A deep cut: On corporate tax cuts

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

The Hindu

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"Tax cuts have enthused Corporate India, but there is the fiscal problem to deal with."

Finance Minister Nirmala Sitharaman ushered in Deepavali early for Corporate India and the markets on Friday with her announcement of deep cuts in corporate taxes and roll-back of some market-unfriendly proposals in the Budget she presented in July.

The move to cut corporate taxes, for which an ordinance has already been issued by the government, is on a par with if not higher than the sentiment-boosting 'dream budget' of 1997 when the then Finance Minister P. Chidambaram cut taxes with gusto. Corporate tax rate has been cut to 22% from 30% for companies that do not avail exemptions — this means that the effective tax rate for such companies will fall from 34.94% presently to 25.17% which is a significant saving indeed. Similarly, for companies that are incorporated after October 1 and whose projects will be commissioned before March 31, 2023, the tax rate will be as low as 15% (compared to 25% currently).

The effective tax rate for this category of companies will be 17.01%, about 12 percentage points lower than what prevails now. The idea behind this move is obviously to generate private investment which is now at low ebb, but an unstated intention could also be to attract foreign investors looking for alternative sites for their global value chains disrupted now by the tariff war between China and the U.S. With these cuts, the government has delivered on a long-standing demand of Corporate India.

The onus is now on the latter to deliver, not just in terms of fresh investment but also in passing on the benefit of lower taxes down the chain to consumers and investors.

Where do the tax cuts leave the government and the fisc? Ms. Sitharaman said that the revenue foregone is ₹1,45,000 crore. This is very significant, especially in the context of the over-estimation of revenues in the Budget and the under-performance in terms of tax collections so far this year.

The 2019-20 Budget assumes net tax revenues of ₹16.49 lakh crore, which is a rather ambitious 25% growth estimate over the actual revenues of ₹13.16 lakh crore in 2018-19. If the revenue foregone now is weighed against this unrealistic Budget target on which the fiscal arithmetic is based, the outlook for the projected deficit this year will be scary for sure. It is a no-brainer that the deficit target of 3.3% for this fiscal is unattainable, as things stand.

The bounty of ₹1.75 lakh crore received from the Reserve Bank of India as dividend is obviously a cushion and it is this money that the government has now given away. But if the fiscal deficit target is to be met, then the gap from the original over-estimation of revenues has to be bridged.

The one route open to the government is to go big on disinvestment where it has already budgeted ₹1,05,000 crore for this year. The actual proceeds should be about double that this fiscal if the original arithmetic is to work. That is not going to be easy. The corporate tax cuts are certainly good for the economy in the medium term but in the short term, until revenues bounce back, the government has a fiscal problem on its hands.

What corporate tax cut means for the Indian economy

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"The corporate tax cut is part of a series of steps taken by the government to tackle the slowdown in economic growth."

In its boldest gambit yet to stir up the economy, the government on Friday issued an ordinance to reduce the corporate tax rate for domestic firms and new manufacturing units by 10 to 12 percentage points, effectively bringing India's tax rates on par with its competing Asian peers.

Finance Minister Nirmala Sitharaman said that the effective tax rate for domestic corporates, inclusive of surcharges, will fall from 34.94% to 25.17% if they stop availing any other tax sops. For new manufacturing firms set up after October 1, 2019 and commencing operations by March 31, 2023, the effective tax rate will fall from 29.1% to 17%.

The story so far:

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.

What lies ahead?

Some see the present tax cut simply as a concession to corporate houses rather than as a structural reform that could boost the wider economy. They believe that the current economic slowdown is due to the problem of insufficient demand which cannot be addressed just through tax cuts and instead advocate greater government spending to boost the economy. Others, however, argue that lackluster demand faced by sectors like automobiles is merely a symptom of supply-side shocks such as the goods and services tax that have affected various businesses and caused job losses. If so, tax cuts and other supply-side reforms can indeed help the economy recover from its slump. However, the government will also need to simultaneously enact along with these tax cuts other structural reforms that reduce entry barriers in the economy and make the marketplace more competitive. The government could, for instance, extend the tax cuts to smaller businesses. The benefits of the present tax cut will also depend on whether the government sticks to its promises in the long run. Investor confidence in the past, it is worth noting, has been affected by retrospective changes to the law made by governments in the past.

Expected Questions (Prelims Exams)

1. Recently the government has cut corporate tax. Consider the following statements regarding corporate tax deduction:

1. Corporate tax cuts are an important step to deal with the slowdown in economic growth.
2. With more money coming into the hands of private sector by this deduction, the production and contribution of the economy will be encouraged.
3. Effective tax rate for domestic corporates will fall from 34.94% to 25.17%.

Which of the above statements are correct?

(a) 1 and 3 (b) 1 and 2

(c) 2 and 3 (d) 1, 2 and 3

Expected Questions (Mains Exams)

Q. Recently, the reduction in corporate tax after being proposed in the Union Budget 2019-20, is being described as a big and relief step. What is the responsible reason behind this? What direct benefits will the move have on the economy.

(250 Words)

Note: Answer of Prelims Expected Question given on 20 Sept. is 1 (d)