Economics

DBS Flash

India: Bets on investment revival with USD20bn tax cuts

Economics/Growth/Monetary/Rates/India

DBS Group Research September 23, 2019

Radhika Rao
Economist

Please direct distribution queries to
Violet Lee +65 68785281 violetleeyh@dbs.com

- *In a reflection of rising urgency to tackle slowing growth, the authorities announced a major set of corporate tax rate easing measures on Friday*
- *Tax on new companies and minimum alternative taxes will be lower*
- *India's rates are now closer to most Asian peers*
- *This potentially carries positive multiplier impact, starting with near-term revival in sentiments*
- *This will lower tax liability for companies, in a structure that is unevenly distributed*
- *Equity markets surged on Friday, while risk-free yields ticked up*
- ***Implications for forecasts**: Measures will entail fiscal costs, pointing to a risk of fiscal slippage or reassessment of the sovereign bond option*
- ***Implications for markets**: Equity markets are likely to stay buoyed. Bond markets will watch the fiscal math with trepidation*

Government cuts corporate tax rates

Following several micro measures in the past month, the government announced a big-ticket fiscal package on Friday. Corporate tax rates were lowered across the board, with those that don't avail any tax incentives to now fall to 22% from 30% earlier. This takes the effective tax rate after surcharge to 25.1% (vs over ~33%). New manufacturing units could avail of an attractive 17% effective rate. An ordinance was passed on Friday to make required changes to the Income Tax Act, making it effective from retrospective from April 1, 2019. Further details are likely in the weeks ahead.

Domestic benchmark equity indices rallied over 4% cheering the decision, boosting the rupee against the dollar. Bond yields, however jumped by over 20bps worried over the fiscal impact.

Highlights of the measures

- Corporate tax rate to be 22% without exemptions
- Effective tax rate after surcharge to be at 25.17%
- The new tax rate is subject to the condition that companies won't avail any other incentive
- Minimum Alternative Tax (MAT) reduced to 15% from 18.5%
- Effective tax for new company setting up from October 2019 shall be 17.1%, in a boost to 'Make in India' initiative and broader manufacturing sector

- Companies that enjoy tax holidays can avail concessional rates after exemption period
- Enhanced surcharge announced in Budget shall not apply on capital gains arising on sale of any securities including derivatives in the hands of foreign portfolio investors
- Buyback tax for listed companies announcing buybacks is exempted
- Enhanced surcharge will not apply to capital gains arising on equity sale or equity-oriented funds liable to STT stabilise flow of funds into capital markets.
- CSR 2% spending to include government, PSU incubators and public funded education entities, IITs

Breakdown of the companies' profiles and effective rates before Friday's move

These tables show sample companies across effective tax rates. The numbers show that a large number of companies contributed a disproportionately lower amount of taxes in relation to their profits in FY18 (likely in FY19 as well). One also notes that the tax liability across companies is unevenly distributed.

Effective tax rate* of companies in the manufacturing and non-manufacturing sectors (FY19)

Share in total profits (%)	% of cos.	Share in total profits (%)	Share in tax liability (%)	Effective tax rates (%)*
Manufacturing	15.5	39.0	36.8	27.8
Non-manufacturing	84.5	61.0	63.2	30.6

*prior to 20 Sep's cuts

Source: Budget, DBS

Profile of companies across range of Effective tax rates (FY18)

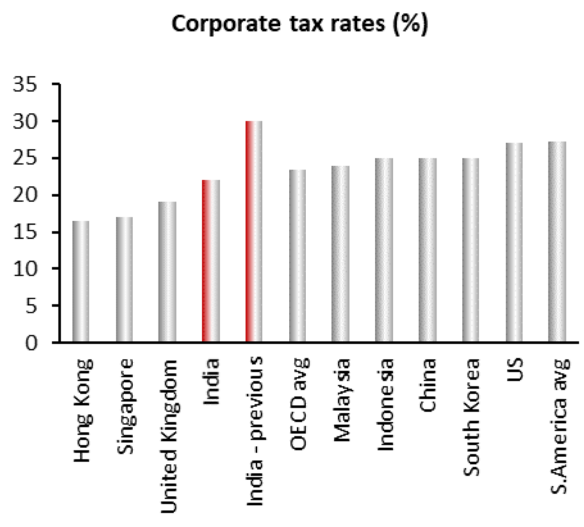
Effective tax rates (%)*	% of cos. (vs total)	Share in total profits (%)	Share in tax liability (%)
Less than zero - 0	45.1	3.2	1.4
0-20	10.3	14.4	7.8
20-25	4.9	27.2	21.8
25-30	18.8	16.3	16.4
30-33	6.3	33.4	41.8
>33	4.1	5.6	10.9
Indeterminate (PBT=0)	10.5	0	0

*prior to 20 Sep's cuts

Source: Budget, DBS

Real impact

The new effective rate takes India closer to its regional peers, on par with China, South Korea, Indonesia (announced an upcoming cut to 20%) and OECD average.



