How to Read Corporate Tax Cut

Writer - Udit Mishra (Editor)

This article is related to General Studies-Paper-III (Indian Economy)

Indian Express

01 Oct., 2019

"The cut in corporate tax rate has been the biggest change; inclusive of cesses and surcharges, the rate has come down from roughly 35% to 25%, and without the cesses and surcharges, to 22% from around 30%."

Speaking at the Bloomberg global business forum last week, Prime Minister Narendra Modi made a strong pitch before global investors to come to India. Back home, the government has initiated a slew of reforms to arrest the slowdown in economic growth.

The cut in corporate tax rate has been the biggest change; inclusive of cesses and surcharges, the rate has come down from roughly 35% to 25%, and without the cesses and surcharges, to 22% from around 30%. The government has also nudged public and private banks to look at providing new loans to businesses, and has been working with RBI to bring down the cost of such loans by improving monetary policy transmission and reducing interest rates.

From a policy perspective, the situation looks primed to benefit the "wealth creators", as the PM referred to business entrepreneurs in his Independence Day speech.

Why has the government cut tax rates?

A corporate tax cut works a lot like an income tax cut for individuals. In essence, a lower corporate tax rate means businesses have more money left with them; in other words, it increases their profits. As charts 1 and 2 show, India's corporate tax rates were quite high in comparison to neighbouring countries. A lower tax rate not only improves corporate profitability but also makes India a more competitive market for investments.

How does this affect economic activity?

The cut has three broad impacts.

One, in the immediate term, it leaves corporates with more money, which they can use to either reinvest in existing firms or invest in new ventures if they think doing so would be profitable. But it is also possible that they may simply use this money to pay off old debts or pay higher dividends to their shareholders. Whether or not companies invest will depend on the prevailing economic conditions.

CHART 1: EFFECTIVE TAX RATES HAVE COME DOWN SHARPLY

	Old effective tax rate	New effective tax rate
TURNOVER LESS THAN Rs 4,000 CR		
Taxable income less than Rs 1 cr	26	22.9
Taxable income more than Rs 1 cr	27.8	24.5
TURNOVER MORE THAN Rs 4,000 CR		
Taxable income less than Rs 1 cr	31.2	22.9
Taxable income more than Rs 1 cr but less than 10 cr	33.4	24.5
Taxable income more than Rs 10 cr	34.9	25.6

Source: Union Budget, PIB, Kotak Institutional Equities

CHART 2: NEW TAX RATE MORE IN LINE WITH NEIGHBOURHOOD

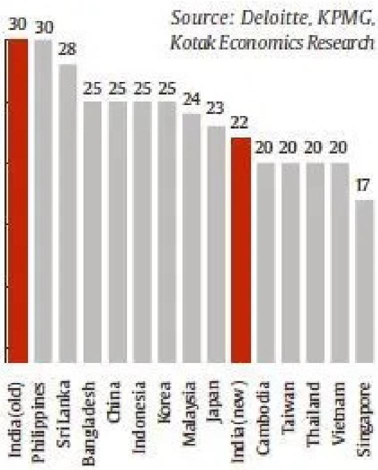

CHART 3: BANKING, FINANCIAL FIRMS GAIN THE MOST

Industry	Share in tax saving (in %)
Banking, Finance & Insurance	42.5
Iron & Steel	6.1
FMCG	6
Mining	5.7
Auto & Ancillary	5
Capital goods	4.3
Crude oil	3.8
Chemicals	3.1
Power	2.8
Infra	2.6

Source: AceEquity, CARE Ratings

Investments crucially depend on the consumption levels in an economy. If there is high consumer demand for, say, cars, firms in that sector would happily invest — but if there is no demand for, say, chocolates, firms in that sector would not invest. However, if the consumption level is depressed because incomes are low across the board, and companies have high unsold inventories (cars and chocolates, etc.), the impact on fresh investments would be muted.

Two, in the medium to long term, that is anywhere between one or two and five years or more, a corporate tax cut is expected to boost investments and increase the productive capacity of the economy. That's because regardless of a slump in demand in the short term, investment decisions are taken after considering long term demand projections. If demand is expected to grow, investments will bear fruit and with lowers taxes, profits will be higher. These investments will also create jobs and increased earnings in due course.

However, a corporate tax cut also depresses economic activity to the extent that it reduces the money in the hands of the government in the form of tax revenues. If this money had been with the government, it would have been spent on either paying salaries or creating new productive assets such as roads — either way, this money would have gone straight to the consumers, instead of the investors.

So, will the tax cut boost growth this year?

It is difficult to argue that it would. There are greater chances that India's GDP growth will continue to struggle in the current financial year despite the corporate tax cut. This is because of a variety of reasons.

