

Emerging Insight

Philippines – Tax cuts may have to wait

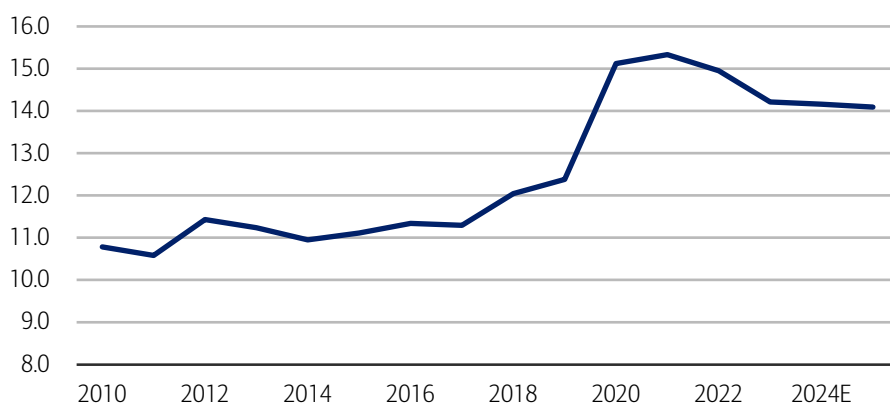
Key takeaways

- Tax cuts on passive income meant to deepen financial markets may have to wait until 2028 due to current lack of fiscal space.
- 2028 goals: 50% debt-to-GDP and 3% deficit to GDP. These imply fiscal spending restraint, and may blunt GDP growth.
- Consumption, sporadic investment spending would be the key drivers of our below-consensus 2024/25E GDP estimate of 5.4/5.5%.

By Jojo Gonzales

Exhibit 1: Government spending as a percentage of GDP

Gently declining



Source: CEIC data, PEP estimates

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Philippines in Focus

Government spending lagged in 2023 and may do so again in 2024E, which is among the factors underpinning our below-consensus 2024/25E GDP growth expectation of 5.4/5.5%. The government now proposes to defer tax reform on passive income to 2028, which may have helped deepen debt and capital markets near term. There is less fiscal space in 2024 than there was pre-pandemic, when these tax cuts were first proposed. Remarkably, government revenue growth has been healthy despite no new taxes, which places the fiscal deficit on track toward its 2028 deficit-to-GDP goal of 3%.

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Glossary

GDP – Gross domestic product

Financial reform timetable reflects limited fiscal space

In Jan-2024, the president revamped the economic section of the cabinet, which included appointing a new secretary at the Department of Finance (DoF). The DoF has since proposed to the Senate to adjust the timing of implementation of Package 4 of the Comprehensive Tax Reform Program (CTRP), which was earlier approved in the House of Representatives and aims to reduce taxes on passive income and financial transactions. These include, among others:

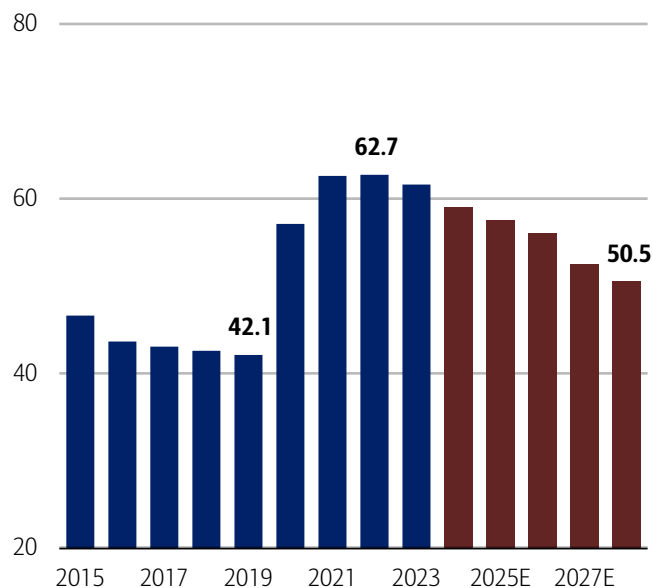
- The proposed reduction in withholding taxes from 20% to 15% will take place in 2028;
- Taxes on dividends, which currently varies depending on nationality of recipient will be maintained and harmonized at 10% in 2028;
- The reduction in stock transaction taxes (for publicly listed shares) will be reduced from 0.6% to 0.1% in 2028;
- Taxes on financial transactions, sales agreements, transfer of unlisted shares or certificates of stock will be maintained until 2027, and removed in 2028.

