

IMPACT OF CORPORATE TAX CUT

Cut in corporate taxes to boost sentiment, although pickup in private investment, GDP growth likely to be back-ended

September 2019

Aditi Nayar
+91 124 4545 385
aditin@icraindia.com

Medha Sinha
+91 124 4545 399
medha.sinha@icraindia.com

Jaspreet Kaur
+91 124 4545 853
jaspreet.kaur@icraindia.com

OVERVIEW

The Government of India (GoI) announced a series of amendments to the Income Tax Act, 1961 and the Finance Act, 2019 through an ordinance on September 20, 2019, intended to revive economic growth and promote fresh private investment in the economy. Primarily, the corporate tax rate for domestic companies has been reduced to 22%, provided they don't avail any exemptions or incentives. The effective tax rate for such companies will now be 25.17%, inclusive of surcharges and cesses. Moreover, to promote investment, new domestic companies (incorporated from October 1, 2019, making fresh investment in manufacturing and commencing production before end-March 2023), will have an option to pay income tax at the rate of 15% if they do not avail any exemptions. The effective tax rate for such companies will now be 17.01%, inclusive of surcharges and cesses.

The lowering of the Corporate tax rate is expected to provide a substantial and broad-based boost to business sentiment in the immediate term and is a long term structural positive, although it would result in an increase in fiscal stress in the short term. This measure would also have a modest knock-on impact on improving consumption demand, particularly for big ticket items. However, the impact on fresh investment activity may be visible only with a lag. Given the moderate capacity utilisation in various sectors, we don't expect a broad-based pickup in capacity expansion by the private sector, until there is greater visibility of a sustained uptick in domestic consumption demand. Moreover, new factories are likely to be relatively automated, raising concerns on the extent of jobs that could be added. In our view, land and labour reforms along with regulatory clarity and consistency are areas where additional measures are required to complement the impact of the tax cut.

Nevertheless, the secular reduction in the tax rate is welcome, as it does not benefit only specific targeted sectors. In ICRA's view, this is a preferable alternative to other measures that were being put forth, for instance, the demand to cut the GST rate for automobiles, which would have generated similar requests from other sectors. Moreover, if firms pass through a portion of their tax savings through lower prices of goods and services, the benefit could potentially reach a larger number of people than an income tax reduction, given the limited number of income tax payers.

Impact on GoI's fiscal deficit: The Government has pegged the gross revenue loss related to the tax cut at Rs. 1.45 trillion, approximately 42% of which would be borne by the State Governments through lower tax devolution to them¹. Therefore, the net impact of this tax cut is likely to be around Rs. 0.8-0.9 trillion, which by itself would translate to a fiscal slippage of around 0.4% of GDP in FY2020. Moreover, the GoI's revenues would take a hit in future years, although the expected, albeit back-ended, pickup in economic activity as a consequence of this tax cut may infuse some buoyancy into direct and indirect tax collections.

Even before the announcement of this reduction in the Corporate tax rate, a substantial shortfall in the GoI's tax collections relative to the FY2020 Budget Estimates (presented in July 2019) seemed likely (refer Exhibit 1); the net tax revenue growth stood at 15.8% in April-July 2019, which was considerably lower than the budgeted target of 25.3% relative to the Provisional Actuals for FY2019. We had estimated that the net tax revenues of the GoI would need to expand by a sharp 28.0% in the last eight months of the fiscal year, to meet the July 2019 Budget Estimate for FY2020, which appeared to be a steep target given the subdued economic outlook.

¹ The Fourteenth Finance Commission had recommended that the states should receive 42% of the shareable tax collections of the GoI over its award period of FY2016 to FY2020, which excludes items such as cess collections. In effect, the central taxes devolved to the states are closer to 35% of the gross central tax collections.

Moreover, the revenue foregone from the recently announced scheme to support exports has been pegged by the Government at Rs. 500.0 billion, although the impact in the current fiscal may be limited to a fraction of this amount.

