Philequity Corner (August 21, 2017)
By Wilson Sy

TRAIN for 'Build, build, build'

Philequity held its investor briefing last Saturday at the Meralco Theater. We presented our market outlook and discussed the catalysts that will support the PSEI's breakout past 8,000. The second part of our briefing was alloted for a presentation on the government's tax reform program. We included the tax reform package in our briefing because we wanted to highlight the importance of this initiative in catapulting the next leg of our country's economic growth. We also wanted to emphasize why tax reform is crucial for the continuation of the secular bull market in Philippine stocks.

The presentation on tax reform was made by Mr. Karl Kendrick Chua, Undersecretary for the Department of Finance. We invited USec Karl to be our guest speaker since he is the workhorse behind the government's tax reform program. His prior experience as a senior country economist for the World Bank has given him a good understanding of how our economy works and how our tax regime compares with regional peers. As such, he is able to explain how the proposed tax reform package will result in a breakout for our economy. Below, we recap the key takeaways from our briefing and share the pertinent questions that were answered during USec Karl's presentation.

1. What is TRAIN?

Tax Reform for Acceleration and Inclusion (TRAIN) is a major component of the Duterte administration's 10-point economic agenda. Spearheaded by Finance Secretary Sonny Dominguez, the program aims to reform the country's tax regime to make it more updated, efficient, equitable and progressive. The measure aims to raise additional revenues that will be used to fund the government's massive infrastructure program (TRAIN for 'Build, build build'). Ultimately, tax reform is envisioned to support our goal of becoming a high-income nation by 2040.

2. Why does the government need to raise taxes if the country is not experiencing a crisis?

The implementation of expanded VAT (eVAT) in 2005 is one of the major reform initiatives that benefitted our economy. The measure was implemented to arrest a widening shortfall in government revenues and avert a full-blown fiscal crisis or a potential default. Its passage has resulted in a stronger fiscal position for the government, thereby supporting our country's stronger economic growth.

USec Karl explained that the Duterte government's tax reform package aims to add to the momentum that was built on sound fiscal policies of past administrations. But instead of averting a crisis, the current tax initiative is designed to promote faster and more inclusive economic growth by supporting the upgrade of our country's infrastructure network. Moreover, funds raised from tax reform will be used to increase the budget for basic services such as education and health care.

3. What are the key components of the tax reform program?

The current tax reform bill, which is up for Senate deliberation, is the first of five tax reform packages that the Duterte government plans to implement. The first package proposes to reduce personal income taxes and index the tax brackets to inflation. This will be compensated by higher excise taxes on oil, automobiles and sugary beverages, as well as the simplification of the VAT system to minimize leakages.

4. How will the general public and the poor benefit from tax reform?

The tax reform program will stimulate economic activity by increasing disposable income through lower personal income taxes. The increase in household income, especially those in the lower income segments, may be used for additional spending, savings or investments.

This will be complemented by an upgrade of our country's infrastructure network, which aims to address urban congestion and improve access in rural areas. Doing these will address bottlenecks in our economy and allow Filipinos in the countryside to better participate in economic activities.

The passage of the TRAIN initiative and the accompanying 'Build, build, build' infrastructure program are expected to unlock our economy's potential and lead to breakout GDP growth rates of 7% or more. Along with better facilities for education and basic services, these will result in faster job creation and better opportunities for the poor. These initiatives will therefore be instrumental in alleviating poverty and promoting faster and more inclusive economic growth.

5. How will the passage of tax reform affect our country's credit standing?

Tax reform will ensure that fiscal responsibility is maintained even as the government undertakes a massive infrastructure upgrade and increases spending for basic services. As we explained in our presentation and as USec Karl pointed out, investors and credit rating agencies reward countries which implement structural reforms and exercise fiscal responsibility. This is why our stock market enjoyed a positive rerating after fiscal reforms were passed by the Arroyo and Aquino administrations. Based on our country's experiences with fiscal reform, the passage of tax reform will result in an improvement in our country's credit standing, which should manifest in lower borrowing rates for the government.

6. What will happen if the tax reform package is diluted or not passed?

In one of his previous interviews, Secretary Sonny said that failure to pass the tax reform package will mean significantly less funding for the government's 'Build, build, build' program. Under this scenario, the infrastructure program will have to be scaled down while some projects are eliminated from the plans. In addition, the government will have less money to spend for basic services and less budget to address national problems such as lack of education, poverty and malnutrition.

Failure to pass the tax reform package or a significant dilution from Finance department's proposed version will deprive our economy of an important growth catalyst. There will be no acceleration in our country's economic momentum while inclusive growth will be much harder to attain. Moreover, we may experience credit rating downgrades if our budget deficit continues to widen as economic growth stalls.

7. The peso touched 51.50 last week. How will tax reform affect the peso?

Starting late last year, the peso has experienced sustained weakness mainly due to our country's current account deficit and our narrowing yield differential vs. developed countries. This was exacerbated by rising geopolitical tensions, which caused the peso to touch 51.50 last week. In this light, we expect the passage of tax reform to provide the peso some respite and counter its recent weakness. This may lead to a recovery in our currency, which may cause the peso to go back to the support level of 50.

8. What is the effect of TRAIN on the stock market?

In our article last week (*Breaking out is hard to do*, August 14, 2017), we explained that the PSEi has failed to stage a convincing breakout above 8,000 and its all-time high of 8,137. We explained in our presentation that the passage of tax reform is one of the main catalysts that may support a decisive breakout of the PSEi. The tax reform package is well-studied by many credit rating agencies, economists and research analysts. It enjoys wide support from many in the business and investment community. The consensus shares the view that the implementation of tax reform will unlock bottlenecks and result in stronger economic growth. Thus, we believe that the passage of tax reform will support the next leg of the secular bull market in Philippine stocks and propel the PSEi to a new all-time high.

Thank you, USec Karl Kendrick Chua!

In our briefing, we presented USec Karl with a plaque of appreciation for his role in pushing for important structural reforms that will strengthen our country. We fully support USec Karl and Secretary Sonny in their efforts to implement structural reforms that will drive stronger and more inclusive economic growth. From what we have seen in our history and in the examples of other countries, these reforms can positively transform our economy, uplift the lives of most Filipinos and lead to a long-term bull market in Philippine stocks.

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