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Assessing the Potential Impacts of Reducing Philippine Corporate Income Tax and Reforming Sectoral Incentives on Poverty and Employment

Abstract

This paper aims to analyze the potential economic effects of a corporate income tax reform (CITIRA). To re-align the country's corporate tax to ASEAN countries, the tax reform package reduces the rate from 30% in 2019 to 20% in 2029. To finance the reduction, corporate incentives are also reduced during the period. The paper analyzes the macroeconomic, employment, poverty, and income distribution effects of the tax reform. Among the several scenarios simulated in the paper, the tax reform that is growth-promoting, employment-generating, and poverty-reducing involves a gradual reduction in corporate tax, a gradual reduction in corporate incentives, and reinvestment of higher corporate profit. All are other scenarios result in inferior effects, especially the scenario where the corporate income tax rate reduction is not accompanied by a reduction in corporate incentives, and the resulting higher corporate income is not reinvested back to the economy.

JEL Classification. H20, C63, C68

Keywords: Corporate Income Tax Reform, Sectoral Incentives, Computable General Equilibrium Model, Poverty Simulation, Philippines

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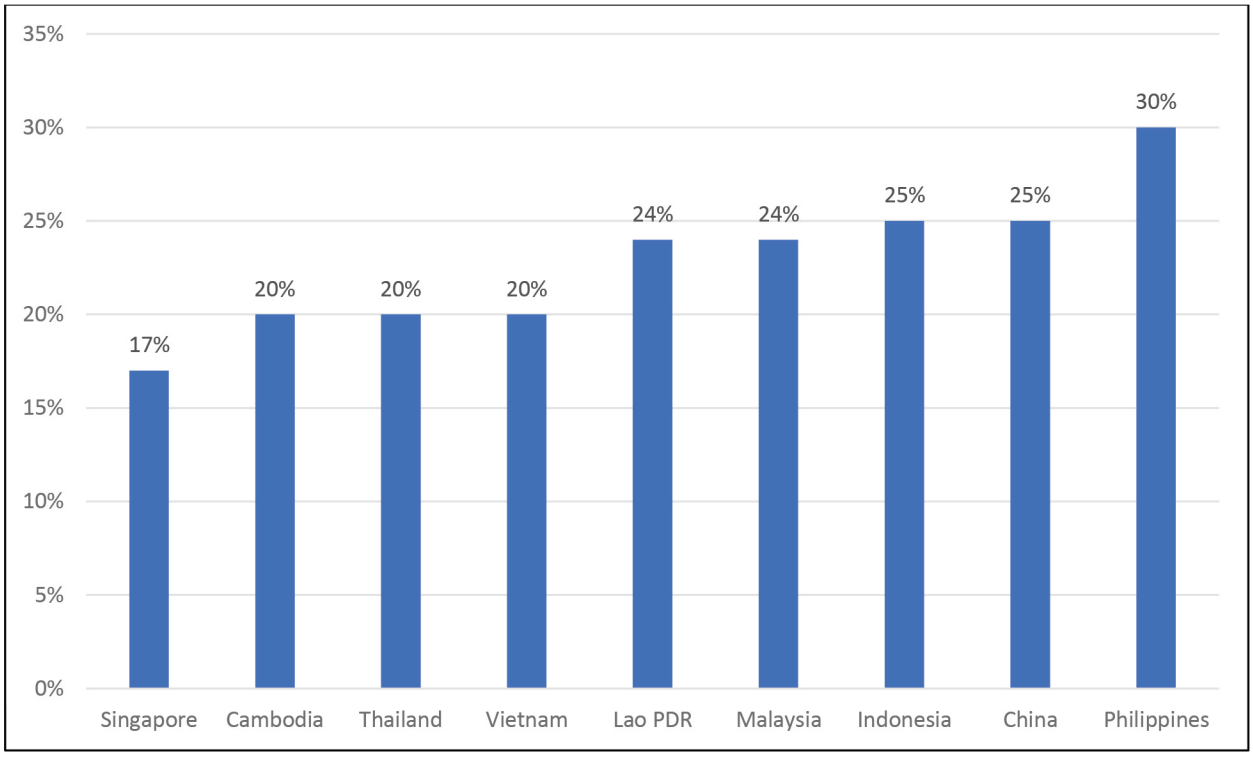
Policy Recommendation:

The Philippines needs to re-align its corporate income tax rates to its neighboring ASEAN countries to be competitive. Thus, the reduction in the corporate income tax rate, which is 30% at present to 20% in 2029 under the tax reform, is critical. However, because corporate income tax is a major source of government revenue, corporate incentives have to be reduced as well to finance/compensate for the reduction in the corporate tax. Also, to realize the full economic benefit of the reform, the government has to ensure that the resulting higher corporate income is re-invested back to the economy.