Source: KPMG, DBS

These changes come as a positive surprise and intended at breaking the cycle of weak sentiments and subdued economic activity. **The real impact will have far reaching for the economy.** First up, this change will result in lower tax outgo for companies that pay normal tax across sectors, including corporates, firms, non-banks, cases stuck under the solvency board etc. payables reduce by ~5-7%.

Secondly, cash savings is expected to encourage leveraged companies to lower their liabilities or cash-rich companies to mull over resuming capex, which in turn carries positive multiplier effects for stakeholders and rest of the economy in the medium-term (bigger operations to carry employment opportunities and higher consumption).

Next, the most notable change is for new manufacturing companies who will henceforth be taxed at 17% amongst the lowest compared to regional peers, marking a boost for *Make in India* initiatives and draw in local/ foreign interests. This is particularly opportune as competition amongst regional peers has been rising to attract divestment flows from companies impacted by the US-China trade conflict. Finally, lower upfront costs compared to the previous tax regime might also convince unorganised players to scale up operations and join the formal sector, thus increasing the overall tax base and collections.

Clearly there will be fiscal costs. The government has pegged the revenue forgone at an estimated around INR1.45trn (0.7% of GDP) per year. Concomitantly, we are mindful that the government will also make some savings on the exemptions that companies were previously availing of and henceforth will have to scale back, if they wish to enjoy lower tax rates. **We assume here that these savings have been accounted for in the fiscal cost estimate provided by the Finance Ministry.**

Without any other revenue offsetting measures, this singlehandedly takes the deficit from -3.3% higher by 0.6-0.7% higher. This trepidation was most telling in the bond markets, as 10Y yields jumped by over 20bps in on Friday. That the fiscal target was not revised has raised hopes of revenue boost from other sources - a) higher borrowings – but this has been denied by the Finance Minister. This suggests a reassessment of the sovereign bond option which will help tap strong global liquidity, b) compensated by savings from existing revenue/ spending heads. Part of this cost will be absorbed by the boost from RBI's excess surplus (0.3% of GDP) as well as accelerated asset divestment plans. News of slower disbursements under the PM Kisan Yojana due to absence of sufficient and updated lack records, could also result in a smaller spending burden than budgeted (INR870bn or 0.4% of GDP). Year-to-date tax and non-tax revenues are tracking below the budgeted pace, pointing to about a 0.5% of GDP shortfall (micro measures add 0.1-0.2%).

Hence, a bid to keep the overall deficit near manageable levels of -3.5-3.6% of GDP will require a scaling back in expenditure in the second half of the year. **With the impact likely to take time to feed through in the coming months, we keep to our growth forecast for the year.**

The central bank is likely to watch these developments closely as risk-free rates rise. With this fiscal boost focused on investment revival and not consumption (hence not inflationary), we reckon that the RBI MPC might proceed with a modest cut at the October MPC. Governor Das also reinforced his dovish bias due to weak inflation and negative output gap.

Group Research

Economics & Macro Strategy

Taimur Baig, Ph.D.
Chief Economist - G3 & Asia
+65 6878-9548 taimurbaig@dbs.com

Chang Wei Liang
Strategist
+65 6878-2072 weiliangchang@dbs.com

Nathan Chow
Strategist - China & Hong Kong
+852 3668-5693 nathanchow@dbs.com

Masyita Crystallin, Ph.D.
Economist – Indonesia & Philippines
+62 21-2988-4003 masyita@dbs.com

Joanne Goh
Regional equity strategist
+65 6878-5233 joannegohsc@dbs.com

Eugene Leow
Rates Strategist - G3 & Asia
+65 6878-2842 eugeneleow@dbs.com

Chris Leung
Economist - China & Hong Kong
+852 3668-5694 chrisleung@dbs.com

Ma Tieying, CFA
Economist - Japan, South Korea, & Taiwan
+65 6878-2408 matieying@dbs.com

Radhika Rao
Economist – Eurozone, India, & Thailand
+65 6878-5282 radhikarao@dbs.com

Irvin Seah
Economist - Singapore, Malaysia, & Vietnam
+65 6878-6727 irvinseah@dbs.com

Samuel Tse
Economist - China & Hong Kong
+852 3668-5694 samueltse@dbs.com

Duncan Tan
FX and Rates Strategist - Asean
+65 6878-2140 duncantan@dbs.com

Philip Wee
FX Strategist - G3 & Asia
+65 6878-4033 philipwee@dbs.com

Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).