Philequity Corner (February 20, 2017)
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Tax Reform – The Next Big Catalyst

Last February 4, we held our investor briefing at the Meralco Theater. We presented our market outlook and discussed the ongoing reflation of the global economy. The second part of our briefing was allotted for the presentation of the government's tax reform program. This was presented by Mr. Joey Salceda, Congressman for the 2nd district of Albay.

We invited Cong. Joey to be our guest speaker because of his background in investments and his extensive experience in government. Before he joined the government, Cong. Joey was a well-respected research analyst for the biggest stock brokerage firms in the country. He was awarded multiple times as best analyst and best economist by reputable investment publications. Cong. Joey talks and thinks like a research analyst and a stock trader, which thus allow him to explain the tax reform program from the perspective of an investor. On top of these, Cong. Joey currently holds the Senior Vice Chairman / Vice Chairman positions for various House committees such as Appropriations, Ways and Means and Economic Affairs.

The importance of fiscal reform

During his presentation, Cong. Joey said that the implementation of eVAT in 2005 saved the country from a fiscal crisis and a potential default. We share Cong. Joey's conviction that the passage of eVAT became one of the most important catalysts behind the secular bull market in Philippine stocks.

This time around, moves to institute fiscal reform are not meant to avert a fiscal crisis. The current tax reform package, which was crafted by our economic managers headed by Finance Secretary Sonny Dominguez, is an integral part of the Duterte administration's 10-point economic agenda. It will allow the government to hike spending on infrastructure and social services while exercising fiscal responsibility. Consequently, these are expected to result in stronger and more inclusive economic growth. We thus believe that the successful passage of the tax reform measures will be a major catalyst for the next leg of the secular bull market.

Fiscal reform in 2005

Although it was a widely unpopular measure then, we at Philequity threw our full support behind the eVAT initiative. Below, we enumerate the various Philequity Corner articles that we wrote in 2005 to stress the importance of the eVAT implementation to our economy and stock market.

- *It's all or nothing for the 12% VAT* – April 25, 2005
- *An urgent appeal to Congress* – May 2, 2005
- *Laying the groundwork with a credible VAT bill* – May 9, 2005
- *Getting our act together after taking the bitter pill of fiscal reforms* – May 23, 2005
- *Philippines – Re-rating story unfolds* – June 6, 2005
- *Right man for the right job* – July 18, 2005
- *Philippine peso – the strongest currency in Asia* – October 24, 2005

Bitter pill for the 'Sick Man'

In our book "Opportunity of a Lifetime", we devoted an entire chapter to discuss the importance of fiscal reform (Chapter 5 – Fiscal Reform in the Philippines). In that chapter, we discussed the fiscal crisis that the country went through after the 1997 Asian financial crisis. A vicious cycle was at play due to the feedback loop caused by higher interest rates, a weakening peso and a growing debt burden. This was accompanied by declining government revenues and a widening budget deficit. For the longest time, the Philippines was referred to as the "Sick Man of Asia." Fortunately, the government under ex-President Gloria Arroyo recognized the problem and acted decisively to arrest the fiscal crisis and avert a possible default.

Turning point for the stock market, the peso and the country

The implementation of eVAT marked a turning point for our economy, the Philippine peso and the stock market. Since the implementation of eVAT, our country's government debt-to-GDP ratio improved from 74% in 2004 to the current level of 42%. Moreover, it became the major catalyst for the bottoming-out of the peso, which we called in 2005 (*Philippine peso – the strongest currency in Asia*, October 24, 2005). Lastly, the eVAT measure laid the groundwork for the secular bull market in Philippine stocks. The PSEi is up 270% return since the implementation of eVAT in 2005.

Tax reform – integral part of the Duterte economic agenda

Tax reform is one of the salient features of the Duterte administration's economic agenda. The initiative is spearheaded by the Department of Finance under the leadership of Secretary Dominguez. On top of raising funds for the government's infrastructure program, the tax reform package aims to promote strong and inclusive growth mainly through the lowering of personal income taxes. Finance Undersecretary Karl Kendrick Chua is currently doing the rounds and is making presentations to various organizations to explain the tax reform program. Below, we summarize the key components of the tax reform package.

1. **Lower personal income taxes (PIT).** Our personal tax rates are the highest in the region. Moreover, our tax brackets are currently not indexed to inflation, thus making our taxpayers prone to income bracket creep. The tax reform initiative seeks to make our PIT system more competitive by lowering taxes for everyone except for high income earners. The proposed tax structure will be unfavorable only for taxpayers with annual income of P13m or more.
2. **Higher excise taxes on fuel.** Compared to other countries, the Philippines has one of the lowest taxes on fuel. Moreover, we have zero tax on diesel. Lastly, fuel taxes have not increased since 1997 since they are not indexed to inflation. The government should therefore have enough leeway to increase excise taxes on fuel since inflation is benign and oil prices are relatively low.
3. **Higher excise taxes on automobile sales.** Increasing taxes on automobiles is a progressive form of taxation, as the higher taxes will be shouldered by those who will purchase vehicles. Moreover, the tax measures propose to levy higher tax rates on purchases of expensive or luxury cars.
4. **Limit VAT exemptions.** The tax reform package seeks to simplify the VAT regime by limiting the number of VAT-exempt transactions, which has led to many leakages. The country currently has 59 lines of VAT exemptions, compared to 37 for Indonesia, 35 for Thailand and only 14 for Malaysia.

Perking up the economy

The tax reform package involves shifting the burden of taxation from the poor to the rich. This is expected to result in faster economic activity, as the incremental benefits to citizens from lower income segments are expected to outweigh the added costs to the rich. Under the proposal, these measures will be implemented on a staggered basis up to 2019 in order to manage the impact on inflation and prevent any shocks on domestic consumption.

Next level of economic growth

As seen in our country's experience with the eVAT implementation in 2005, tax reform may be bitter pill to swallow but it can make the whole body become better. The current tax reform package will unlock the country's potential and propel the economy to next level of growth. It will allow the government to upgrade the state of our infrastructure and provide better social services while also making economic growth faster and more inclusive. This is the reason why the Duterte Cabinet, led by Finance Secretary Sonny Dominguez, are strongly batting for the passage of the tax reform package. This initiative is a crucial cog of the Duterte administration's 10-point economic agenda, as it will help the government achieve the following national goals:

- GDP growth at 9% by 2019 assuming 2.5% global GDP growth
- Reduce poverty incidence to 15% by 2022 from current 21.6%
- GNI per capita of $12,000 from the current $3,500
- Maintain fiscal responsibility – cap budget deficit at 3% of GDP

We share the government's enthusiasm about the implementation of the tax reform package and its plans to hike infrastructure spending. If these initiatives are implemented promptly and properly, we believe that these can give rise to the next leg of the secular bull market in Philippine stocks.