Indian Journal of Economics and Business
Vol. 19 No. 2 (December, 2020)
Copyright@ Ashwin Anokha Publications & Distributions
http://www.ashwinanokha.com/IJEB.php

Fiscal and other Implications of a Cut in Corporate Tax: Indian Experiences

Nihaljyoti Das
Research Scholar, Department of Economics, Gauhati University, Assam, India

Corresponding Authors Email id: nihaljyotidas19@gmail.com

Received: 07th September 2020
Revised: 11th November 2020
Accepted: 10th December 2020

Abstract : This paper evaluates the need for a cut in the corporate tax rate in India by looking into the present scenario of the Indian economy. It also explores the possible effects of the fiscal reform on the Indian economy and how it might come out of the prevalent economic slowdown. The study found that a cut in the corporate tax rate has a far-reaching effect on the Indian economy and can remedy the current economic downturn and make structural changes in the long run. It argues that after a cut in the corporate tax rate, India has emerged as a lucrative destination for making capital investments. However, most of the effects of a cut in the corporate tax rate are not instantaneous. However, its detrimental effects can be visible in the short run. Therefore, the government of India has to come up with some other reforms to deal with those short-run effects.

Keywords: Corporate tax, Fiscal reform, Economic slowdown, Investment

INTRODUCTION

After the industrial revolution, the corporate sector emerged as an essential sector. After that, the concept of taxing corporate incomes or corporate taxation started to get more and more important in the world (Ambirajan, 1964). A corporation tax is a direct tax levied on the total taxable income of a company. The constitution empowers the Union government to levy a corporate tax in India. A corporate tax is said to be a direct tax that the tax burden cannot be shifted to final consumers, but there is a school of thought that considers the burden of corporate tax can be shifted to its consumers in the form of a price rise. However, there have not been many studies to validate the statement (Reddy & George, 2013). A corporation is required to pay direct taxes in the form of corporation tax, which is levied on the corporation's income. In contrast, a corporate dividend distribution tax is levied on the dividend paid by the corporation to its shareholders (Chelliah, 1996).
Corporate tax is levied at a flat rate for each category of corporate entities. Still, it may be subject to some rebates and exemptions that vary with the activities, criteria, or type of corporate income, profits, and investments. Such rebates and exemptions, like tax concessions offered to corporations, have changed with time. A few recently introduced rebates and exemptions include the depreciation allowance, development rebate, investment allowance, tax holidays, etc. Some economists argue that

these concessions have resulted in tax evasion simply because corporations use these concessions as loopholes for tax invasion (Reddy & George, 2013). To simplify the corporate tax regime, the Task Force on Direct Taxes (also known as the Kelkar Task Force Report, 2002) has made some recommendations. In its report, the Kelkar Committee has advised that reducing tax rates on corporate income and broadening the tax base by reducing or eliminating the number of incentives can help achieve the goal (Minister of Finance & Company Affairs, 2002). It is because eliminating incentives and moderation of tax rates would clean up the taxation laws related to corporate income and reduce distortions. As a result, the tax base would expand, and tax administration and compliance would become easier (Chelliah, 2002).

This paper studies the various implications of a cut in the corporate tax rate. For this purpose, the paper has four sections. Section I provides a brief introduction to corporate taxation in India with some justification for the cut in the corporate tax rate. Section II studies the need for a fiscal policy reform like a cut in the corporate tax rate by providing various data related to the condition of the Indian economy. Section III examines the different positive effects of the fiscal reform and how it will stimulate economic growth through its multiplier effect. Section IV discusses the various ill effects of such a fiscal reform, including a cut in the corporate tax rate. Finally, Section V summarises the conclusions drawn from the analysis.

