

Corporate Tax: A brief assessment of some exemptions

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The government of India has announced its plans to gradually phase out incentives within the corporate tax regime and correspondingly reduce the statutory tax rate on corporate profits to 25 percent over a period. Such a proposal makes it imperative to evaluate the efficacy of the existing incentives in terms of the specific targets that each of these incentives were expected to achieve. Therefore, in order to establish whether the existing incentives have been able to achieve the desired outcomes three such incentives are evaluated- area based exemptions, incentives to special economic zones (SEZs) and the incentives to scientific research.¹

1. Exemption to Backward Regions

The union government initially offered the incentives for locating manufacturing activity in the north east with the introduction of the North East Industrial and Investment Promotion Policy. The government later extended such incentives to Jammu & Kashmir (J&K) in 2002 and to Himachal Pradesh and Uttarakhand in 2003. The period of each incentive policy announcement was 10 years, i.e., the units had to start commercial production within 10 years from the date of notification of the scheme. The policy announced for the North Eastern states lapsed in 2007, and has been followed by an extension of the same policy for another 10 years.

The incentives offered to companies for locating their production activities in backward areas include

1. 100 per cent exemption from Central excise duty (or CENVAT) for 10 years from date of commercial production
2. 100 per cent exemption from Corporate Income Tax (CIT) for initial five years followed by 30 per cent for companies and 25 per cent for other firms for a further period of five years from the date of commercial production. For states in the North East, CIT exemption of 100 per cent is available for the entire 10 year period.
3. Capital investment subsidy of 15 per cent of investment in plant and machinery subject to a ceiling of Rs. 3 million for new units as well as for existing units for substantial expansion. The ceiling is substantially higher for the

North Eastern states, where even subsidy of over Rs. 300 million can be approved by the DIPP.

4. There is an interest subsidy of 3 per cent on working capital loan given to units in J&K

The nature of incentives offered to companies operating within these states therefore must be evaluated on the basis of the size of activity in the states measured by the capital formation as well as the value added. However, there is also the possibility of economic activity shifting to the state where such incentives exist from the neighbouring states. Therefore, while trying to ask if the level of activity increased it must be evaluated if this increase came at the expense of a shift of activity from other states. Lastly, once the government decides to phase out such an incentive it may encourage some of the units to shift out of these states.

Based on the analysis undertaken by Rao et al. (2016) three main results emerge with respect to the incentives offered to backward regions. One, there has been an expansion in the economic activity in the incentivised regions with their share in total output/value added as well as in capital and employment increasing over time. But the benefits have not accrued uniformly to all the incentivised states. Uttarakhand and Sikkim seem to have benefitted **more than the other states**. **Two, there is not much** evidence of a large scale shift of economic activity from the neighbouring states to the incentivised states – since the level of activity did not decline in these states taken together. Three, on whether the states would witness sustained economic activity once the incentive period is over, evidence seems to suggest that the industry is footloose and hence a part of the economic activity might not be sustained once the incentives are withdrawn.

2. Incentives to SEZs

As per the SEZ Act 2005 the units operating in SEZs were given tax holidays and deductions for capital investment. All of these incentives were geared to achieve the targets as specified by the SEZ Act - higher level of activity, promotion of exports of goods and service, promotion of investment from domestic and foreign sources, creation of employment opportunities and development of infrastructure facilities. Given these objectives the tax incentives to SEZs are

evaluated in terms of their impact on investment, exports and employment.

It is observed that the total “incremental” investment in SEZs during the period 2004-05 to 2013-14 amounted to 1.74 per cent of total investment. When the incremental investment for 2004-05 to 2011-12 is calculated based on the change in the ratio of investment to GDP, total investment in SEZs accounts for only 8.02 per cent of such incremental additional investment. On the face of it, therefore, it is difficult to attribute the increase in investment in the period since 2004-05 to the SEZ policy. In other words, factors other than the SEZ policy seem to have played a larger role in driving the expansion in capital formation in India since 2004-05.

As far as exports are concerned, the estimates suggest that there is no statistical significant break in the performance of Indian exports in the period after the introduction of SEZs. In other words, while the exports of SEZs have increased much faster than that of exports from the rest of the country, the overall exports from India does not display an increase suggesting that perhaps the gains reported in SEZs may have come from a shift in location of exports from Domestic Tariff Area (DTA) to SEZs.

Further, given the level of Investment, it would appear that the employment generation in the SEZs is considerably lower than in the manufacturing sector in the DTA. While it is possible that investments reported in SEZs include a considerable amount of investment in infrastructure development, there is no evidence available currently on the split of investment into those by a developer and those by units located within SEZ.

3. Incentives to R&D

The deduction offered to expenditure on scientific research to companies that undertake in-house research is a super deduction of 200 per cent of the revenue expenses incurred by them, provided they have a dedicated research facility approved by the Department of Scientific and Industrial Research. For companies that do not carry out in-house research 175% weighted deduction is available for any payments made to a research association, university, college or other institution and 125 % of any payment made to a company.

The purpose of incentives to R&D is to promote innovation and/or improve production processes in the economy. Therefore R&D incentives can be evaluated on the basis of the returns that such R&D activity generates i.e. patents, incomes from patents as well as performance of companies undertaking R&D.

The result from the analysis suggest that while there seems to be some evidence of an economy-wide relationship between the patents applied for and the increments in R&D expenses as well as total income for use of intellectual property received from abroad, there seems to be no evidence to suggest that the companies witness an improvement in the process of production upon incurring R&D expenses. Further, the income per unit of the patents, trademark and industrial design have remained far below the global average which suggest that while India is increasingly registering patents abroad it is not registering a comparable income on its intellectual property.

Conclusion

There is evidence to suggest that companies are utilising the opportunities created by the provision of incentives. In the case of all the three incentives considered, the economic activity seems to have grown within the incentive regime. There is no clear evidence to support the conjecture that this growth in corporate activity within the incentivised activity is incremental additional activity which would not have existed if the incentive regime did not exist. This is especially evident in the case of special economic zones. This also suggests that the overall level of economic activity might not be very different if the incentive regime is withdrawn. In case the incentives being used to influence the location of economic activity, while there is anecdotal evidence to suggest that some of the economic activity might move out of the incentivised area after the incentive regime comes to an end, since that stage is not yet manifest, there is no firm evidence as yet on this aspect.

ⁱ Rao, R. Kavita, S. Tandon and S. Mukherjee (2016), “Corporate Tax: A brief assessment of some exemptions”, Working paper No. 165, National Institute of Public Finance and Policy (NIPFP), New Delhi, March 2016.