The objective of this policy note is to analyze the potential economic effects of the reduction in the Philippine corporate income tax by 1% annually from 30% in 2019 to 20% in 2029, and the financing of such reduction through higher compensatory sectoral taxes as a way of reducing sectoral incentives. At 30%, the country's corporate income tax rate is the highest in neighboring countries in the SEA region (Figure 1). The re-alignment of the country's corporate income tax to rates comparable to ASEAN countries is expected to improve the competitiveness of the Philippines as an investment destination.

Figure 1
Corporate Income Tax Rate in the Neighboring ASEAN Region



Source: Asian Development Bank, 2019

The Philippines also extends several incentives to various sectors. These incentives generate various tax expenditures from the income tax holiday, gross income earned, investment promotion and priority plan, among others. In 2017, the estimated foregone government revenue from these incentives amounted to Php 322.5 billion, which is 6.9% of total sales (Table 1). Figure 2 indicates some of the key beneficiary sectors of these incentives (bars that have darker blue shade) that include other manufacturing (22.9%), semi-conductor (16.3%), real estate (13%), motor vehicle (7.9%), other electrical (7.1%), and business process outsourcing (BPO, 6.6%).

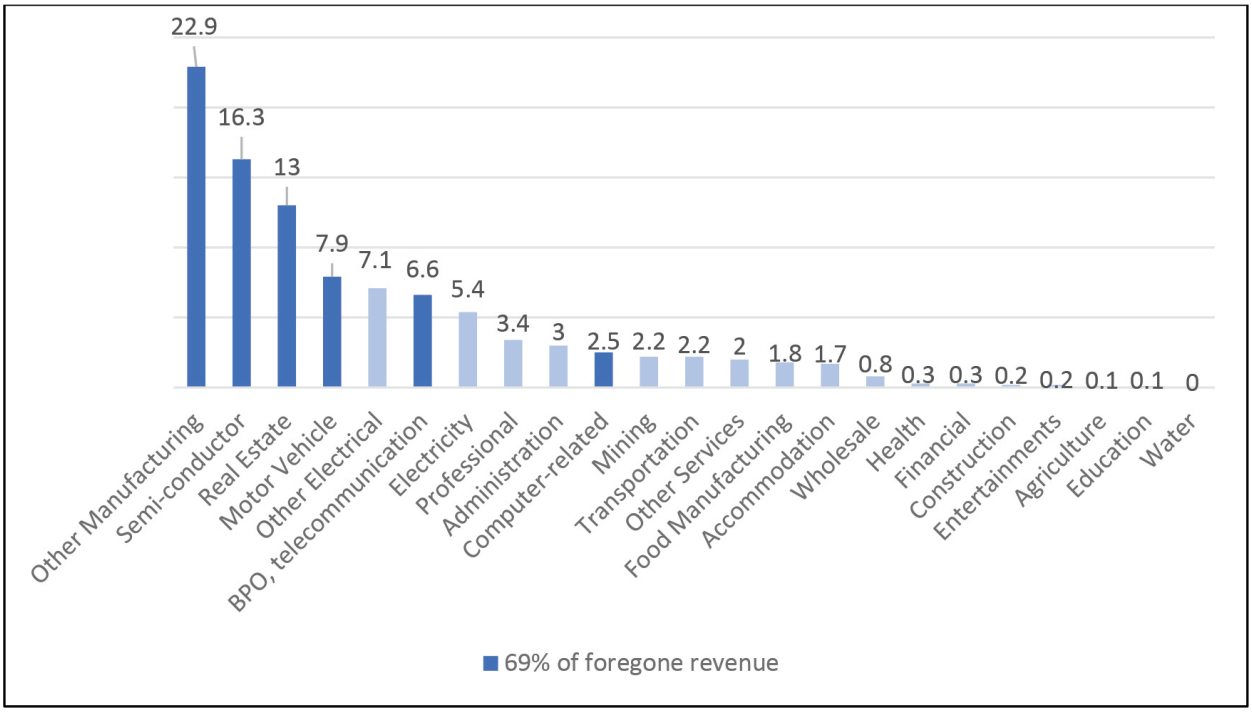
Table 1
Foregone Government Due to Incentives (Php million)

