PITO

PRIVATE INVESTMENT AND TRADE OPPORTUNITIES

ECONOMIC BRIEF
NO. 7

OPENING THE DOOR: THE PHILIPPINE FOREIGN INVESTMENTS ACT OF 1991

East-West Center

The *PITO Economic Brief* Series

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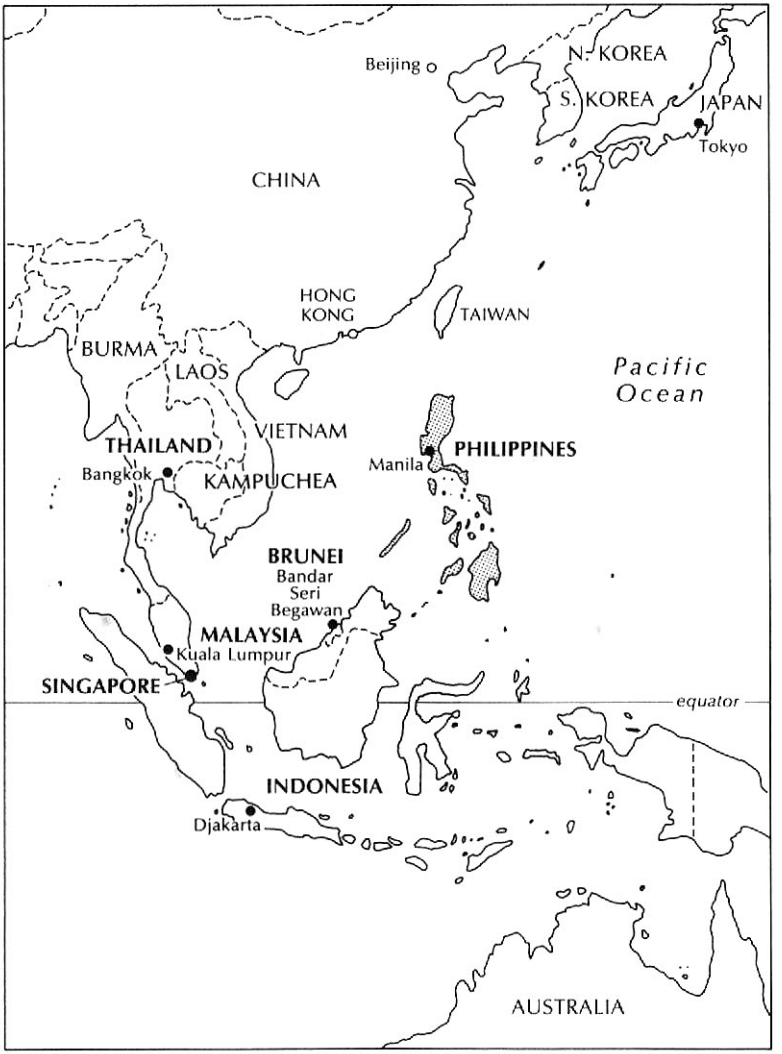
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INTRODUCTION: THE ECONOMY IN THE 1980s

The Philippine economy in the 1980s had its ups and downs—the early years were characterized by deep recession, the middle years were characterized by major stabilization efforts followed by growth, and the last two years have shown a slowdown. The mid-1980s saw probably the worst episode in Philippine postwar economic history. In 1984, triggered by a serious political crisis the previous year, the country's gross domestic product (GDP) declined by 7.6 percent, direct foreign investment plunged by 47 percent, and inflation was a high 53.8 percent (Table 1).

With the advent of the new government in 1986 and the institution of major economic reforms, the economy recovered somewhat. Economic performance after 1988, however, was disappointing. GDP growth decreased from 6.3 percent in 1988 to 5.9 percent in 1989 and declined further to 2.1 percent in 1990. The slowdown in growth was primarily due to underlying weaknesses in the economy including the debt burden and slow implementation of programs relating to infrastructure, agrarian reform, and population growth. Moreover, there was also slow progress in bringing about reforms relating to monetary, industrial,

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This paper was written by Professor Victoria S. Licuanan and Ms. Cecilia C. Carlos of the Asian Institute of Management for the Private Investment and Trade Opportunities (PITO) Project. Unless otherwise indicated, the views expressed are those of the authors and do not necessarily reflect those of the Institute.