One, official statistics show that workers in several key sectors of the economy such as agriculture and manufacturing, etc. have seen their incomes stagnate. There is also increased joblessness in the country. This essentially means people's buying power is severely constrained and that is why they are buying less, resulting in companies having high unsold inventories.

Two, as an analysis of 2,377 companies by Care Ratings shows (chart 3), 42% of the tax-saving as a result of the corporate tax cut will go to firms in the banking, financial and insurance sectors. But these firms can at best lend to others — they cannot directly invest and start manufacturing units. So while the tax savings will help them become stronger financially, there may not be an immediate boost to economic activity. Other sectors in the table like Auto & Ancillary, Power, and Iron & Steel are already struggling with overcapacity, and are thus unlikely to invest.

Three, while the headline rates show a sharp fall in tax rates, it has been pointed out that since, thanks to exemptions, the effective corporate tax rate paid by companies was already 29.5%, the new tax rate of 25% is not as dramatically lower as initially thought — thus limiting the positive impact of the cut.

However, in the longer run, the tax cut will indeed, boost economic activity.

What happens to the fiscal deficit?

While announcing the cuts, Finance Minister Nirmala Sitharaman had said that the corporate tax cut will cost the government Rs 1.45 lakh crore in revenues foregone. That is 0.7% of GDP. If added to the budgeted fiscal deficit (which maps the government's borrowing from the market) of 3.5% of GDP, the impact would have been substantial with the fiscal deficit going to 4.2%.

But here, too, the negative impact is not as much as what was initially assessed, even though the FM has ruled out cutting expenditure to contain the fiscal deficit.

This is again because of a variety of reasons. One, as mentioned earlier, the tax foregone may not be as high. Two, a considerable portion of the tax foregone will come back to the government via the dividends that public sector firms may announce as they too pay lower taxes. Three, whatever is the tax foregone, it will be shared almost equally between the Centre and states. Moreover, the RBI has already given Rs 58,000 crore of extra dividend that was not budgeted earlier. Lastly, the spike in stock markets and the overall business sentiment would likely mean that the government will earn more from disinvestment.

The result is that the fiscal deficit is expected to go up to only 3.7% of GDP.

Corporate Tax Reduction

Why in discussion?

- Finance Minister Nirmala Sitharaman on Friday, among other things, announced a significant cut in corporate tax rates, thus bringing down the effective tax rate (including various cesses and surcharges) on corporations from 35% to 25%. Also under the new corporate tax policy, new companies that set up manufacturing facilities in India starting in October and commence production before the end of March, 2023 will be taxed at an effective rate of 17%. Following the government's decision, both the Nifty and the Sensex rose over 5%, which is their biggest one-day rise in a decade.

Why is the government cutting taxes?

- The corporate tax cut is part of a series of steps taken by the government to tackle the slowdown in economic growth, which has dropped for five consecutive quarters to 5% in the June quarter. The most immediate reason behind the tax cut may be the displeasure that various corporate houses have shown against the government's policies. Many investors, for instance, were spooked by the additional taxes on them that were announced by the government during the budget in July and began pulling money out of the country. The government hopes that the new, lower tax rates will attract more investments into the country and help revive the domestic manufacturing sector which has seen lackluster growth.

What impact will it have on the economy?

- Tax cuts, by putting more money in the hands of the private sector, can offer people more incentive to produce and contribute to the economy. Thus the present tax cut can help the wider economy grow. The corporate tax rate, it is worth noting, is also a major determinant of how investors allocate capital across various economies. So there is constant pressure on governments across the world to offer the lowest tax rates in order to attract investors. The present cut in taxes can make India more competitive on the global stage by making Indian corporate tax rates comparable to that of rates in East Asia. The tax cut, however, is expected to cause a yearly revenue loss of ₹1.45 lakh crore to the government which is struggling to meet its fiscal deficit target. At the same time, if it manages to sufficiently revive the economy, the present tax cut can help boost tax collections and compensate for the loss of revenue.

Expected Questions (Prelims Exams)

1. Consider the following statements regarding Corporate Tax–

1. It is a type of direct tax levied on the profit of companies.
2. The base rate has been reduced from 30% to 25%.
3. The effective rate has been reduced from 35% to 22%.

Which of the above statements is/are correct?

(a) Only 1

(b) 1 and 2

(c) 2 and 3

(d) All of the above

Expected Questions (Mains Exams)

Q. How the recent reduction in corporate tax can positively affect foreign investment in India? Will the reduction in this corporate tax rate affect the Indian revenue in any way? Discuss.

(250 Words)

Note: Answer of Prelims Expected Question given on 30 Sept. is 1 (d).