	2017 Sales	2017 Foregone Revenue
Agriculture	25,447	339
Mining	59,730	7,199
Food manufacturing	322,843	5,797
Semi-conductor	694,472	52,469

Other electrical	240,683	22,981
Motor vehicle	389,412	25,337
Other manufacturing	919,500	73,853
Electricity	200,462	17,316
Water	1,554	156
Construction	16,123	761
Wholesale	149,070	2,698
Transportation	134,367	6,974
Accommodation	77,906	5,617
Professional	112,982	11,027
Computer-related	102,298	8,018
BPO, telecom	236,734	21,351
Financial	7,249	875
Real estate	308,892	41,894
Administration	108,775	9,597
Education	3,456	271
Health	7,076	899
Entertainments	7,124	506
Other Services	509,262	6,574
Total	4,635,418	**322,508**

Source: DOF, 2019.

Figure 2
Foregone Revenue Due to Sectoral Incentives in 2017 (% share)



Source: DOF, 2019.

In this policy brief, the results of three simulations are presented:

1. SIM 1 – Gradual reduction in corporate income tax and corporate incentives so that the tax adjustments are neutral in terms of deficit/GDP ratio over the period 2020 to 2029. Also, the resulting higher corporate income is reinvested back to the economy.
2. SIM 2 – Gradual reduction in corporate income tax only without any other compensatory tax adjustments to finance the reduction.
3. SIM 3 – Gradual reduction in corporate income tax and corporate incentives so that the tax adjustments are deficit/GDP neutral. However, the resulting higher corporate income is not fully reinvested back to the economy, but a portion is declared as dividends.

Results and Discussion

Table 2 presents the macroeconomic and employment effects of the corporate tax reforms. SIM 1 generates the best effects. Relative to the baseline, which involves no corporate tax reforms, in 2029, real GDP is higher by 7.4%, real investment by 22.6%, and employment by 2.3 million, whereas prices are lower by 3.2%. The deficit/GDP ratio is maintained at 3.2%.

The worst-case scenario is presented under SIM 2, wherein the corporate income tax reduction is not accompanied by reductions in corporate incentives. The deficit/GDP ratio increases to 4.3% in 2029. Real GDP declines slightly relative to the baseline. Real investment and employment decline from 2020 to 2026, but increases marginally in 2029. Prices generally increase during the period, except for a minimal decline toward the end of the period.

Table 2
Macroeconomic and Employment Effects of Corporate Tax Reforms, Year-on-Year Relative to Baseline

