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Is there a scope for lowering corporate tax rate further?

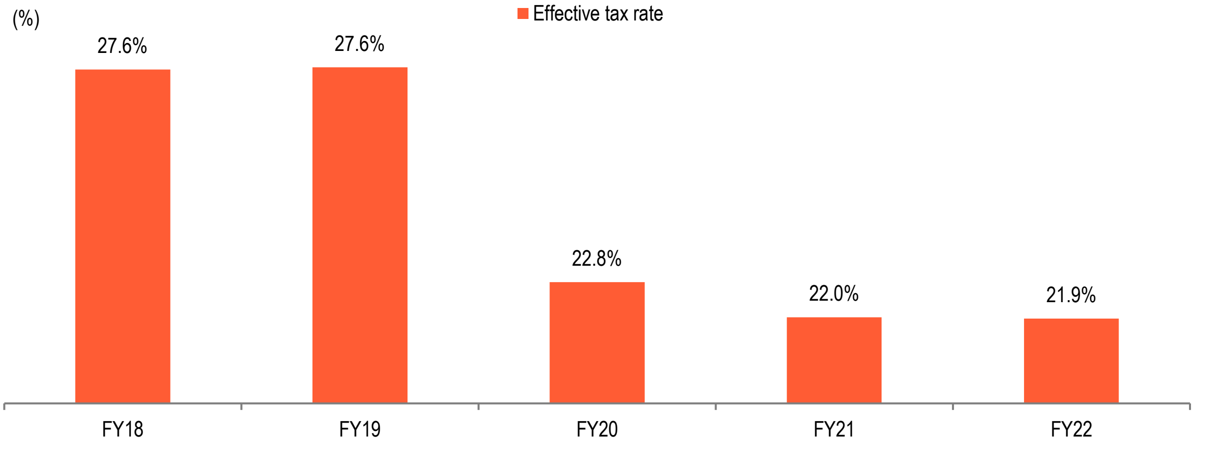
In Sep'19, the Union Government in a surprise move slashed corporate tax rate on both existing and new domestic manufacturing units. This was done to incentivize domestic production amidst a loss in economic momentum. Subject to the condition that no other incentive or exemption is availed by a domestic company, it can pay a tax rate of 22%, which implies an effective tax rate of 25.17%. Similarly, to attract fresh investments, tax rate for new domestic companies (incorporated after 1 Oct 2019) was also reduced to 15% (effective tax rate of 17.01%).

With the Budget coming up, suggestions and demands have been put forward to lower the corporate tax rate further to spur investment and production. This comes against the backdrop of emerging signs of deceleration in the economy. Firms have been grappling with higher input costs, which still have not been fully passed on the consumers. There have also been early signs that the pent-up demand narrative is slowly fading. Even on the global front, there have been increased expectations of a global recession.

In this study, we have looked at a sample of 5,714 companies spread across both manufacturing as well as the services sector, since we want to understand what has been the trend in the effective tax rate for these companies. We have looked at the effective tax rates over the last 5 years i.e between FY18-FY22. In the next step, we have removed companies which had a negative Profit Before Tax (PBT) in any of the five years. The sample size then comes down to 2,576 companies. With this sample, we then calculate the effective tax rate and analyse the same.

For the aggregate sample, we see that the effective tax rate has declined from 27.6% in FY18 and FY19, to 22.8% in FY20 as the reduced corporate tax became effective from this year. Since then, there has been some further moderation in the effective tax rate which continues to hover around ~22%. It is interesting to note that this is below the effective tax rate of 25.17% specified by the government.

Figure 1: Effective tax rate has come down



Source: Ace Equity, Bank of Baroda Research

We now look at the effective tax rate of companies in FY22. For this, we have constructed a frequency distribution of companies. It can be seen that a majority of companies (44.1%) had an effective tax rate between 25-30%. This is consistent with the government notified effective tax rate. Furthermore, around 20% companies had a lower tax rate of between 20-25%, and another 17% having an effective tax rate of below 20%. The divergence between firms with respect to the effective tax rate is due to the extent of exemptions/subsidies taken by the particular business. However, there are companies which had a higher tax rate of above 30%. Most of these were concentrated in the finance, capital goods, chemicals and textiles sector. It must be noted that there are some companies which had negative tax in FY22. These have been categorized separately, however their number is very low (3%).

