices and dividends remitted by Philippine subsidiaries of US companies to their parent companies.

There are issues about the application of the preferential tax treaty rates on dividends, interests, and royalties paid or payable to US residents. An entity must obtain a tax treaty relief ruling from the BIR to qualify for preferential tax treaty rates and treatment. However, according to several tax lawyers, the requirements for tax treaty relief applications are burdensome. Even stricter regulations issued in 2010 disqualifying late filings from availing of the preferential tax rates. The volume of tax treaty relief applications also has resulted in processing delays, with most applications reportedly

pending for over a year. Some publicly-listed companies reportedly have opted to withhold a final 30% withholding tax on dividend payments to foreign investors rather than go through the tedious process of securing tax treaty relief rulings for preferential tax rates.

The Supreme Court of the Philippines ruled in favor of Deutsche Bank AG Manila Branch (DB Branch) and held that the failure to strictly comply with the domestic law requirement under Revenue Memorandum Order (RMO) No. 1-2000 to file a tax treaty relief application (TTRA) 15 days prior to the transaction should not deprive a taxpayer of the benefit of a tax treaty. The Supreme Court reversed the decision of the Court of Tax Appeals (CTA) and upheld the provisions of the tax treaty over a BIR administrative issuance. This is following the time-honored international law principle of "pacta sunt servanda" which in English means "agreements must be kept". This principle demands that all states that enter into treaties must perform its treaty obligations in good faith (*Deutsche Bank AG Manila Branch vs. Commissioner of Internal Revenue*, G.R. No. 188550, promulgated Aug. 19, 2013).

The BIR appears to be altering its position on tax gains through liquidation. Previously, it had consistently applied Philippine-United States Tax Treaty provisions exempting foreign companies from capital gains and corporate income tax on profit from the redemption and sale of shares by Philippine affiliates/subsidiaries being liquidated. However, a 2009 ruling involving a foreign company held that such gains were subject to corporate income tax but not to capital gains tax. In another case, the BIR ruled that the gains were subject to tax on dividends. A number of transactions involving partial liquidations through shares redemption reportedly are on hold because of this unresolved issue. Tax lawyers maintain that any gains from partial or full liquidation should be exempt under the Philippines-United States Tax Treaty.

A recent BIR ruling also states that a liquidating company and its shareholders are taxable upon distribution of residual assets, but the ruling does not clarify which taxes apply to the liquidation company.

The BIR has issued rulings involving non-US investors asserting that the stock transfer tax is an ad valorem transactional tax-different from the capital gains tax-and therefore, applies on the sale of publicly-listed shares in the stock exchange. These rulings contradicted previous exemptions from the stock transfer tax by virtue of bilateral tax treaty provisions exempting foreign nationals from tax on capital gains. This interpretation could complicate the processing and resolution of similar tax treaty relief applications by US and other foreign investors.

A foreign company without a branch office that renders services to Philippine clients is considered a permanent establishment and is liable to pay Philippine taxes if its personnel stay in the country for more than 183 days for the same or a connected project in a twelve-month period. However, BIR rulings on the taxation of permanent establishments have been inconsistent on whether to treat them as resident or non-resident foreign corporations.

## **OPIC and Other Investment Insurance Programs**

The Philippine government currently does not provide guarantees against losses due to inconvertibility of currency or damage caused by war. The Overseas Private Investment Corporation (OPIC) can provide US investors with political risk insurance against risks of expropriation, inconvertibility and transfer, and political violence, pursuant to the US-Philippines Investment Incentive Agreement that enables OPIC to support investment in the country. The Philippines is a member of the Multilateral Investment Guaranty Agency.

## **Labor**

Managers of US-based companies widely report that Philippine labor is relatively low cost and motivated. In addition, the Philippine labor force possesses strong English language skills. As of October 2012, the Philippine labor force was estimated at 40.4 million, with an unemployment rate at 7%. This figure includes employment in the informal sector and does not capture the substantial underemployment in the country.