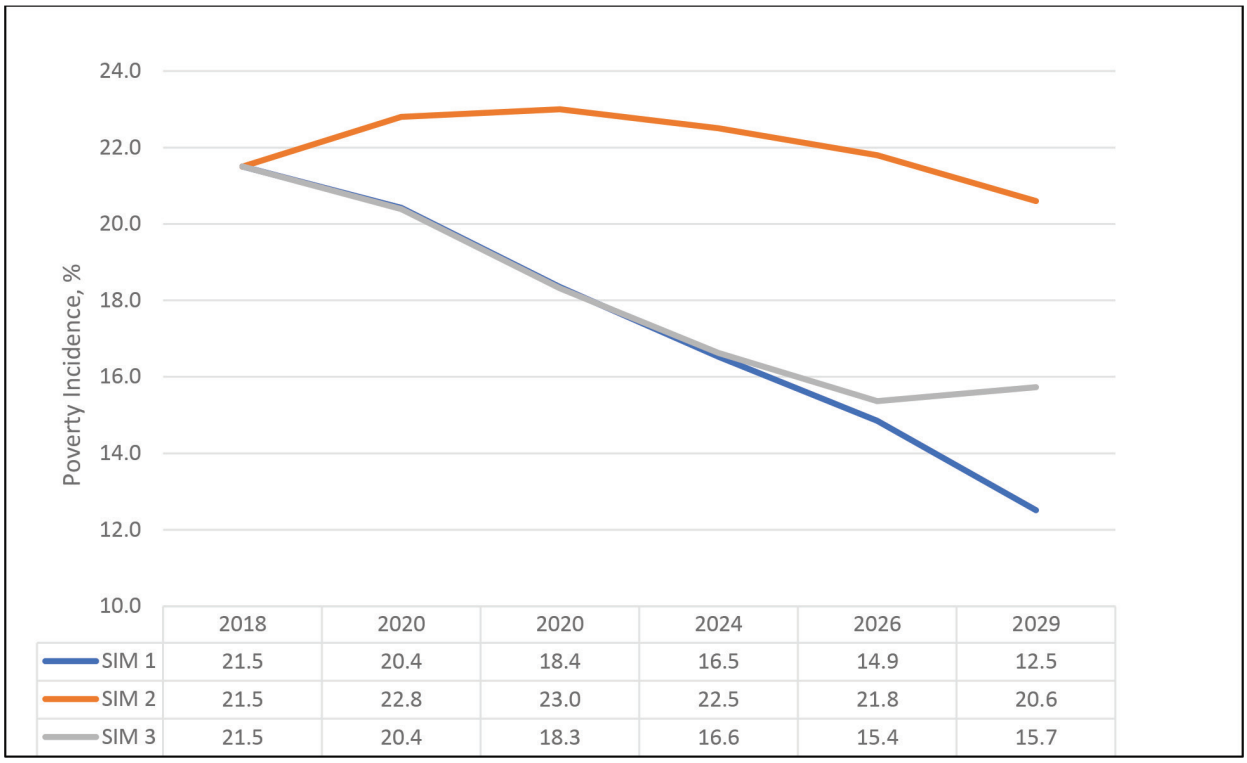
	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Real GDP, % relative to baseline										
SIM 1	-0.2	0.2	0.7	1.5	2.3	3.3	4.3	5.3	6.4	7.4
SIM 2	0.1	-0.2	-0.5	-0.7	-0.9	-0.9	-0.9	-0.7	-0.6	-0.3
SIM 3	-0.2	0.1	0.7	1.4	2.2	3.1	3.9	4.7	5.4	5.7
Real Investment, % relative to baseline										
SIM 1	2.2	4.4	6.6	8.8	11.0	13.2	15.5	17.8	20.2	22.6
SIM 2	-2.4	-2.7	-2.6	-2.3	-1.9	-1.3	-0.5	0.3	1.2	2.1
SIM 3	2.3	4.4	6.5	8.6	10.5	12.3	13.6	14.3	14.0	11.8
Deficit/GDP, %										
SIM 1	-3.2	-3.2	-3.2	-3.2	-3.2	-3.2	-3.2	-3.2	-3.2	-3.2
SIM 2	-3.2	-3.3	-3.4	-3.5	-3.6	-3.8	-3.9	-4	-4.2	-4.3
SIM 3	-3.2	-3.2	-3.2	-3.2	-3.2	-3.2	-3.2	-3.2	-3.2	-3.2
Prices, % relative to baseline										
SIM 1	-0.4	-0.8	-1.2	-1.6	-1.9	-2.3	-2.6	-2.9	-3.2	-3.5
SIM 2	0.5	0.6	0.6	0.5	0.5	0.4	0.2	0.1	-0.1	-0.3
SIM 3	-0.5	-0.9	-1.3	-1.7	-2.0	-2.3	-2.6	-2.7	-2.8	-2.6

Employment, '000 relative to baseline										
SIM 1	212	426	644	868	1,097	1,331	1,569	1,811	2,058	2,311
SIM 2	-179	-199	-195	-171	-130	-74	-4	73	160	258
SIM 3	203	405	605	803	993	1,168	1,311	1,401	1,399	1,233

Source: Authors' calculations

The poverty effects of the three scenarios are presented in Figure 3. The best-case economic scenario under SIM 1 results in a consistent decline in the poverty incidence over the period (Philippine Statistics Authority, 2016).[1] By 2029, poverty incidence declines to 12.5% from 21.5% in 2018. The decline in real GDP, real investment, and employment under SIM 2 increase the poverty incidence from 2018 until 2026. SIM 3 results in lower poverty incidence. However, the decline is smaller compared to SIM 1, especially in 2026 and 2029.

