Matthews Asia Perspective

The Implications of India's Tax Cuts

Sriyan Pietersz
Investment Strategist
Matthews Asia

India's sluggish economy has been in a slow, downward spiral. Initially this was caused by non-performing loans that hampered credit supply, then by unintended effects of government reforms from demonetization to Goods and Services Tax (GST) implementation, a liquidity squeeze in the shadow- banking sector that choked consumption, and finally by a crisis of confidence in the consumer and business sectors.

The Reserve Bank of India took aggressive measures with 110 basis points of rate cuts and liquidity easing year to date. But the central bank's latest action, a significant fiscal stimulus in the form of US$20 billion in tax cuts aimed at boosting investment and consumption, may re-ignite confidence. The measures signal a shift in the government's stance from prioritization of stability to growth and underpin the potential for an investment-led growth recovery in 2020.

Importantly, the tax stimulus also should offer foreign corporations a competitive alternative for manufacturing investment as they seek options to diversify away from China. As growth recovers, tax revenues should also recover, helping to narrow the fiscal deficit over the medium term.

Corporate Tax Cuts Aimed at Reviving Economy

India's government announced the stimulus measures to revive an economy that decelerated from GDP growth of 8% year-on-year to 5% within one year. The cornerstone of the measures so far is the US$20 billion stimulus in the form of a corporate tax cut that lowers the effective tax rate to 25% from 34%, effective from the current fiscal year 2020 that started in April 2019.

Companies are given the option to pay tax at the new rate, subject to the condition that prior exemptions would no longer apply. This would make sense for some—the average tax rate for the top 100 companies in India is 30% (and the median is 32%). Companies that wanted to continue to claim tax exemptions could do so and move to the new lower rate when the exemptions expire. For these companies, the minimum alternate tax rate was reduced to 15% from 18.5%, providing some positive relief. The impact on total tax revenue will be around 0.7% of GDP, of which around 0.4% is at the central budget level (with the remainder at the state level).

Options for Corporations

The tax cuts provide corporations with several options: 1) raise retained earnings or pay down debt; 2) distribute gains to shareholders; 3) use tax savings to lower prices for consumers; or 4) invest in capital expenditures.[1] Out of these, corporations are most likely to invest in capex for a few reasons: the government has given a new 17% tax rate incentive for manufacturing investment (vs. the 25% general rate); the capex cycle had bottomed out; and improved business sentiment tends to have a positive feedback loop.

[1] Capital expenditures is the money spent by a business on acquiring or maintaining fixed assets, such as land, buildings and equipment.

Capex investment is a significant driver of Indian economic growth—particularly corporate capex, which is almost double the size of the public capital expenditure. Additionally, the manufacturing element is notable. Close to half of the private sector is employed in manufacturing, and increased investment drives job and income creation, which in turn support sustainable consumption (as opposed to consumption funded by debt or savings drawdown).

Tax Cuts Put India in More Competitive Position

The new 17% tax rate for new manufacturing companies set up after Oct. 1, 2019, looks aimed at pulling in manufacturing foreign direct investment (FDI) from companies looking to diversify investment from China. At a national level, the tax cuts put India in a more competitive position in terms of attracting FDI inflows. A 17% tax rate puts it on the same level as Singapore and at the headline 25% it brings India closer to Taiwan, Thailand and Vietnam, which levy a 20% corporate tax.

Other regional competitors such as Indonesia have announced tax cuts. The cuts do not phase in until 2021, however, whereas India's cut is effective now. It is worth noting that apart from Taiwan, Korea and Vietnam, the data indicate that only India has picked up any production relocation flows (around US$1.1 billion, the same as Vietnam, although not very significant relative to Indian GDP)—and this is before the tax cuts. So while other issues related to land, labour, infrastructure, and the ease of doing business may take time to change, the tax factor could actually help make India a serious option.