Multinational managers' report that total compensation packages tend to be comparable with those in neighboring countries. In the call center industry, the average labor cost is between US\$2.22 and US\$3.74 per hour (Source: Business Process Association of the Philippines). Regional Wage and Productivity Boards meet periodically in each of the country's 16 administrative regions to determine minimum wages, with the National Capital Board setting the national trend.

During the reporting period, the non-agricultural daily minimum wage in the National Capital Region is P446 (approximately US\$10.37), although some private sector workers receive less. Cost of living allowances are given across the board. Most other regions set their minimum wage significantly lower than Manila. The lowest minimum wage rates were in the Southern Tagalog Region, where daily agricultural wages were P199 (US\$4.59). Regional Boards may grant various exceptions to the minimum wage, depending on the type of industry and number of employees at a given firm.

Literacy in both English and Filipino is relatively high, although there have been concerns in the business and education communities that English proficiency was on the decline. The Department of Education, under its National English Proficiency Program, continues its efforts to strengthen English language training, including school-based mentoring programs for public elementary and secondary school teachers aimed at improving their English language skills.

Violation of minimum wage standards is common, especially non-payment of social security contributions, bonuses, and overtime. Philippine law provides for a comprehensive set of occupational safety and health standards, although workers do not have a legally protected right to remove themselves from dangerous work situations without risking loss of employment. The Department of Labor and Employment (DOLE) (<http://www.dole.gov.ph>) has responsibility for safety inspection, but a severe shortage of inspectors makes enforcement extremely difficult.

The Philippine Constitution enshrines the right of workers to form and join trade unions. The mainstream trade union movement recognizes that its members' welfare is tied to the productivity of the economy and competitiveness of firms; frequent plant closures have made many unions even more willing to accept productivity-based employment packages. The trend among firms of using temporary contract labor continues to grow. During the reporting period, DOLE reported one strike involving 20 workers. The DOLE Secretary has the authority to end strikes and mandate a settlement between the parties in cases involving the national interest, which can include cases where companies face strong economic or competitive pressures in their industries. In 2012, there were 135 registered labor federations and 16,647 private sector unions. The 1.38 million union members represented approximately 3.4% of the total workforce of 40.4 million. Mainstream union federations typically enjoy good working relationships with employers.

Special economic zones or ecozones often offer on-site labor centers to assist investors with recruitment. These centers coordinate with DOLE and Social Security Agency and can offer services such as mediating labor disputes. Although labor laws apply equally to ecozones, unions have noted some difficulty organizing inside them.

There have been some reports of forced labor in connection with human trafficking in the commercial sex, domestic service, agriculture, and fishing industries.

The Philippines is a signatory to all International Labor Organization (ILO) conventions on worker rights but has faced challenges enforcing them. Unions allege that companies or local officials use illegal tactics to prevent them from organizing workers. The quasi-judicial National Labor Relations Commission reviews allegations of intimidation and discrimination in connection with union activities. In September 2009, the government cooperated with a high-level ILO mission to investigate labor rights violations in the country. The ILO mission noted issues relating to violence, intimidation, threat, and harassment of trade unionists and the absence of convictions in relation to those crimes. It also observed obstacles to the effective exercise in practice of trade union rights. In response to ILO mission recommendations, the government constituted the Tripartite Industrial Peace Council (TIPC) to monitor the application of international labor standards and has proposed several legislative measures to address weaknesses in the Labor Code.

Congress passed the Kasambahay Bill in September 2012, which provides more benefits and protection to domestic workers. This legislation came on the heels of the Senate ratification of the ILO Convention on Decent Work for Domestic Workers and the Maritime Labor Convention, the "bill of rights" for almost 2.5 million household workers and 400,000 seafarers worldwide.