Table 1 Major Economic Indicators: Philippines

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Unemployment rate (% of labor force)	5.3	6.0	5.4	6.2	7.1	6.7	9.5	8.3	8.6	8.8
GDP growth (%, 1985 prices)[1]	3.2	3.6	1.9	-7.6	-7.4	3.4	4.8	6.3	5.9	2.1
Gross fixed capital formation (billion pesos, 1985=100)	165.7	179.6	190.2	127.6	87.7	94.9	111.6	124.5	153.9	158.4
BOP ($ million)	(547)	(1,671)	(2,118)	243	2,301	1,242	264	650	(143)	(185
Exchange rate (pesos:$, annual average)	7.9	8.5	11.1	16.7	18.6	20.4	20.6	21.1	21.7	24.3
External debt ($ billion, end of year)	20.89	24.68	24.82	25.42	26.25	28.26	28.65	27.92	27.62	28.55
As % of GNP	58.8%	67.2%	75.9%	83.5%	87.9%	96.6%	87.4%	74.0%	65.9%	65.0
Inflation rate	11.98	8.72	14.15	53.79	17.70	3.06	7.39	10.13	8.46	13.12

Notes:
1. Preliminary estimates with 1985 as the base year.

Sources: Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries*, July 1991; Philippine Government, National Statistical Coordination Board, Economic and Social Statistics Office, unpublished mimeos, May 1991; Philippine Government, Central Bank, unpublished mimeos.

trade, and exchange rate policies. These difficulties were compounded by continuing political problems as well as a series of natural disasters in 1990 and 1991.

Reflecting the country's economic performance, the inflow of foreign investments into the Philippines has been low, especially compared with its neighboring countries. From an average of over US$300 million per year in 1981/82, the inflow of direct foreign equity investment into the Philippines declined to a low of less than US$100 million in 1987 and 1988, although it rose to an average of US$200 million in 1989 and 1990. Renewed confidence in the economy played a large part in attracting foreign investments toward the end of the decade. The availability of a debt-equity swap facility also helped to increase foreign investment. Overall, however, the record on foreign investments was disappointing. This sluggishness in foreign investment growth occurred despite the Omnibus Investments Code of 1987 which consolidated incentives embodied in separate previous laws and gave additional incentives to enterprises located in less-developed areas, holders of special investors visas, regional headquarters, and firms in the export processing zones. Despite aligning Philippine investment incentives with those of other Asian countries, investments in the Philippines by the major capital-exporting countries such as Japan was much lower than in other ASEAN countries.

As a result of the country's disappointing economic performance, poverty, unemployment, and underemployment are among the most serious problems of the Philippines. It is

estimated that more than one-half of the population is below the poverty line. An estimated 30 percent more are underemployed. Moreover, in the first quarter of 1991, 4.2 million—15.2 percent of the estimated 27.6 million work force—were unemployed.

It is estimated that until 1997, an average of 955,000 people will join the labor force each year. As a result, extreme poverty will continue to exist particularly in the countryside where there is lack of employment opportunities. These figures do not include those persons estimated at over 650,000 who were displaced by the Mt. Pinatubo eruptions in 1991.

THE FOREIGN INVESTMENTS ACT OF 1991

It was against this background of deepening unemployment that the new foreign investments act was born. After a series of meetings, the Philippine Legislature's Joint Congressional Hearings Committee on Investments Review adopted full employment (a 3 percent unemployment rate and 5 percent underemployment rate) by 1997 as the objective of investments legislation. Achieving this goal calls for the creation of 1.24 million jobs per year, which can only be done by a major increase in investments. The Foreign Investments Act of 1991 (R.A. No. 7042) was enacted to liberalize foreign investment rules in order to attract, promote, and welcome productive investments from foreign nationals in activities that significantly contribute to national industrialization and socioeconomic development.

