

Opinion

The macro arithmetic of corporate tax cuts

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The move is rightly aimed at raising the profitability and productivity of investment. However, a major fiscal slippage is likely

C Rangarajan / DK Srivastava

The changes in corporate income tax (CIT) changes announced last month by the Finance Minister constitute an important milestone in India's recent legacy of tax reforms, aimed at lowering tax rates and broadening tax bases. In the early 90s, the Chelliah Committee had recommended bringing down the CIT rate from between 51.75-57.5 per cent to 45 per cent. It was gradually brought down to 40 per cent, and then further to 35 per cent in 1997-98. Later, based on the Shome Committee (2001) and Kelkar Committee (2002) recommendations, the basic CIT rate was brought down to 30 per cent in 2004-05.

In 2015-16, the then Finance Minister announced that the basic CIT rate would be reduced to 25 per cent. But action on this was slow. The latest reforms go beyond this by lowering the basic rate to 22 per cent for domestic companies and 15 per cent for new manufacturing companies. The cess and surcharges however continue.

The effective tax rate linked to the basic tax rate of 22 per cent is 25.17 per cent. While availing this lower rate, the companies will have to forego the benefits of any tax exemptions and deductions. Using information available for 2017-18 based on a sample of 8,41,687 companies drawn from the budget documents, we can divide these companies into three groups, namely beneficiary domestic companies (Group A), status quo domestic companies (Group B) and status quo foreign companies (Group C). Group A companies are those with an effective rate above 25.17 per cent. These companies are likely to take advantage of the lower rate. Group B companies have an effective rate below 25.17 per cent. They may prefer to continue with the existing rates while availing tax exemptions and/or deductions. Foreign companies have no option except to continue with the status quo.

(table 1)

Table 1

Share in tax and tax base of Beneficiary/status quo companies					
Group	Group classification	Share in number of companies (%)	Share in profit before tax (%)	Share in total tax revenues (%)	Effective tax rate (%)
A	Beneficiary domestic companies	93.2	74.3	76.7	30.4
B	Status quo domestic companies	2.6	17.5	12.4	20.9
C	Status quo foreign companies	4.2	8.3	11	39.1
		<i>Number</i>	<i>₹ cr</i>	<i>₹ cr</i>	
	Total	8,41,687	15,18,224	4,47,744	29.5

Source: Statement of Revenue Impact of Tax Incentives under the Central Tax System: Financial Years 2017-18 and 2018-19 (Union Budget 2019-20)

Group A companies have a relatively larger share in the number of companies, their profit before tax, and their contribution to tax revenue (*table 1*). This group includes the automobile and automobile components companies, among others.

Group B companies account for only 2.6 per cent in terms of number of companies. But their share in the tax base at 17.5 per cent and tax paid at 12.4 per cent is relatively larger. This group includes gas, petroleum, and cement companies.

Group C largely includes companies operating in to financial services, mining and quarrying, and telecommunications sectors.

Impact on tax revenues

The cost of this reform in terms of revenue foregone in 2019-20 can be estimated using the distinction between the beneficiary and status quo groups. First, we reassess the 2019-20 Budget estimate of CIT revenues given at ₹7,66,000 crore by using 2018-19 CGA actuals instead of revised estimates. The budgeted growth rate over CGA actuals at 15.4 per cent (14.2 per cent with respect to 2018-19 RE) also requires a downward adjustment due to the economic slowdown. Budget estimates for 2019-20 were based on a nominal GDP growth assumption of 12 per cent. CIT revenues grew only by 4.6 per cent in the first five months of 2019-20. We have reassessed CIT revenues assuming a nominal GDP growth at 10 per cent and using a buoyancy of 1.2. The assumed buoyancy in 2019-20 (BE) with respect to 2018-19 (RE) was a little less than 1.2. The reassessed CIT revenue is estimated at ₹7,43,201 crore. This may be used to derive the revenue impact of the CIT reforms.

