First Senate Hearing on
Package 2 of the Comprehensive Tax Reform Program
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OPENING STATEMENT

Karl Kendrick Chua
Undersecretary of Finance

(Pleasantries)

Introduction

I would like to begin by thanking the Senate for being open to a continued partnership in making our tax system simpler, fairer, and more efficient. Through our shared efforts, the type of tax system we have today will determine the type of country and economy we will have in the future.

In his third State of the Nation Address, President Duterte emphasized the urgency of passing a comprehensive tax reform program of five packages. The House of Representatives responded by quickly passing Package 2 and is currently hearing the other packages. We look forward to working with the Senate to hear and debate this important reform, which is already 23 years in the making, since it was first proposed in 1995.

Package 2, or the corporate income tax and incentives reform, follows the same principle of TRAIN. In Package 1, we lowered personal income taxes while broadening the consumption tax base. In Package 2, we propose to lower the corporate income tax rate, while broadening the tax base through more prudent grant of tax incentives and improved compliance.

The passage of TRAIN, and hopefully Package 2, continues the process of fiscal consolidation that won us a succession of credit rating upgrades. With tax reform, we have shown the world that we are a responsible country that can pay our bills and provide a better future for all our people, and not just a few.

TRAIN and inflation

In recent months, TRAIN has been unfairly blamed for the elevated inflation rate we are currently experiencing. Estimates show that TRAIN contributes only 0.4 to 0.7 percentage points to the 6.4 percent inflation in August. That means that for every 100 pesos in additional spending, TRAIN only accounts for 6 to 9 pesos.

This is hard to believe if we do not face the facts. For instance, of the 12-peso per liter increase in diesel price, only 2.8 pesos is due to the excise tax, or some 25 percent. The bigger part or 75 percent is due to the rapid increase in the price of imported fuel—a situation that defied the forecasts of all institutions. [This means that for every 100 pesos in additional spending, higher imported oil price accounts for 18 to 27 pesos, as opposed to 6 to 9 pesos for TRAIN.] Thus, we should not conclude that TRAIN alone caused the higher inflation.

Moreover, we encountered major shortages in rice, vegetables, fish, meat, and sugar, some attributable to supply mismanagement. These food items contributed 2.4 percentage points to August inflation or some 38 pesos for every 100 pesos in additional spending in August.

Furthermore, among TRAIN's largest relative price impacts are excise taxes on tobacco and sweetened beverages. For these products, the tax rate is intentionally punitive to improve the health of Filipinos. On tobacco, 80 percent of the increase in cigarette prices is not due to TRAIN but better tax compliance. In other words, inflation would be lower if rampant tax evasion continued.

Finally, robust domestic demand, driven by some 33 billion pesos monthly that we return to the people, such as the lower personal income tax, is contributing to inflation in the short-term given supply constraints.

So why are we saying all these? We believe it is important to emphasize correct attribution of causes because we are interested in effective solutions, and we cannot find these solutions if we look in the wrong places. We also need to understand the issue of inflation better lest it cloud our judgement of the merits of Package 2.

To cushion the impact of food inflation, Administrative Order 13 was issued on September 21, 2018 to remove non-tariff barriers and streamline administrative procedures on the importation of agricultural products. We also eagerly await the passage of the rice tariffication bill that is now in the Senate plenary to help bring down rice prices.

The measures in agriculture are in addition to the Unconditional Cash Transfer and *Pantawid Pasada* programs, which are funded by TRAIN to address TRAIN-induced inflation. In 2019, further targeted subsidies are proposed to help the poor cope with elevated prices. Over the medium-term, improved infrastructure and social services will boost productivity and real income, and not reliance on more incentives, subsidies, exemptions, and freebies.

Package 2

Concerns around inflation are understandably affecting the public's appreciation of Package 2. Another concern is the fear of investment and job losses, as well as business uncertainties. Some are valid concerns but others have little basis or are politicized. Please allow me to objectively explain the merits of the proposed reform.

Contrary to what some may think, Package 2 is pro-investment and pro-incentive. The main difference going forward is that the grant of incentives will be fairer and more accountable.

The first incentive that we will give is lower corporate income taxes for all, especially to the hundreds of thousands of micro, small, and medium corporates. But we will do this gradually and prudently so that we can fund our current priorities that these firms also need, such as infrastructure and a skilled and healthy workforce.

The approved House bill calls for reducing the corporate income tax rate from 30 to 20 percent over 10 years. With lower tax rates, such a proposal is hardly inflationary while creating millions of jobs as firms expand with more money at their disposal.

Moreover, we will continue to support priority activities with tax incentives that are performance-based, targeted, timebound, and transparent. These analogies and illustrations might help to understand these principles better.

First, when we receive a scholarship to study, it is given not forever and not without conditions. We must pass the course and get a good grade. If we don't then we lose the scholarship. This is what performance-based means. We propose that firms that enjoy incentives must be bound by a contract on job creation or export targets, for instance.