Several factors make the new foreign investment law timely:

1. Filipino capital alone cannot finance the level of investments required for full employment if this is to be achieved within the next decade. Capital requirements are estimated to average P148 billion annually, an amount which is roughly equal to 15 percent of current GNP. The domestic capital markets have proved too thin to support infrastructure projects and industrialization, along with the requirements to support the fiscal deficit.
2. The existing laws on foreign investment did not reflect the current conditions of the Philippine economy. The last major substantial change in laws regarding foreign business in the Philippines was made in 1968. The situation in 1968 was far from the current conditions—natural resources were abundant, the economy was strong, and the population was small. The nation's per capita income was higher than that of other countries in the region. There was no pressure on the economy to provide employment. Hence, the law in 1968 was formulated in a different environment and its intent was to insure that foreigners did not exploit the nation's resources and monopolize the domestic market. The emphasis of the law in 1968 was meant to protect the Filipino businessman rather than to create jobs.

From November 1989 to February 1990, public hearings were conducted by the Executive Department and the Legislature in a Joint Congressional Investment Policy Review. Opposition to liberalizing the investment laws came only from a small segment of business.

Basic Investment Code prior to the Foreign Investments Act of 1991

Prior to the Foreign Investments Act of 1991, all investments—domestic and foreign—in the Philippines were governed by the provisions of the Omnibus Investments Code of 1987. This code specified preferred areas of investments where incentives were granted, as well as areas open for foreign investments which were not entitled to incentives. Areas for investments with incentives were identified in the Investments Priorities Plan (IPP), which was prepared annually by the Board of Investments (BOI). Incentives were also granted to enterprises operating in less-developed areas and in export processing zones.

As a rule, foreigners were allowed to have up to 40 percent of equity in most business enterprises in the Philippines without prior authority from the Board of Investments. One-hundred percent foreign ownership, however, was allowed only in: (1) enterprises in preferred "pioneer" areas as listed in the IPP subject to constitutional and/or statutory limitations, provided that within 30 years or a longer period as the BOI may determine, 60 percent of the equity of these enterprises would be owned by Filipinos; (2) enterprises operating in export processing zones; and

(3) enterprises in areas declared as nonpioneer but which export at least 70 percent of production.

Foreign investments in excess of 40 percent of the capital stock of the enterprise were allowed subject to prior authorization from BOI as contained in Book II of the Investment Code. The authorization constituted a license for these investors to do business in the Philippines. Foreign investments authorized under this book, however, were not entitled to incentives. In granting approval, BOI saw to it that: (1) the activity applied for was not inconsistent with the IPP, (2) such activity would contribute to the sound and balanced development of the economy, (3) the activity conformed with the constitution and laws of the country, (4) the business activity had not been adequately exploited by Philippine nationals, and (5) the business did not promote monopolies or combinations in restraint of trade.

Salient Provisions of the Foreign Investments Act of 1991

The Foreign Investments Act of 1991 does not provide incentives to foreign investors over and above the Omnibus Investments Code (which remains on the books). Rather, it sets the process and criteria for allowing and accepting foreign investments. It repeals Articles 44 to 56 of Book II of Executive Order No. 226 (Omnibus Investments Code of 1987) which specified the areas open for foreign investments without incentives. The new Act opens all areas of economic activity outside the Negative List to 100-percent foreign equity.

The salient provisions of the Act are the lifting of the restriction on the extent of allowable foreign equity ownership, the formulation of a Foreign Investment Negative List, and the transitory provisions.