Table 2

Estimated revenue impact of new CIT rates (₹ cr)				
Group	Pre-reform reassessed tax revenue	Estimated profit before tax (tax base)	Post-reform estimated tax revenue	Revenue loss
Group A	5,69,830	18,72,270	4,71,250	98,579
Group B	91,948	4,39,795	91,948	0
Group C	81,423	2,08,001	81,423	0
Total	7,43,201	25,20,067	6,44,621	98,579

Source (basic data): Statement of Revenue Impact of Tax Incentives under the Central Tax System: Financial Years 2017-18 and 2018-19 (Union Budget 2019-20) and Authors' estimates

Using the proportion of tax revenues in 2017-18 for companies in Groups A, B, and C, the corresponding revenues may be derived at the old rates. Tax revenues divided by the effective tax rate gives an estimate of its tax base. On this tax base for Group A companies, the new lower CIT rate of 25.17 per cent is applied. For Groups B and C, there is no change since their effective rate continue at the earlier rates of 20.9 per cent and 39.1 per cent respectively. The estimated revenue loss is thus ₹98,579 crore (Table 2), lower than the revenue foregone estimate given by the government at ₹1,45,000 crore. Since the basis of these estimates has not been made explicit, it is difficult to make any observations on this.

Impact on fiscal deficit

The impact on the fiscal deficit of CIT and other reforms for 2019-20 would depend on a broader set of factors. Relative to the budget estimates, downward adjustments are required for all central taxes since the base year (2018-19) figures, as well as the nominal growth and assumed buoyancy numbers, appear to be out of alignment. Second, the revenue cost of the CIT reforms and the earlier announcement relating to the export incentives (₹50,000 crore) should be provided for. On the positive side, we need to take into account the effect of RBI additional dividends.

There would be positive effects of the stimulus through the CIT reforms and export incentives, but these may take time to work themselves out. From the RBI transfer of ₹1,76,051 crore, after deducting ₹90,000 crore, which has already been provided for in the Budget, ₹86,051 crore is included. This assumes that like last year when an interim dividend of ₹28,000 crore was paid by the RBI, the Central government may again ask for an interim dividend of a similar amount in 2019-20.

In summary, we estimate the following positive and negative effects to have a broad idea of the likely fiscal slippage (*table 3*).

Table 3

Adjustments relative to Budget estimates for 2019-20 (₹ cr)			
Item	Total	Centre	States
Revenue cost of CIT reform	98,579	62,463	36,116
Revenue cost of export subsidy	50,000	31,682	18,318
Revenue cost of downward revision of BE	2,14,006	1,35,602	78,404
Total Revenue cost	3,62,585	2,29,747	1,32,838
Less: Additional dividends from RBI	86,051	86,051	
Net Revenue Loss	2,76,534	1,43,696	1,32,838
Net Revenue Loss as % of GDP*	1.3	0.7	0.6

Source (basic data): Statement of Revenue Impact of Tax Incentives under the Central Tax System: Financial Years 2017-18 and 2018-19 (Union Budget 2019-20) and Authors' estimates; *reassessed GDP for 2019-20

Given the potentially large slippage in fiscal deficit, the Central government would do well to enhance efforts to garner additional non-tax revenues as well as disinvestment proceeds over and above the budget estimates. The effect on the State governments is also a matter of concern and worry. While a rise in fiscal deficit in a difficult year may be condoned, it should not be allowed to persist. That has clearly a long-term implication.

The standard remedy for a decline in overall demand is to increase government expenditure. Tax cuts also imply this, but only indirectly. Purely looked at from the demand angle, increased government

expenditure may have a more direct impact. Tax cuts, however, in the present case have more of a reform flavour.

Likely effects

The impact of the changes in corporate tax rates depends primarily on how the tax benefits will be utilised by the corporate sector. If the additional profits are utilised to increase capital expenditure, corporate investment will go up and spur production in the future years. On the other hand, if the benefits are converted into additional dividends, it will have a demand-side effect. There will be a pick-up in demand and this may have more immediate effect. However, it is difficult to estimate what impact it will have in the current year.

Overall, the CIT reforms are supply-side reforms aimed at increasing the profitability and productivity of investment. India's CIT rates have now become globally competitive. There is intra-sectoral neutrality across industry and services except for new manufacturing which has got an added boost. Supply-side reforms take time to work themselves out.

Going ahead, a fresh look is needed over the continuance of cess and surcharges. Perhaps, government must also move forward to abolishing the option of two rates and have only one rate with no exemptions. Continuation of the reform process also calls for bringing personal income tax rates in alignment with the new CIT rates.

Rangarajan is former Chairman, PMEAC and former Governor, RBI. Srivastava is Chief Policy Advisor, EY India and former Director, Madras School of Economics. Views are personal

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