Table 1: Effective tax rate across companies

Effective tax rate	Number of companies	% Share of Total
More than 30%	399	15.5
Between 25-30%	1,136	44.1
Between 20-25%	520	20.2
Less than 20%	443	17.2
Negative tax	78	3.0
Total	**2,576**	**100.0**

Source: Ace Equity, Bank of Baroda Research

Next we have categorized the companies on the basis of their net sales in FY22. We have roughly used the MSME definition given by the government. It must be noted that while it pertains only to manufacturing firms, we have included services firms as well. Across all categories, there has been a reduction in effective tax rate in FY20 (when the government lowered corporate tax rate). On a disaggregated level, for companies with turnover less than Rs 5 crore (micro), the effective tax rate has been very low in almost all the years. Interestingly, while the effective tax rate for these firms averaged around 14% between FY18-FY20, it actually increased to 15.2% in FY21. In Fy22, this dropped sharply to 12.1%.

Table 2: Effective tax rate across companies

Net sales in FY22	Number of companies	FY18	FY19	FY20	FY21	FY22
less than Rs 5 crores	434	14.8	14.4	14.2	15.2	12.1
Less than Rs 5-50 crores	319	18.0	22.2	18.9	25.4	21.3
Between Rs 50-250 crores	608	22.9	22.0	18.4	21.9	21.8
Over Rs 250 crores	1,215	28.0	27.9	23.0	22.1	22.1
Total	**2,576**	**27.6**	**27.6**	**22.8**	**22.0**	**21.9**

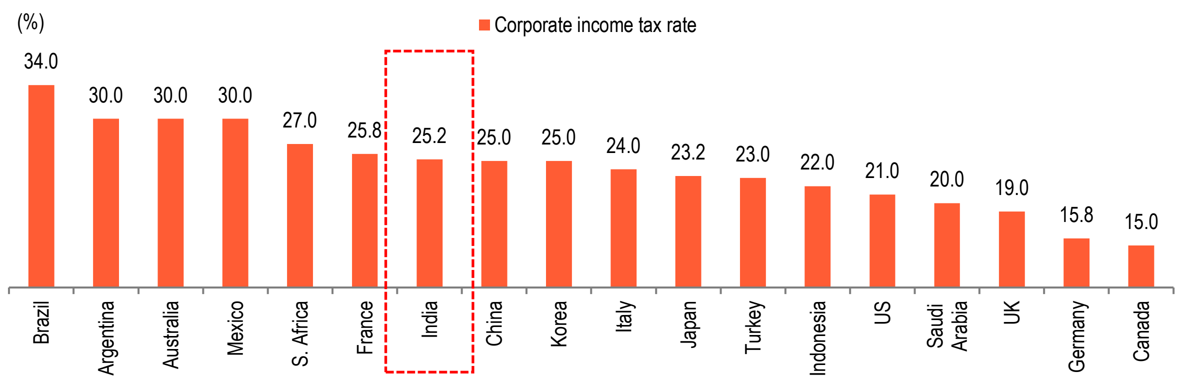
Source: Ace Equity, Bank of Baroda Research

For firms with net sales between Rs 5-50 crores, the effective tax rate has shown variation. While it reduced to 18.9% in FY20 from 22.2% in FY19, it edged up significantly in FY21 to 25.4%. It did decline to 21.3% in FY22, but has remained above average. For medium enterprises (turnover between Rs 50-250 crores), while the effective tax rate declined from 22.9% in FY18 to 18.4% in FY20, it edged up to 21.9% in the year thereafter and remained elevated at 21.8% even in FY22. For the large companies (annual turnover exceeding Rs 250 crores), which account for more than 40% of the total sample, the effective tax rate has been relatively higher. However, the tax rate has shown significant moderation. From 28% in FY18, it declined to 23% in FY20. It has remained at 22.1% in the period thereafter.

Conclusion:

It is not new for companies to demand tax sops in the run-up to the Budget. Companies put forward a myriad of factors supporting their claim, ranging from higher input costs to waning domestic demand. However, as this study shows, the effective tax rate for companies has declined sequentially and substantially, since the government announced the cut in corporate tax rate in Sep'19. Furthermore, the effective tax rate in India is lower than several other Emerging Economies such as Brazil and Argentina, and even some advanced economies such as Australia and France. Apart from this, fiscal cost for the government will also be a significant deterrent, particularly since the government is likely to focus on fiscal consolidation.

Figure 2: Corporate tax rate across countries



Source: Ace Equity, Bank of Baroda Research

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