Aside from the impact of the reduction in the Corporate tax rate, we estimate that the gross tax revenues of the GoI would likely trail the FY2020 BE by Rs. 1.0-1.5 trillion, with a net impact of approximately Rs. 0.6-1.0 trillion for the GoI. Therefore, we now estimate the GoI's gross tax revenues to be lower than the FY2020 BE of Rs. 24.6 trillion by a considerable Rs. 2.5-3.0 trillion (refer Exhibit 3). Moreover, we estimate the GoI's net tax revenues to be lower than the FY2020 BE of Rs. 16.5 trillion by a considerable Rs. 1.4-1.9 trillion (refer Exhibit 4).

Notably, the FY2019 provisionals had pegged the GoI's gross tax revenues at Rs. 20.8 trillion, a considerable Rs. 1.7 trillion lower than the Revised Estimates (RE) for that year. Presumably, the taxes devolved to the states in FY2019 were based on the GoI's estimates of tax collections in FY2019 RE (Rs. 7.6 trillion; refer Exhibit 2), which suggests that the devolution of taxes to the states in that year was higher than required. We estimate this excess transfer at around Rs. 0.6-0.7 trillion. A portion of the adjustment of the excess devolution in FY2019, appears to have already been undertaken in April-July 2019, with a 6% YoY reduction in central tax devolution to the states in these four months. Adjusting for this excess transfer of central tax devolution in FY2019, we estimate the net Central tax shortfall at Rs. 0.7-1.3 trillion in FY2020.

Importantly, a portion of this tax shortfall would be offset by the transfers from the Reserve Bank of India, which are higher than budgeted by Rs. 0.6 trillion. Therefore, we estimate the revenue receipts of the GoI to be Rs. 0.1-0.7 trillion lower than budgeted. With a low Rs. 123.6 billion collected through disinvestment in April-July 2019, there is a continuing lack of clarity regarding whether the steep disinvestment target of Rs. 1.05 trillion for FY2020 would be achieved, despite the expected pick up in business sentiment after the Corporate tax cut.

Based on our estimate of nominal GDP of Rs. 208 trillion for FY2020, and the aforesaid revenue shortfall of Rs. 0.1-0.7 trillion, fiscal slippage of up to 40 bps now appears inevitable given that the GoI's tax collections will fall short of its budget estimates². Expenditure cuts may still be undertaken to prevent the fiscal deficit from rising too sharply in FY2020.

We now expect the GoI's H2 FY2020 borrowing calendar for dated Government securities (G-sec) to be revised upwards, which would keep G-sec yields at elevated levels. However, the anticipated introduction of the new benchmark 10-year G-sec over the next month, would pare the 10-year G-sec yield to some extent. In our view, further monetary easing of around 25 bps in the upcoming policy review, is already priced in to the current bond yields.

² As per the Fiscal Responsibility and Budget Management (Amendment) Act, 2018, the GoI's fiscal deficit can exceed its target in a year on account/s of national security, act of war, national calamity, collapse of agriculture severely affecting farm output and incomes, structural reforms in the economy with unanticipated fiscal implications and decline in real output, by up to one-half per cent of the GDP of that year.