NEED FOR CUT IN CORPORATE TAX RATE

The Indian economy is going through an economic slowdown due to cyclical and structural reasons. India's real gross domestic product (or inflation-adjusted GDP) grew by 5 percent in the first quarter of the fiscal year 2019–20, the slowest growth in the last six years. The growth rate was 7.99 percent in nominal terms, the lowest since December 2002. One of the major components of India's GDP is investment, induced by both private and government sectors. It has been a key driver of growth since liberalisation. Gross Fixed Capital Formation (GFCF), which is a measure of investment in the economy, has declined from 34.3 percent in 2011 to 28.8 percent in 2018, and particularly in the private sector, it has fallen from 26.9 percent in 2011 to 21.4 percent in 2018 (Reserve Bank of India, 2019). The slackening of investment lowers infrastructure development, causes hesitation in creating small businesses, and stops entrepreneurs from investing in research and development. Consequently, it acts as a hurdle in the path of technological development. However, as put forward by Prof. Joseph Schumpeter (1942), innovation is crucial for the holistic growth of an economy and helps gain a competitive advantage over others. To boost innovation and improve operational efficiency to make profits for a more extended period. However, as mentioned earlier, the business environment is not conducive to making fresh investments. The Index of Industrial Production (IIP) indicates that sectors like mining, manufacturing, and construction are most affected.

The automobile industry is being hit hard by this slowdown in the manufacturing sector. Its sales are experiencing negative growth from 26,266,179 vehicles in 2018-19 to 21,546,390 vehicles in 2019-20 (Society of Indian Automobile Manufacturers, n.d.). According to the Society of Indian Automobile Manufacturers (SIAM), passenger vehicles, overall commercial vehicles, three-wheelers, and two-wheelers have registered negative growth of 23.56 percent, 22.95 percent, 6.66 percent, and 16.18 percent, respectively, in April-September 2019 over the same period last year. Consequently, companies have reduced their production to a total of 14,427,724 vehicles, including passenger vehicles, commercial vehicles, three-wheelers, two-wheelers, and quadric cycles, in April-September 2019 as against 16,645,330 in April-September 2018, registering a de-growth of 13.32 percent over the period (Society of Indian Automobile Manufacturers, 2019). This reduction in production has contributed significantly to the loss of jobs in the sector and the related sectors. According to the official data

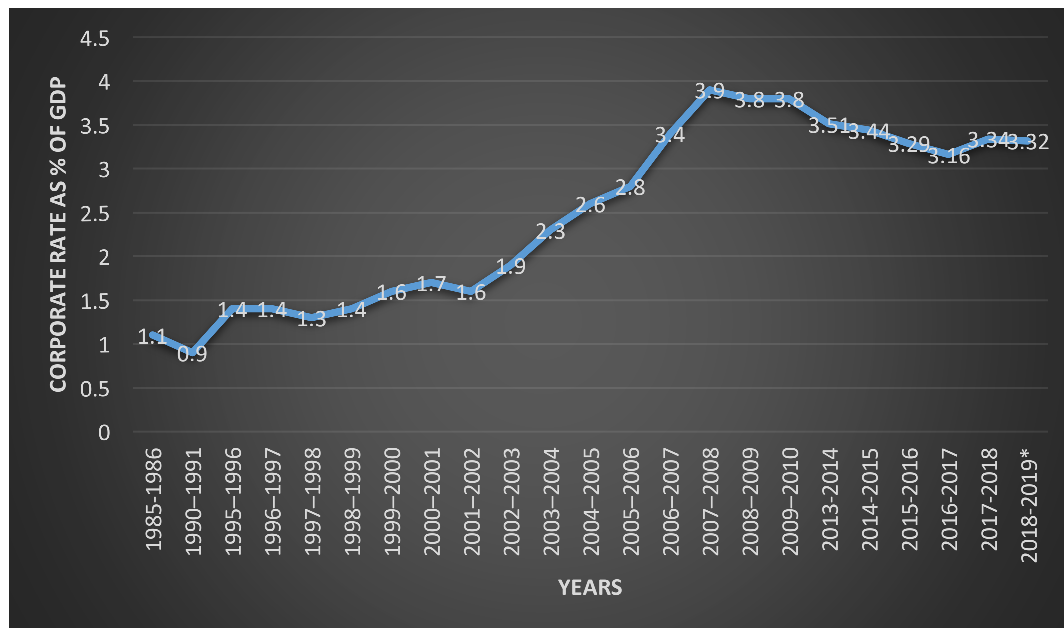
released by SIAM, 2.30 lakh jobs have been lost due to a reduction in passenger car sales. Also, 300 dealerships have shut down recently, affecting around 10 lakh jobs in the auto component manufacturing industries. These factors have contributed to overall unemployment in India. The unemployment rate has risen from 6.6 percent in January 2019 to 8.45 percent in October 2019 (The Centre for Monitoring Indian Economy, 2019). Reduced jobs, inability to create new jobs and other factors resulted in a contraction in consumption expenditure, that is, private final consumption expenditure (PFCE). PFCE is an essential component of GDP in India as it contributes around 55-60 percent of the total GDP. However, a sharp fall in PFCE in the first quarter of the fiscal year 2019–20 to 3.1 percent compared to 7.2 percent in the last quarter of 2018–19 has significantly contributed to the economic slowdown (Reserve Bank of India, 2019).