Extent of allowable foreign equity ownership. Under the Foreign Investments Act of 1991, there are no restrictions on the extent of foreign ownership of export and domestic market enterprises except in areas included in the negative list where the maximum 40-percent equity restriction under the Omnibus Investments Code of 1987 still prevails. Furthermore, export enterprises operating in areas in List C are also open to 100-percent foreign ownership. The Act also greatly simplifies the registration procedure for the entry of new investments. Under the new law, the foreign investor has only to register with the Securities and Exchange Commission before starting to do business or invest in a domestic enterprise up to 100 percent (as long as the area of activity is outside the negative list). There is no need for the foreign investor to secure prior authority from the BOI for this.

Foreign Investment Negative List. The Foreign Investment Negative List contains the areas of economic activity reserved to Philippine nationals. The negative list identifies areas which are not open to 100-percent foreign equity. Hence, an investor from any country can easily verify from the list, whether the business he is contemplating can be wholly owned by him or is subject to the

maximum 40-percent foreign equity restriction. The list is composed of 3 component lists—A, B, and C—as follows:

List A — This list enumerates the areas of activity reserved for Philippine nationals as mandated by the Constitution and other specific laws. Areas in which foreign nationals are prohibited to operate include: (1) mass media; (2) practice of profession, e.g., doctors and lawyers; (3) small-scale utilization of natural resources; (4) retail trade, except supermarkets; and (5) pawnshops which are single proprietorships.

Also in list A are areas where, according to the Constitution and specific laws, foreign equity participation is limited to 40 percent. This includes: (1) ownership of land, (2) large-scale utilization of natural resources, (3) operation of public utilities, (4) banking and investment houses, (5) recruitment of workers, (6) shipping and air commerce, and (7) supermarkets.

List B — This list contains activities regulated by law such as defense-related activities (manufacture, repair, storage and/or distribution of firearms, ammunition and other similar items) and activities which have implications on public health and morals (manufacture and distribution of

dangerous drugs, all forms of gambling, bars, massage clinics and other similar establishments). Small and medium-sized domestic market enterprises (with paid-in capital of less than US$500,000 or its equivalent) are also reserved for Philippine nationals unless they involve the use of advanced technology. Export enterprises of similar size are also reserved for Philippine nationals if they utilize depleting natural resources as raw materials.

List C — This list contains areas where existing enterprises already adequately serve the needs of the economy and the consumers and where further foreign investments are not required.

Amendments to Lists B and C may be made upon recommendation by appropriate agencies to the National Economic Development Authority (NEDA) which in turn will endorse these recommendations to the President for approval and to be promulgated by a presidential proclamation. The first regular negative lists will be in force at the end of the transitory period. Amendments to Lists B and C will not be made more often than once every two years. Areas included in List C will remain on the list for two years without prejudice to re-inclusion upon new petition and due process.

Transitory provision safeguards. The implementing rules and regulations promulgated and issued by NEDA took effect in mid-November 1991. Following this, there is an initial transitory period of 36 months. This period gives the government time to promote the new legislation and draw up a sound list of areas where foreign investments will be limited, and allows investors time to investigate opportunities and implement investments. In addition, provisions for safeguards have been made in order to assure Filipino businessmen that the Foreign Investments Act will not displace them but will provide a competitive environment.

During the transitory period a transitory negative list will be in effect. The areas to be covered by Lists A and B of the transitory list will be the same as in the regular list. List C, on the other hand, will cover import and wholesale activities not integrated with production or manufacture of goods, services requiring a license or specific authorization, and domestic market enterprises owned in the majority by a foreign licensor and/or its affiliates producing items which are currently being produced by Philippine nationals under a technology, know-how and/or brand name license from such licensor (see Appendix A and B).

These activities are reserved to Philippine nationals only during the transitory period. All other areas outside this short list will be open to foreign equity participation of up to 100 percent. The regular List C containing "adequately served industries" will take effect only after the transitory period.

FUTURE INVESTMENT TRENDS AND OPPORTUNITIES FOR FOREIGN INVESTORS

The newly approved Foreign Investments Act of 1991 opens up previously restricted areas of the economy to foreign investors. With this opening of the doors to foreign investment and the incentives offered under the Omnibus Investment Code of 1987, it is expected that the Philippines will be better able to compete with its Asian neighbors in attracting foreign capital.