A Boost to Confidence

From a broader perspective, the tax cuts have provided an immediate boost to confidence and may have helped arrest downside risks to growth while providing a catalyst for an improved structural domestic growth trend. The short-term implications of the cuts have been positive for markets: the equity market reaction was India's biggest one-day move in a decade. While the economic benefits won't accrue immediately, the economy can benefit longer term as growth picks up due to rising inbound investment, job creation and thus a boost in incomes. Sectors that are exposed to this shift are those in consumption-oriented sectors, select banks and industrial estates.

These tax changes come alongside other government announcements such as liberalizing FDI regulations in contract manufacturing, providing additional liquidity support to Housing Finance Companies and plans to recapitalize SOE banks. Taken as a whole, these should help arrest the negative feedback loop in the economy and stabilize demand.

The Fiscal Implications

Having covered the benefits of the tax stimulus, it is worth considering the fiscal implications around the tax cuts. At 0.7% of GDP, the hit on the tax base is material. The tax cuts are likely to cause some slippage in the FY20 fiscal balance toward -4% of GDP (from the FY20 target of -3.3%). The authorities are likely to offset part of this slippage by a higher disinvestment target and lower on-budget food subsidies. It must be noted, however, that the main uncertainty that already existed on tax revenues stems from the weak underlying economic conditions.

If these conditions persist, weakening business and consumer confidence are likely to spiral downward into even lower investment and consumption in the following fiscal year (particularly since private corporate investment is the major component of overall investment). This would then lead to even weaker tax revenues and further deterioration in the fiscal deficit. In turn, this could cause sovereign bond yields to rise and drive reversal of capital flows that are needed to finance India's current account deficit.

Consequently, we believe that fiscal stimulus is a positive strategy that when employed together with significant liquidity and monetary stimulus (110 basis points year to date), will help to drive a recovery in growth in 2020. Low base effects will also apply from 2020, making a solid growth recovery likely. As growth recovers, tax revenues should also recover, helping to narrow the fiscal deficit over the medium term.

Date	Announcement	Details
Aug. 23	Foreign portfolio investment (FPI) surcharge	Removal of enhanced surcharge levied on FPI under budget announcements
	State-owned enterprises recapitalization	Upfront immediate release of pre-announced 700 billion Indian rupee for SOE banks recapitalization
	Banks loan products	Banks to launch repo rate/external benchmark linked loan products
	Liquidity to housing finance companies	Additional liquidity support to Housing Finance Companies 200 billion Indian rupee by the National Housing Board thereby increasing it to 300 billion Indian rupee
	Micro, Small and Medium Sized Enterprises (MSMEs) Goods and Services Tax (GST) refund	All pending GST refund due to MSMEs to be paid within 30 days. In future all GST refunds to be processed in 60 days of application. Delayed payment from government/central public sector enterprises to be reviewed by cabinet secretariat
	Ease of Doing Business	Continued focus toward "Ease of Doing Business." Violations under corporate social responsibility rules to be treated as civil liability and not a criminal offence
	Additional depreciation for autos	15% additional depreciation benefit in fiscal year 2020 on purchase of automobiles
	Autos Scrappage Policy	Government will consider a scrappage policy for autos
	Removal of new vehicle purchase ban	Ban on purchase of new vehicles on government departments removed
Aug. 26	Reserve Bank of India (RBI) dividend	RBI announced an annual dividend of Rs1,760 billion Indian rupee, including a special dividend of 526 billion Indian rupee
Aug. 28	Policy boost to manufacturing	Liberalization FDI regulations in contract manufacturing, relaxed souring norms for single brand retail and relaxation of FDI rules in coal mining and media.
Aug. 30		Third wave of SOE bank mergers announced including recapitalization plans.
Sept. 14	Policy boost to exports and housing	MEIS scheme in exports replaced by new scheme while a stressed fund was announced for the real estate sector
Sept. 19	Corporate tax cuts	Government announces corporate tax cuts lowering effective rate to 25% from 34%.

IMPORTANT INFORMATION

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