In addition to the factors mentioned above, the economy is also affected by some exogenous factors. Due to the trade war, increasing tension between the USA and China has contracted global trade, which has affected India's exports. Indian exports have been declining for the last two consecutive quarters, from 580014 crore rupees in the third quarter of the fiscal year 2018-19 to 552461 crores in the second quarter of the fiscal year 2019-20, causing a 4.75 percent decline in these nine months (Reserve Bank of India, 2019). However, there is an argument that India should benefit from the trade war as the companies are coming out of China and looking for new destinations to set up their production units. However, due to a lack of competitiveness with other economies in terms of profitability, as corporate tax rates are high, India cannot attract companies to set up their manufacturing units here. Apart from all these, the Indian economy predominantly depends on domestic consumer demand for its growth in GDP terms. However, consumption-driven growth cannot be sustainable as an increment in consumption demands finances through dipping savings and increasing leverage. Also, to get a higher growth rate for a more extended period like China, it has to look for alternatives. One alternative could be significantly increasing its exports to reduce its reliance on domestic consumption demand. To achieve this goal, India has to expand its manufacturing sector by increasing production capacity and setting up new manufacturing units. Increased production can help in enhancing export capacity.

EFFECTIVENESS OF CUT IN CORPORATE TAX RATE

To analyse the implication of the fiscal reform introduced by the government of India, it is essential to know the importance of corporate taxation for the Indian economy. As announced by the current Finance Minister in her Budget speech, corporate tax is the single largest source of income for the government of India. For every rupee earned by the government, 21 paise comes from corporate taxation (Government of India, 2019). However, the present situation is different from that of the earlier period (see Figure 1).

Figure 1: Trends in Share of Corporate Tax Rate in GDP



Source: Economic Survey, Government of India, various issues
*Budget Estimates

As shown in Figure 1, the contribution of corporate taxation in the GDP has been increasing continuously over the years. From 1.1 percent of GDP in 1985-86 to 3.9 percent of GDP in 2007-08, it is the highest contribution so far. After that, it declined to 3.34 percent in 2017-18, and it is estimated to be 3.32 percent in 2018-19 according to budget estimates (see Figure 1). Nevertheless, the budget estimates must be revised as the fiscal reform comes after the budget announcement. Historically, it has been seen that whenever there was a cut in the corporate tax rate, it has contributed towards an increase in corporate tax as a share of GDP. In 1990-91, a cut in corporate tax rate from 51.75-57.5 percent to 45 percent and then a further cut down to 35 percent in 1997-98, showed an upward trend in corporate tax revenue collection from 0.9 percent of GDP in 1990-91 to 1.4 percent of GDP in 1995-96, and after the cut of 1997-98, it has improved gradually from 1.3 percent in 1997-98 to 3.9 percent in 2007-08, and in between, a further cut was made in 2004-05 by the government, which helped in boosting the tax collection. After that period, the collection of corporate tax revenue is declining. So, whenever there is a cut in the corporate tax rate, it helps the government increase the collection of corporate tax revenue as proposed by the Kelkar Task Force Report (2002). One possible reason could be that lower corporate tax rates left the companies with a larger share of their profits, which they used for re-investment to enhance their profitability further. While increasing their profits, the companies have also contributed to increasing the tax base. This expansion in the tax base has resulted in higher tax revenue for the government of India.