The major opportunities for profitable foreign investments in the Philippines are those for which incentives are given. These are listed in the 1991 Investment Priorities Plan. The following are the broad areas of economic activity for which incentives are available:

1. Basic industries or those which foster sustained industrialization through strong forward linkages to other sectors. Included are petrochemical complex, primary and secondary processing of ferrous metals, basic industrial chemicals, etc.
2. Resource-based industries such as mining and forest plantations. Also included in this broad category are contract-growing schemes as well as primary processing of agricultural crops, aquaculture, livestock and poultry.
3. Inputs to export industries and ancillary support industries for exports.
4. Support facilities/services to industries and projects that serve the common requirements of industries for transportation and communication facilities.

5. Tourism-oriented services.

Export projects are also automatically entitled to incentives upon registry with the BOI.

In addition to drawing up a negative list, NEDA will formulate a list of industries strategic to the development of the economy. The strategic industries list is a positive list of areas where investments are encouraged. This list will specify, as a matter of policy and not as a legal requirement, the desired equity participation by government and/or private Filipino investors in each strategic industry.

Beyond these areas, there are other opportunities for foreign investment. For example, as a result of recent events in the country, the government will be undertaking massive infrastructure repair and development which will require a huge investment. These will provide opportunities for foreign investors in construction and public utilities. To boost economic performance, the government will continue to encourage labor-intensive and/or export-oriented industries, which makes these potential investment growth areas. The government-led development of industrial estates and export processing zones are geared toward the expected influx of investments. Banking reforms have also been initiated in the direction of supporting bigger funding capacities for banks. The Department of Trade and Industry expects more investments to come in because of the stabilization measures such as reduced budgetary deficits, lower interest rates, and stable exchange rates in addition to the new legislation. Furthermore, the 9-percent import levy, which became effective January 1991 and

which was a major deterrent to investments, has recently been reduced to 5 percent. This move is expected to attract more investors.

When will the beneficial effects of the Foreign Investment Act and other incentives and policy measures be felt? Economic performance in the next two years will depend heavily on the results of the stabilization program, as well as on the extent to which the economy's structural weaknesses are addressed and effectively remedied. Much also depends on the ability of the government to channel its efforts to repair the damage to infrastructure and productive capacity brought about by the calamities which befell the country in 1990 and, more recently, the eruption of Mt. Pinatubo.

Domestic political developments as well as external events will also play important roles. The perceived lack of political stability has played a major part in the reluctance of foreign investors to come to the Philippines. And for U.S. investors in particular, the non-renewal of the contract for the U.S. bases in the Philippines adds to the uncertainty over investments. Hence, an important factor affecting foreign investments is the outcome of the presidential elections in May 1992.

This suggests it could take some time for the impact of the Foreign Investments Act to be translated into fresh investments. The country may not see substantial foreign investments over the next 18 months as investors wait for the results of the stabilization program, as well as for the next administration to be in place and to see what its policies are.

POLICY DIRECTIONS

Aside from legislation liberalizing the entry of foreign investment, there is a need to improve the general economic climate, so that it is easier and cheaper to run businesses. To complement the Foreign Investments Act of 1991, there are six additional bills which are currently at various committee levels in the Legislature. These bills are scheduled for bicameral enactment before the end of 1991.

House Bill No. 29712 calls for the establishment of regional and provincial manpower development and skills training centers to absorb foreseen technology transfer as more and more foreign investments enter the country.

House Bill No. 30520 imposes a uniform 10-percent tariff on capital equipment imports, which now ranges from 10 percent to 50 percent.

House Bill No. 30521 seeks to allow the equity of multilateral financial institutions to be classified as Filipino.

House Bill No. 30522 allows net operating loss carry-over and accelerated depreciation as deductions to taxable income.