Second, although we want to help as many sectors as possible—and this is what we currently do with some 336 special laws that grant incentives—we cannot and should not because we cannot afford to give incentives left and right without a commensurate increase in the tax base. Not to mention that this is a chaos of priorities that demands harmony. That is why we have to choose which sectors really matter for the future. This is what targeted means. We propose that all sectors that satisfy the criteria set forth in the Strategic Investment Priority Plan or SIPP be granted competitive incentives.

Third, when we give allowance to our children, it ends when they become adults. We do not give allowances when they have aged and earning their own money. This is what time bound means. We propose that all approved projects be given incentives for 5 to 7 years and after this period they are free to apply again if they innovate. When we give incentives so generously and without limits, this practice erodes both accountability and performance.

Fourth, when we give an incentive to one group, another group pays for it in the form of higher taxes. The one that shoulders the incentives has the right to know who is benefiting from his hard-earned money. This is what transparent means. We propose that the names of firms receiving incentives be made public, including the amount of their incentives and their contributions to society.

The first important step towards a fairer and more accountable tax incentives system was taken by the previous Congress and Administration when they enacted the Tax Incentives Management and Transparency Act (TIMTA) in 2015, which allowed us to verify the scale of the problem. In 2015 alone, we gave away a total of 301 billion pesos-worth of incentives. The preliminary 2016 figure shows a 71 percent increase in income and customs duties incentives alone (from 104.4 to 178.6 billion pesos).

To complement the TIMTA reform, we propose to strengthen further the policy environment surrounding the grant of incentives by:

1. Improving governance through an amended TIMTA law and an expanded Fiscal Incentives Review Board or FIRB to ensure more transparency and accountability in the grant of tax incentives.

2. Harmonizing the incentives regime so that we only have one basis for granting incentives through the SIPP based on a rigorous evaluation process that conforms to national priorities. For this to happen, we need to first repeal all 136 special laws on investment incentives and consolidate the valid ones in the SIPP.

3. Enhancing the competitiveness of our tax incentives package to include a combination of income tax exemptions, reduced net income tax rate, and several additional deductions, such as those on labor, training, R&D, infrastructure, and domestic content, so that we can directly incentivize job creation, purchase of local parts, and investment in long-term infrastructure.

Cost benefit analysis

Tax incentives are a social investment. This means that every peso given up as an incentive must benefit society in the form of better jobs, faster innovation, and countryside development. Some of the incentives granted, however, were entirely unnecessary given the inherent attractiveness of our market size, our natural and human capital advantages, and our freshly gained competitiveness.

Our cost benefit analysis shows that around half of registered enterprises deserved the incentives they received, while others did not as they would be profitable anyway even without the incentives, as evidenced by the large dividends paid out to shareholders.

It is important to note that incentives are not the only factor that drive investments. President Duterte's policy to attract foreign investments, which he spelled out in a speech before Singaporean investors is to first, provide a safe place for businesses by maintaining peace and order, second, wipe out corruption, and third, eliminate red-tape in the bureaucracy, to which the recently enacted Ease of Doing Business Law is a welcome development.

Abuse of the tax incentives system

While the debates around Package 2 have largely centered around incentives, one dire consequence of our present incentive regime is the possible rampant abuse of transfer pricing and spread of harmful tax practices.

The Harvard Kennedy School course on Comparative Tax Policy and Administration lists the top 10 abuses of tax incentive regimes as follows (of which the first 4 are common in the Philippines):

1. Export zones – leakages into domestic economy.
2. Regional investment incentives and enterprise zones – diverting activities to outside the region or zone.
3. Transfer pricing schemes with related entities (through sales, services, loans, royalties, and management contracts).
4. Disguising or burying non-qualifying activities into qualifying activities.
5. Domestic firms restructure as foreign investors.
6. Existing firms transform into new entities to qualify for incentives.
7. Churning or fictitious investments (lack of recapture rules).
8. Schemes to accelerate income (or defer deductions) at the end of a tax holiday period.
9. Overvaluation of assets for depreciation, tax credit, or other purposes.
10. Employment and training credits – fictitious employees and phony training programs.

Some of these abuses we can control or enforce better, but no amount of enforcement will be adequate if our current system is prone to these abuses. These abuses are estimated to cost the government some 43 billion pesos in 2015 alone, on top of the 301 billion pesos in tax incentives that we grant, or a total of 344 billion pesos.

Conclusion

We recognize the value of incentives as a key component of a country's policy toolkit. We assert, however, that incentives should not be given indiscriminately at the expense of building up our more powerful attractions: first, a skilled and hardworking talent pool that needs sufficient human capital investments, second, an ambitious infrastructure development program that requires fiscal commitment, and third, a sizeable small and medium enterprise community that deserves to be treated fairly.

Far from the claim that we are killing the goose that lays the golden egg, we want to reform our current tax system so that the fattened goose may share its food with everyone else.

We look forward to an objective discussion of the proposed reform.

Thank you.