It is evident from Figure 1 that a reduction in the corporate tax rate and the elimination of tax incentives for companies can result in the broadening of the tax base. However, it will take some time to realise the effect. For the time being, the government may have to bear an amount of 1.45 lakh crore per year as revenue foregone from the fiscal reform. However, instead of looking at it as a loss of tax revenue, this can also be seen as an expenditure made to boost economic growth. This fiscal reform may have incurred a loss to the government in the form of a loss of tax revenue. However, it will go into the

hands of the corporate sector as tax relief, which they can utilise to pay back loans and buy back debts (which are faced with excessive debt obligations). Ultimately, it can help improve balance sheets, pay a higher dividend to shareholders, or boost salaries to pump credit into the system, which will help the economy in both ways. It will provide support on the supply side. However, it will also have a demand-side effect. It would help with a pick-up in demand through higher salaries to workers, higher dividends to shareholders, and a reduction in prices, which may have a more immediate effect. However, it is not easy to estimate its impact on the current year.

Further, since the rate of inflation is within the RBI's target range of four percent, with a deviation of two percent on either side, the reduction in the effective corporate tax rate from 30.4 percent to 25.17 percent would immediately benefit corporations in the following ways:

1. The after-tax profits of the companies will increase as they have to pay less tax on their profits;
2. More investment projects will be economically feasible due to higher returns on capital invested after tax.
3. There will be a rise in corporate cash flow in the economy;

A reduction in the corporate tax rate is also beneficial for the capital formation process. The equity price will increase due to an increase in the after-tax profit of the corporation and an improvement in the real after-tax return on capital investment (as inflation is at the targeted level, so it will not eliminate the benefits of the tax cut). As a result of a rise in equity prices, equity investors would most probably expect appreciation returns in addition to their dividend returns. It will result in a higher total return on equity investment for corporate investors, making equity investment more competitive with other investment options. As a result, more equity capital will be available in the hands of corporations. Therefore, corporations can reduce their reliance on debt financing as more equity capital is less risky than debt financing. A reduction in the demand for debt financing should also reduce interest rates, thereby making more capital investment projects economically feasible and, at the same time, further increasing the relative returns from equity investment. Thus, reducing the corporate tax rate should help end the vicious circle by having favorable impacts on investment, profitability, creating a healthier security market, and employment (Brown, 1978).

Furthermore, too much reliance on domestic consumption demand for growth cannot lead the Indian economy to grow faster. It has to look into expanding its manufacturing sector and exports significantly. However, as mentioned earlier, the manufacturing sector in India is going through a bad phase due to the economic slowdown. The corporate tax rate was not competitive enough to attract foreign investment and companies to set up their manufacturing units in India. Previously, India was in the second position with the highest corporate tax rate among the G20 countries, only after Argentina (see Table 1). However, other Asian countries had lower rates than India, which made them attractive as an investment destination (ceteris paribus). Therefore, India was not competitive due to its high corporate tax rates. To make India competitive, it essentially needed to cut its corporate tax rate. However, it was a matter of debate for many about how much the tax rate should be reduced. In 2015-16, the then Finance Minister announced that the basic corporate tax rate would be reduced to 25 percent. However, on September 20, 2019, the current Finance Minister announced that the basic corporate tax for existing domestic companies would be 22 percent. The effective rate will be 25.17 percent, including all cess and surcharge (Press Information Bureau, 2019). However, after the announcement, other countries have also revised their tax rates to increase their competitiveness in the world market. However, it is not that other countries are doing so just because India will do it. They have done so as it is an effective strategy to enhance their competitiveness in the world economy as the weighted average

statutory corporate income tax rate has declined from 46.64 percent in 1980 to 29.41 percent in 2017, representing a 37 percent reduction over the 37 years (Abbas et al. 2012; Bunn, 2018).