The DoF reasons that when these reforms were first proposed (pre-pandemic), the government had fiscal space to accommodate the revenue loss. However, the debt-to-GDP ratio has since increased from 42% in 2019 to nearly 63% in 2023. The proposed tax cuts on passive income and financial transactions would have eroded government revenue further.

Meanwhile, the government does not appear to be proposing much by way of new taxes but they are (1) updating real property valuations to help national and local governments to increase property tax collections; (2) imposing taxes on digital transactions; and (3) reforming the pension scheme for military and uniformed personnel. Items 1 & 2 mildly improve revenue while # 3 reduces government budgetary contributions. Instead, the government is pursuing intensified tax collection rather than new taxes, in keeping with the president's 2022 campaign promise.

Exhibit 2: Government debt-to-GDP (in %)

42% pre-pandemic, peaked in 2022, aimed to ease to 50% by 2028E

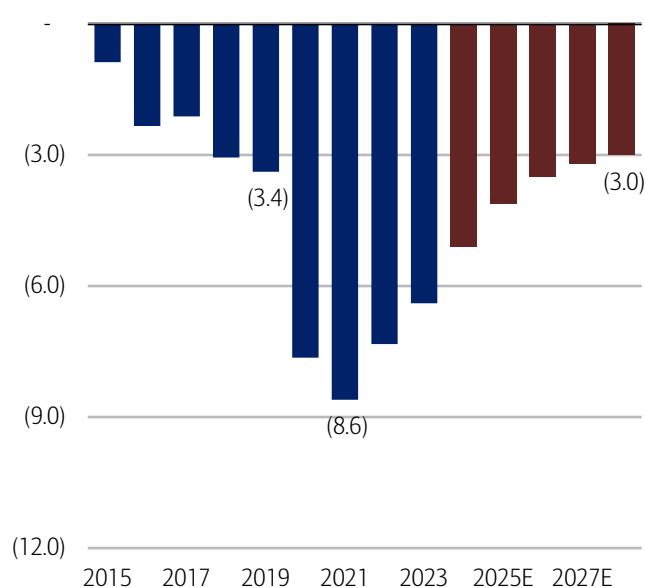


Source: CEIC data, Department of Finance (DoF) targets, estimates

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Exhibit 3: Government deficit-to-GDP

Spiked in 2021 and seen to gradually subside to 3% by 2028E



Source: CEIC data, DoF estimates

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If any comfort, the government appears to be able to fund its deficit easily with a mix of domestic and foreign borrowing. At end-2023, roughly 32% of government debt was foreign, down from 37% in 2016. In the last three years (2021-23E) less than one-fifth of net borrowing was foreign, suggesting that domestic money market conditions are liquid enough to accommodate government financing. Indeed, the government in late February sold a record Php585bn (US\$10.5bn) of 5-year Retail Treasury Bonds (RTBs) at a coupon of 6.25%. The Treasury had also indicated plans for a global US\$-denominated bond issue possibly within 1Q24.