Exhibit 1: Trends in Corporate Tax Collections

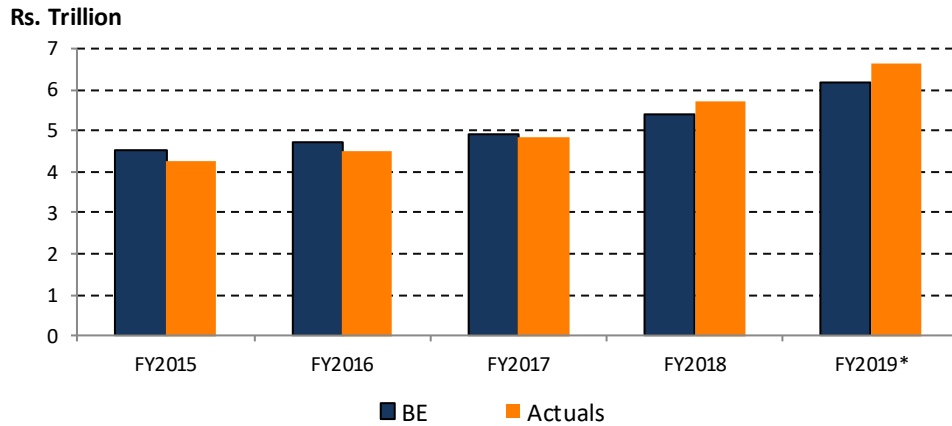
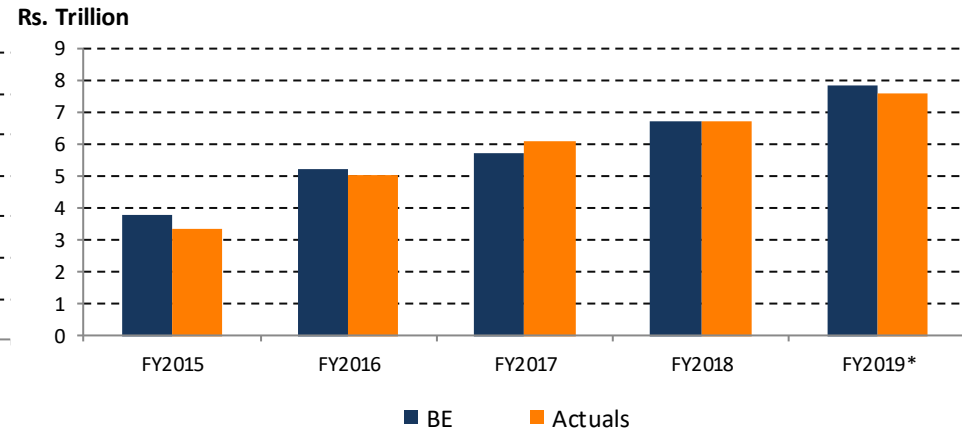


Exhibit 2: Trends in Centre Tax Devolution (Assignment to States)



BE: Budgeted Estimates; *Figures for FY2019 are Provisional Estimates
 Source: Gol Budgeted Documents; CGA, Ministry of Finance; Gol; CEIC; ICRA Research

Exhibit 3: Trends in Gol's Gross Tax Revenue

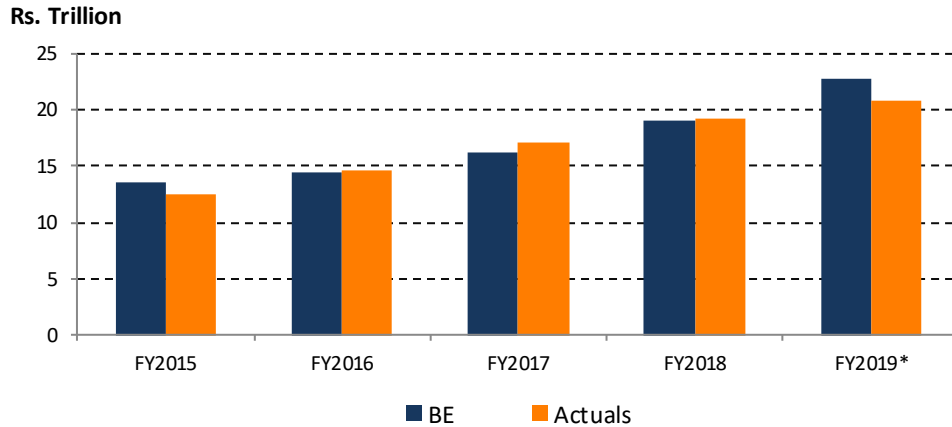
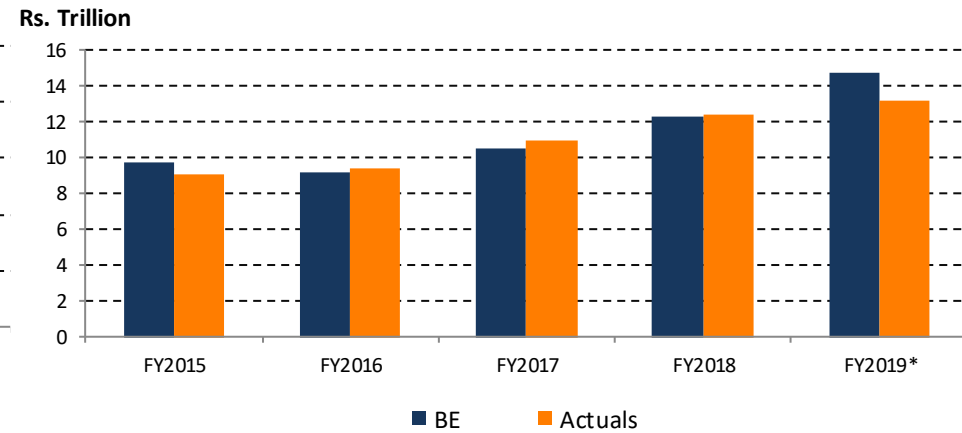