In the era of globalisation, capital flows into economies with higher profitability. With the new effective tax rate, India has become a lucrative destination to invest in and set up a new manufacturing unit in India. At 17.01 percent, India's tax rate for new domestic manufacturing companies is the lowest among the G20 countries (see Table 1). With investment coming to India and starting production units in India, it will boost the "Make in India" campaign, aiming to make India a manufacturing hub for the world and become a leader in exports like China. This fiscal reform creates employment in huge numbers as manufacturing, and other sectors need extra labour to expand their production activities. Wages or salaries will also hike as demand for labour positively correlates with wages. Thus, a reduction in the corporate tax rate could go a long way towards solving the prevailing problems of the economic slowdown in the Indian economy. And not only that, it will help in making structural changes in the economy by transforming India from a consumption-driven economy to an export-driven economy.

Table 1: List of G20 Countries with their Present and Previous Effective Corporate Tax Rates

Country	Region	Present	Previous
Argentina	America	35	35
Brazil	America	34	34
France	Europe	31	33
Japan	Asia	30.86	30.86
Australia	Australia	30	30
Germany	Europe	30	30
Mexico	America	30	30
South Africa	Africa	28	28
Canada	America	26.5	26.5
India	Asia	25.17 (17.01)*	34.61
China	Asia	25	25
Indonesia	Asia	25	25
Netherlands	Europe	25	25
South Korea	Asia	25	25
Spain	Europe	25	25
Italy	Europe	24	24
Turkey	Europe	22	22
United States	America	21	21
Russia	Europe	20	20
Saudi Arabia	Asia	20	20
United Kingdom	Europe	19	19
Switzerland	Europe	18	18
Singapore	Asia	17	17

Source: Tradingeconomics.com

* 17.01% is for new manufacturing units.

DANGERS OF CUT IN CORPORATE TAX RATE

Past evidence shows that a cut in the corporate tax rate effectively increases corporate tax revenue. However, it takes time to realise the effects on tax revenue. However, possible adverse effects of a cut in the corporate tax rate should be considered since it will have a more immediate effect on the economy.

The government's estimate of tax revenue foregone from the fiscal reform is 1.45 lakh crores per year. It would increase the fiscal deficit target for the government. According to budget estimates for 2019–20, total tax revenue collection from corporations will be 7.66 lakh crores in 2019–20. However, after deducting the cost of the fiscal reform, it will be 6.21 lakh crores (18.9 percent decline from budget estimates). The fiscal deficit target for the government has to be revised due to the reduction in corporate tax revenue. The fiscal deficit, including the cost of the fiscal reform, will be 848,760 crores, which is 4 percent of the GDP estimated by the government of India. So, the reform will cost around 0.7 percent of GDP, as estimated for 2019–20. However, if the government of India wants to keep the fiscal deficit at the targeted level, it has to curb its expenditure. In both ways, the reform will have a detrimental effect on the Indian economy in the short term. Therefore, it can further aggravate the problem of economic slowdown.

Moreover, with a cut in the corporate tax rate, a larger share will be in the hands of corporates, and they have to decide whether they should increase their production through investing out of their profits or keep it with them. If they decide to hold their profits as savings, this will widen the gap between rich and poor. Therefore, this fiscal reform can affect income distribution in favour of the wealthy class (Nallareddy, Rouen & Suárez Serrato, 2018). Considering the present scenario of weak consumer demand, a rational investor (or producer) would not make a new investment (or increase its production capacity). Instead, it can curtail its production if consumer demand falls further (as reflected in India's manufacturing sector). It would again curtail jobs and wages. Consequently, result in the prevalence of higher income inequality in society.

Further, a cut in corporate tax rate may also impact the fiscal democracy of the government as international tax competition harms the national tax autonomy of all countries. This Increased competition among the countries constraint their ability to impose a tax on mobile capital. However, small economies can benefit from a cut in the corporate tax rate but at the cost of large economies as fighting back by large economies through lower tax rates will be too costly for them (Genschel & Schwarz, 2012).