House Bill No. 30884 seeks to expand the definition of a condominium unit to allow foreign ownership of land in industrial estates.

House Bill No. 31547 grants 50 years and another 49 years more to foreign leases of land outside industrial estates and would apply to individuals or corporations who have

effective lease arrangements within five years from the approval of the bill.

There are also legislation proposed which are aimed at deregulation of transportation and communications and the liberalization and deregulation of the banking system. The set of bills on transportation and communications are aimed at increasing efficiency of the transport and telecommunications industries. The pending bills on the deregulation and liberalization of the banking system include provisions for the opening of bank branches and offices in the countryside, a Rural Banks Act, the development of a medium- to long-term financial intermediation system, relaxing lending regulations for producers having ready markets, and abolishing gross tax receipts on banks and other financial institutions.

The implementing rules and regulations for the Foreign Investments Act are also expected to ease the entry and operations of foreign investors. Along the same lines, a further policy direction is that of reducing bureaucracy in general. Further, there is increased awareness of the importance of political stability, peace and order, and good labor relations in encouraging investments, whether foreign or domestic.

There is growing realization of the advantages that a more open investment climate can bring to the country. The role of foreign investments in bringing about industrial and agro-industrial development in neighboring ASEAN countries has not gone unnoticed. The sense of urgency brought on by the growing economic crisis, coupled with continuing reexamination of the

reasons for the country's poor economic performance and record in attracting foreign investment compared to its ASEAN neighbors, has resulted in a change in the direction of policy towards a promotional and liberalizing stance rather than a protective one.

Appendix A

Foreign Investment Negative List During the Transitory Period
(Pursuant to R.A. 7042)

LIST A: FOREIGN OWNERSHIP IS LIMITED BY MANDATE OF THE CONSTITUTION AND SPECIFIC LAWS

No Foreign Equity Allowed

1. Mass Media
2. Services involving the practice of licensed professionals
3. Retail trade
4. Cooperatives
5. Private security agencies
6. Small-scale mining
7. Engaging in the rice and corn industry except as authorized by the National Food Authority (NFA)

Up to Twenty-Five Percent Foreign Equity

8. Private recruitment, whether for local or overseas employment

Up to Thirty-Percent Foreign Equity

9. Advertising

Up to Forty-Percent Foreign Equity

10. Exploration, development and utilization of natural resources (Note: Full foreign participation is allowed through a financial or technical assistance agreement with the President)

11. Ownership of private lands

12. Operation and management of public utilities

13. Ownership/establishment of educational institutions requiring authorization from the Department of Education, Culture and Sports (DECS)

14. Financing companies regulated by the Securities and Exchange Commission

Varying Foreign Equity Limitation

15. Construction (See Annex for detailed listing)

LIST B: FOREIGN OWNERSHIP IS LIMITED FOR REASONS OF SECURITY, DEFENSE, RISK TO HEALTH AND MORALS, AND PROTECTION OF LOCAL SMALL AND MEDIUM-SCALE ENTERPRISES

Up to Forty-Percent Foreign Equity

1. Manufacture, repair, storage, and/or distribution of firearms, ammunition, lethal weapons, military ordnance, explosives, pyrotechnics, and parts, peripherals and ingredients used in the manufacture thereof

2. Manufacture and distribution of dangerous drugs

3. Sauna and steam bathhouses, massage clinics and other like activities regulated by law because of risks they may impose to public health and morals

4. Other forms of gambling, e.g., race track operation, race-horse ownership/importation

5. Domestic market enterprises with paid-in equity capital of less than the equivalent of US$500,000 unless they involve advanced technology

6. Export enterprises which utilize raw materials from depleting natural resources, and with paid-in equity capital of less than the equivalent of US$500,000