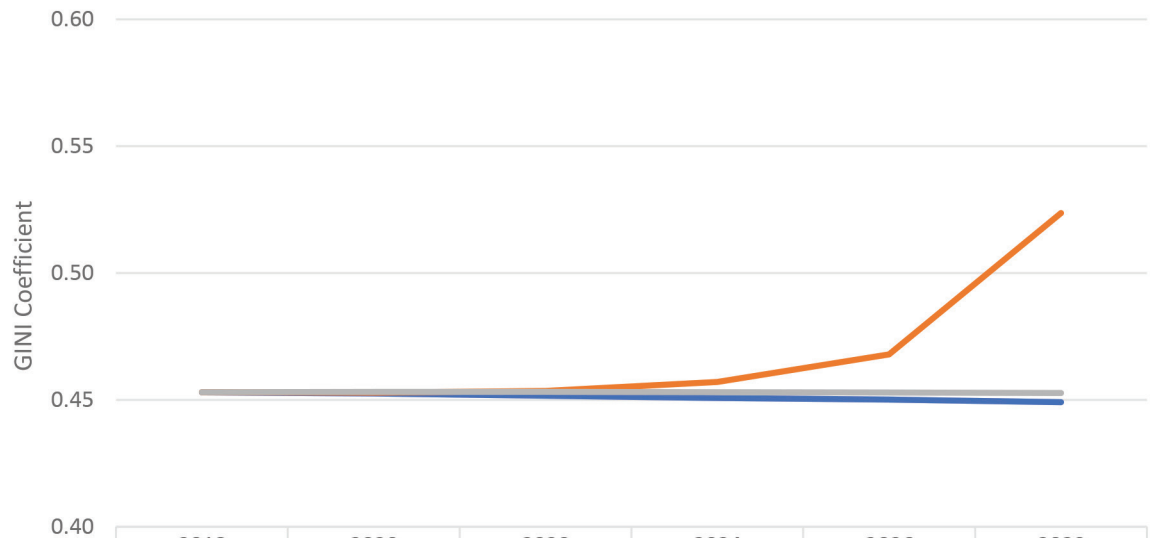
Figure 3
Poverty Incidence Effects of Corporate Tax Reforms (Poverty Incidence, %)



The distribution effects of the corporate income tax reforms are presented in Figure 4. Both SIM 1 and SIM 3 result in a minimal decline in the GINI coefficient. However, under SIM 2 where higher corporate profits as a result of the adjustments in corporate taxes are not fully reinvested back into the economy but declared as dividends will lead to higher GINI coefficients, especially toward the end of the period. This is because capital is largely owned by higher-income groups. Thus, the dividend declaration will greatly affect these groups, whereas lower-income groups will be left out.

[1]The analysis uses the 2015 Family Income and Expenditure Survey (FIES) because the 2018 FIES is not yet available.

Figure 4
Distributional Effects of Corporate Tax Reforms (GINI Coefficient)



	2018	2020	2020	2024	2026	2029
SIM 1	0.4530	0.4525	0.4516	0.4507	0.4501	0.4491
SIM 2	0.4530	0.4529	0.4536	0.4570	0.4679	0.5236
SIM 3	0.4530	0.4532	0.4532	0.4530	0.4529	0.4527

Conclusion

The results indicate that re-aligning the country's corporate income tax rates to levels that are prevailing in neighboring ASEAN countries generates positive economic effects as long as it is neutral in its effects on the deficit/GDP ratio. Given that corporate income tax is a major source of revenue for the government, a compensatory reduction in corporate incentives is critical to eliminate the impact on the government budget balance. Also, the government has to make sure that higher corporate profits as a result of the tax reform are re-invested back to the economy; otherwise, the tax reforms will generate negative distributional effects.

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