Exhibit 4: Trends in Centre's Net Tax Revenue



BE: Budgeted Estimates; *Figures for FY2019 are Provisional Estimates
 Source: Gol Budgeted Documents; CGA, Ministry of Finance; Gol; CEIC; ICRA Research

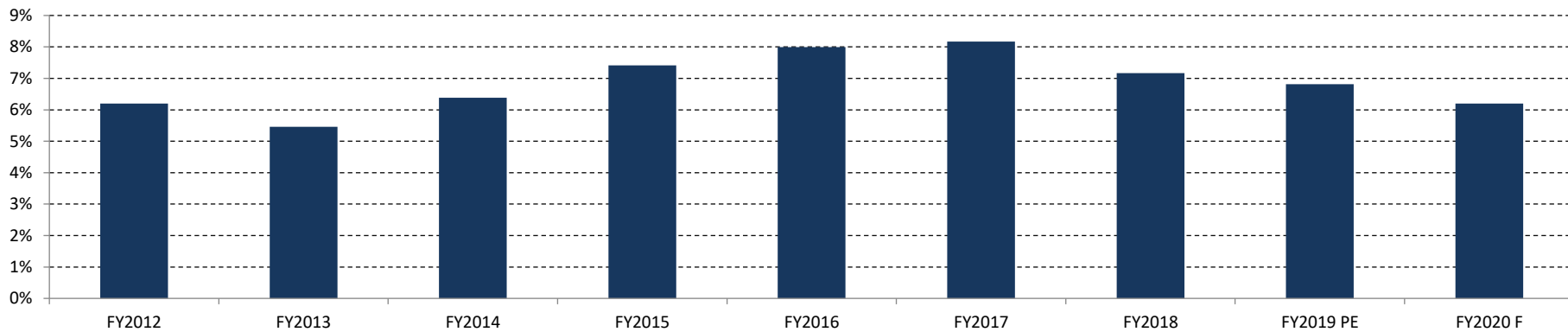
Impact on fiscal health of State Governments: Based on the above calculations, it appears that sharply lower Central tax devolution to the state governments is a looming risk to the general government fiscal health as well as spending. Given our estimates of the excess transfer of Central tax devolution in FY2019, and the likely shortfalls in Central tax collections in FY2020, we estimate that the aggregate Central tax devolution to the states may be around Rs. 1.5-2.0 trillion lower than what was budgeted by the GoI.

Sizeable expenditure reduction or deferral is likely to be required to avoid substantial fiscal slippage at the state government level, given that the borrowing limit set by the GoI acts as a soft constraint to the size of the states’ fiscal deficits. Already, the gross issuance of state development loans in April-September 2019 (upto September 17, 2019), has displayed a sharp expansion of 34% (led partly by factors such as the YoY contraction in central tax devolution and substantial redemptions). In our view, likely cuts to productive and/or capital expenditure at the state level, pose a key risk to the economic growth outlook.

Unless the Corporation tax cut generates a broad-based buoyancy in tax collections over the medium term, the state governments’ fiscal health may come under considerable stress, especially if the duration of compensation related to GST losses is not increased beyond the current five-year period.

Impact on GDP growth: Based on our assessment that the pickup in private sector investment activity would be back-ended whereas government expenditure restraint would be required in the remainder of this fiscal, particularly at the state government level, we are not yet revising our FY2020 GDP forecast upward from 6.2% (refer Exhibit 5).

Exhibit 5: Trend in Growth of GDP (at Constant 2011-12 Prices)



PE: Provisional Estimates; F: ICRA’s Forecasts

Source: CSO; CEIC; ICRA Research

Impact on inflation and monetary policy: Given that at least a portion of the tax cuts would have to be absorbed through lower state government expenditure, the impact on inflation may be modest. Additionally, some firms may choose to pass through a portion of their tax savings through lower prices of goods and services.