CONCLUSIONS

Looking at the scenario of the Indian economy, it became necessary for the Government of India to respond to the slowdown in economic activities. In this respect, a cut in the corporate tax rate is very effective due to the growing importance of the corporate sector in the Indian economy. Moreover, changes in corporate tax rates can induce both supply-side and demand-side factors, which makes it an important policy tool to deal with the present economic slowdown and make structural changes to attain higher growth for the Indian economy. However, it will take some time to realize these effects. However, it may enhance existing economic slowdown and income inequality in the short run. To deal with this, the Government of India has to bring some other reforms to revive economic activities. Overall, the policy of cut in corporate tax rate by the Government of India is needed to boost the Indian economy. However, India has to bring some other reforms to become a sustainable economy with higher growth rates. For the time being, it can be said that it is one of those fiscal reforms needed to make structural changes in the economy, and many other reforms are coming ahead with time.

REFERENCES

Abbas, S. M. A., Klemm, A., Bedi, S. and Park, J. (2012).*A Partial Race to the Bottom: Corporate Tax Developments in Emerging and Developing Economies*. International Monetary Fund

Ambirajan, S. (1964).*The taxation of corporate income in India*. Bombay: Asia Publishing House

Brown, M.V. (1978).*Reducing Taxation of the Corporate Income Stream: The Corporate Tax Rate and Taxation of Dividends*. Financial Analysts Journal 34(03): (57-63)

Bunn, D. (2018).*Corporate Income Tax Rates around the World, 2018*Retrieved December 2, 2019 from https://taxfoundation.org/corporate-tax-rates-around-world-2018/

Chakraborty, P. (1997).*Tax Reductions and Their Revenue Implications: How Valid Is the Laffer curve?* Economic and Political Weekly 32(17): (887-890)

Chelliah, R.J. (1996). *Towards sustainable growth*. New Delhi: Oxford University Press.

Chelliah R.J. (2002).*Task Force Recommendations on Direct Taxes*. Economic and Political Weekly 37(50): (4977-4980)

Genschel, P. & Schwarz, P. (2012).*Tax competition and fiscal democracy,* TranState working papers, No. 161, University of Bremen, Collaborative Research Center 597: Transformations of the State.

Government of India (2019).*Budget Document 2019-20*.Ministry of Finance. New Delhi: Government of India.

Ministry of Finance (various issues).*Economic Survey*. New Delhi: Government of India.

Minister of Finance & Company Affairs (2002).*Report of the Task Force on Direct Taxes*. New Delhi: Government of India.

Nallareddy, S., Rouen, E., & Suárez Serrato, J. C. (2018). *Do corporate tax cuts increase income inequality?* (No. w24598). National Bureau of Economic Research.

Press Information Bureau (2019).*Corporate tax rate slashed to 22% for domestic companies and 15% for new domestic manufacturing companies and other fiscal reliefs.*Retrieved November 22, 2019 fromhttps://pib.gov.in/newsite/PrintRelease.aspx

Reddy, Y.V. & George, R. (2013).*Corporation tax in India: the road travelled so far*. Decision Official Journal of Indian Institute of Management Calcutta 40(3): (213–221)

Reserve Bank of India (2019). "Handbook of Statistics on the Indian Economy." *RBI Database*

Schumpeter, J. (1942).*Capitalism, Socialism, and Democracy*. United States: Harper & Brothers

Society of Indian Automobile Manufacturers (2019).*Auto Market De-Growth Continues Exports of Passenger Vehicles and Two Wheelers Positive.*Retrieved February 1, 2020 fromhttps://www.siamindia.com/pressrelease-details.aspx?mpgid=48&pgidtrail=50&pid=441

Society of Indian Automobile Manufacturers (n.d.). Domestic sales trends Retrieved December 22, 2020 fromhttps://www.siam.in/statistics.aspx?mpgid=8&pgidtrail=14

The Centre for Monitoring Indian Economy (2019).*Unemployment Rate in India*. RetrievedJanuary 2, 2020 from https://unemploymentinindia.cmie.com/

Tradingeconomics.Com (2019). List of Countries by Corporate Tax Rate | G20Retrieved January 2, 2020 fromhttps://tradingeconomics.com/country-list/corporate-tax-rate?continent=g20