LIST C: OTHER AREAS COVERED BY R.A. 7042 AND OTHER LEGISLATIONS, ADMINISTRATIVE REGULATIONS AND PRACTICES

No Foreign Equity Allowed

1. Ownership, operation and management of cockpit and cockfighting activities

Up to Forty-Percent Foreign Equity

2. Import and wholesale activities not integrated with production or manufacture of goods

3. Services requiring a license or specific authorization, and subject to continuing regulation by national government agencies other than the BOI and SEC which at the time of the effectivity of R.A. 7042 are restricted to Philippine nationals by existing administrative regulations and practice of regulatory agencies concerned, e.g., travel agencies, tourist lodging services (pension houses and tourists inns), and convention and conference organizers, life and nonlife

insurance agencies including professional reinsurance services and insurance brokerage

4. Enterprises owned in the majority by a foreign licensor and/or its affiliates for the assembly, processing or manufacture of goods for the domestic market which are produced by a Philippine national as of the date of effectivity of R.A. 7042 under a technology, know-how and/or brand name license from such licensor during the term of the license agreement

NOTE: THIS LIST DOES NOT INCLUDE BANKING AND OTHER FINANCIAL INSTITUTIONS AS THEY ARE GOVERNED AND REGULATED BY THE GENERAL BANKING ACT AND OTHER LAWS UNDER THE SUPERVISION OF THE CENTRAL BANK OF THE PHILIPPINES.

Appendix B

Annex to the Foreign Investment Negative List
During the Transitory Period

	Activity	Foreign Equity Limitation
1.	Licensed professions covered under List A.2	0%
	a. Engineering	
	b. Medical and Allied Professions	
	c. Accountancy	
	d. Architecture	
	e. Criminology	
	f. Chemistry	
	g. Customs Broker	
	h. Forestry	
	i. Geology	
	j. Marine Deck Officer	
	k. Marine Engine Officer	
	l. Master Plumbing	
	m. Sugar Technology	
	n. Social Work	
	o. Librarian	
	p. Law	
2.	Activities covered under List A.15	
	a. Contracts for the construction and repair of locally-funded public works	25%
	b. Contracts for the supply of materials materials, goods and commodities to government-owned or controlled corporation, company, agency or municipal corporation	40%

c.	Private domestic and overseas construction contracts	40%
d.	Contracts for the construction of defense-related structures (e.g., land, air, sea and coastal defenses, arsenal barracks, depots, hangars, landing fields, quarters, hospitals)	40%
e.	Construction of public utilities	40%

3. Investment areas/activities under List B.1 requiring clearance from the Philippine National Police (PNP)

   a. Firearms (handguns to shotguns); parts of firearms and ammunition thereof; instruments or implements used or intended to be used in the manufacture of firearms

   b. Gunpowder

   c. Dynamite

   d. Blasting supplies

   e. Ingredients used in making explosives:

Potassium Chlorate	Sodium Perchlorate
Ammonium Nitrate	Barium Nitrate
Potassium Nitrate	Copper (11) Nitrate
Sodium Nitrate	Lead (11) Nitrate
Sodium Chlorate	Amorphous Phosphorus
Nitric Acid	Hydrogen Peroxide
Nitrocellulose	Calcium Nitrate
Ammonium Perchlorate	Strontium Nitrate Powder
Dinitrocellulose	Toluence
Glycerol	Cupric Nitrate
Potassium Perchlorate	

f. Telescopic sights, sniperscope and other similar devices

4. Investment areas/activities under List B.1 requiring clearance from the Department of National Defense (DND)

a. Guns and ammunition for warfare

b. Nuclear weapons and ordnance

c. Military ordnance and parts thereof (e.g., torpedoes, mines, depthcharges, bombs, grenades, missiles)

d. Gunnery, bombing, and fire control systems and components

e. Guided missiles/missile systems and components

f. Tactical aircraft (fixed and rotary-winged), components and parts thereof

g. Space vehicles and components systems

h. Combat vessels (air, land, naval) and auxiliaries

i. Weapons repair and maintenance equipment

j. Military communications equipment

k. Night vision equipment

l. Stimulated coherent radiation devices, components and accessories

m. Biological warfare components

n. Armament training devices

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