### **Foreign Trade Zones/Free Ports**

Enterprises enjoy preferential tax treatment when located in export processing zones, free trade zones, and certain industrial estates, collectively known as economic zones, or "ecozones." Enterprises located in ecozones are considered to be outside the

customs territory and are allowed to import capital equipment and raw material free from customs duties, taxes, and other import restrictions. Goods imported into free trade zones may be stored, repacked, mixed, or otherwise manipulated without being subject to import duties and are exempt from the GPH's Selective Pre-shipment Advance Classification Scheme. While some ecozones have been designated as both export processing zones and free trade zones, individual businesses within them are only permitted to receive incentives under a single category.

### **Philippine Economic Zone Authority (PEZA)**

There are 273 operating ecozones in PEZA, composed primarily of manufacturing, IT parks and centers, tourism, medical tourism parks and agro-industrial ecozones. Of these 273 operating ecozones, PEZA manages three government-owned export-processing zones (Mactan, Baguio, and Cavite) and administers incentives to enterprises located in the other 270 privately-owned and operated ecozones. Any person, partnership, corporation, or business organization, regardless of nationality, control and/or ownership, may register as an export, IT, tourism, medical tourism, or agro-industrial enterprise with PEZA, provided that the enterprise physically locates its activity inside any of the proclaimed ecozones. PEZA administrators have earned a reputation for maintaining a clear and predictable investment environment within the zones of their authority. As of October 2012, PEZA reported investments amounting to P137.9 billion (about US\$3.39 billion), 10.30% higher than the P125.104 billion (about US\$3.07 billion) for the same period in 2011.

Information technology parks or centers house PEZA-registered enterprises that export IT-enabled activities such as software development, multimedia graphics, animation, engineering and architectural designs, IT research and development, data encoding, transcribing, call centers, and other business process outsourcing (BPO) and knowledge process outsourcing (KPO) activities. Information technology parks or centers are not allowed to host manufacturing activities.

### **Bases Conversion Development Authority**

The ecozones located inside former US military bases are independent of PEZA and subject to the Bases Conversion and Development Authority (BCDA) (<http://www.bcda.gov.ph>). BCDA-administered zones include the Clark Freeport Zone (Angeles City, Pampanga), the John Hay Special Economic Zone (Baguio), the Poro Point Freeport Zone (La Union), and the Bataan Technology Park (Morong, Bataan). The BCDA also oversees the Subic Bay Freeport Zone (Subic Bay, Zambales).

These ecozones offer incentives comparable to those offered by PEZA. Additionally, both Clark and Subic have their own international airports, power plants, telecommunications networks, housing complexes, and tourist facilities.

### **Other Zones**

The Phividec Industrial Estate (Misamis Oriental, Mindanao) is governed by the Phividec Industrial Authority, a government-owned and controlled corporation. Incentives available to investors are comparable to those offered by PEZA and also include special

low rates for land leases. Two lesser-known ecozones are the Zamboanga City Economic Zone and Freeport (Zamboanga City, Mindanao) and the Cagayan Special Economic Zone and Freeport (Santa Ana, Cagayan Province). The incentives available to investors in these zones are very similar to PEZA incentives but are administered independently. In addition to offering export incentives, the Cagayan Economic Zone Authority is authorized by law to grant gaming licenses.

### **Foreign Direct Investment Statistics**

The Philippine SEC, BOI, National Economic and Development Authority (NEDA) (<http://www.neda.gov.ph>), and the Central Bank each generate direct investment statistics. SEC, BOI and NEDA record investment approvals. The Central Bank records actual investments based on the balance of payments methodology, readily available in US dollar terms. Central Bank data are widely used as a reasonably reliable indicator of foreign investment stock and foreign investment flows.

The figures in Table 1 below refer to foreign direct investment (FDI) stock reported by the Central Bank. Disaggregation of net FDI flows by country and by industry is presented in Tables 2 and 3, respectively. Table 4 provides a list of top foreign investors

### **Textbook:**

Good Governance & Social Responsibility, Dr. Christopher Biore, Dr. Roberto Gonzales, Prof. Jose Lemuel Caparas, Dean Nilo Burgos and Prof. Win Ballada, ASEAN (Academicians, Students, Educators and Alliance) Inc.

2024