Based on our forecasts of the inflation (FY2020 average of 3.5%) and growth (FY2020 GDP growth of 6.2%) trajectory, the space for additional monetary easing appears to be limited to 25 bps, which we anticipate would be undertaken in the October 2019 review of the Monetary Policy Committee.

Nevertheless, the efficacy of incremental rate cuts in rapidly instigating a turnaround in economic growth remains uncertain, given continuing structural constraints such as the cost of land acquisition, moderate capacity utilisation levels, relatively high debt levels of some corporate groups and reluctance of Banks to lend for project finance.

ABOUT ICRA

ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange.

Alliance with Moody's Investors Service

The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder. The participation of Moody's is supported by a Technical Services Agreement, which entails Moody's providing certain high-value technical services to ICRA. Specifically, the agreement is aimed at benefiting ICRA's in-house research capabilities, and providing it with access to Moody's global research base. The agreement also envisages Moody's conducting regular training and business seminars for ICRA analysts on various subjects to help them better understand and manage concepts and issues relating to the development of the capital markets in India. Besides this formal training programme, the agreement provides for Moody's advising ICRA on Rating-products strategy, and the Ratings business in general.

The ICRA Factor

Our services are designed to

- Provide information and guidance to institutional and individual investors/creditors;
- Enhance the ability of borrowers/issuers to access the money market and the capital market for tapping a larger volume of resources from a wider range of the investing public;
- Assist the regulators in promoting transparency in the financial markets;
- Provide intermediaries with a tool to improve efficiency in the funds raising process.

Business Contacts

Mr. L. Shivakumar
E-mail: shivakumar@icraindia.com
Tel: +91 22 6114 3406 / +91 98210 86490

Mr. Jayanta Chatterjee
E-mail: jayantac@icraindia.com
Tel: +91 80 4332 6401/ +91 98450 22459

Media and Public Relations

Ms. Naznin Prodhani
E-mail: communications@icraindia.com
Tel: +91 124 4545 860

Registered Office:

1105, Kailash Building, 11th Floor,
26, Kasturba Gandhi Marg,
New Delhi - 110 001
Tel: + 91 11 2335 7940-45

Corporate Office:

Building No.8, 2nd Floor,
Tower A, DLF Cyber City Phase II,
Gurgaon- 122 002
Tel: +91 124 4545300

Ahmedabad

1809-1811, Shapath V,
Opposite Karnavati Club
S.G. Highway, Ahmedabad - 380015
Tel: +91 79 4027 1500/01

Bengaluru 1

'The Millenia', Tower- B, Unit No. 1004,
10th Floor, 1 & 2 Murphy Road,
Bengaluru - 560 008
Tel: +91 80 4332 6400

Bengaluru 2

2nd Floor, Vayudooth Chamber,
15-16, Trinity Circle, M.G. Road,
Bengaluru - 560 001
Tel: +91 80 4922 5500

Chennai

5th Floor, Karumuttu Centre,
634, Anna Salai, Nandanam
Chennai - 600 035
Tel: +91 44 4596 4300

Hyderabad 1

No. 7-1-58, 301, 3rd Floor, 'CONCOURSE',
Above SBI-HPS Branch, Ameerpet,
Hyderabad - 500 016
Tel: +91 40 4920 0200

Hyderabad 2

4A, 4th Floor, SHOBHAN,
6-3-927, A&B Somajiguda,
Raj Bhavan Road,
Hyderabad – 500082
Tel: +91 40 40676500

Kolkata

A-10 & 11, 3rd Floor,
FMC Fortuna 234/3A,
A.J.C. Bose Road,
Kolkata -700 020
Tel: +91 33 7150 1100/01

Mumbai

3rd Floor, Electric Mansion
Appasaheb Marathe Marg,
Prabhadevi,
Mumbai - 400 025
Tel: +91 22 6169 3300

Pune

5A, 5th Floor, Symphony,
S. No. 210 CTS 3202 Range Hills Road,
Shivajinagar, Pune - 411 020
Tel: +91 20 2556 0194, 020 6606 9999

Email: info@icraindia.com

Helpdesk: 9354738909

Website: www.icra.in/ www.icraresearch.in