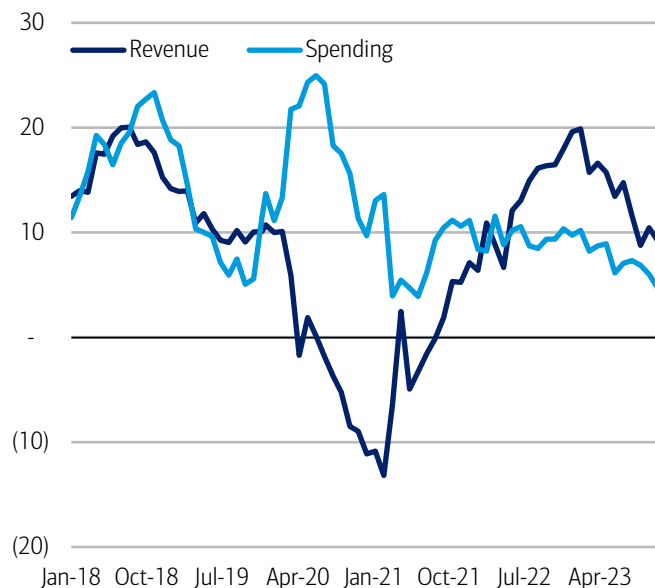
Government may not be a GDP growth driver

Given the lack of fiscal space, we see government spending lagging overall GDP growth in 2024, as in 2023. Recall that mid-way in 2023, lack of government spending growth was singled out as a key factor that caused GDP growth to underwhelm (2Q GDP grew 4.3% as government spending fell 7%). While we saw a brief pick-up in government spending in 3Q23, it was not sustained given the constraints imposed by the 2023 budget. While the 2024 budget implies slightly improved spending growth, it is seen to lag nominal GDP growth. Moderate spending growth may persist until 2025.

With only private consumption and sporadic investment spending seen as GDP growth drivers in the near term, our GDP growth forecast for 2024/25E is 5.4/5.5% and below the 6.5-7.5% growth expectation embedded in the 5-year fiscal program assembled by the Development Budget Coordination Committee (DBCC). Critical to our expectation of sustained private consumption growth would be receding inflation, reduced unemployment and underemployment, and further adjustments in minimum wages in 2024. Private investment may be driven more by easing interest rates, inventory replenishment and, in the case of the property sector – project completion. The government is continuing infrastructure projects begun by the previous administration, but new large-scale infrastructure projects are being offered through private-public-partnerships starting with the Php170bn (US\$3bn) 15-year operations and maintenance agreement for the Manila International Airport, awarded in Feb-2024.

Exhibit 4: Spending grew 4% in the first 11 months of 2023

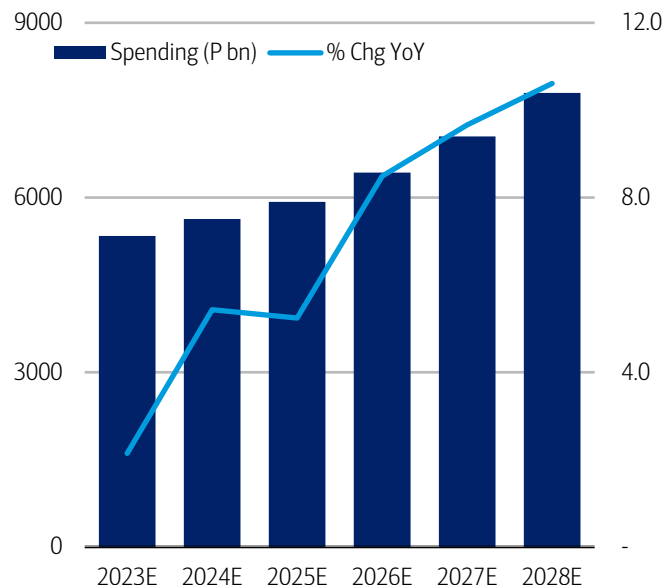
Revenue grew 9% to help reduce the fiscal deficit



Source: CEIC data, PEP estimates. Data is shown in 3-month moving average growth rates
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Exhibit 5: Planned government spending growth

Low single-digit growth in 2023-25E, gently accelerating in 2026-28E



Source: CEIC data, PEP estimates

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