BUDGET 91-92 : CORPORATE TAXATION

J V M SARMA

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After the major overhaul of the corporate tax system last year, it is not surprising that the new budget has left it by and large untouched. Last year, by lowering the statutory tax rate by as much as 10 per cent points, by doing away with the minimum tax law, and by abolishing major tax incentives, namely, the investment allowance, investment deposit scheme, and backward area allowances, the then finance minister had created a great deal of flutter and excitement. It was hoped that these steps, while creating a climate conducive for new investment, would result in a net increase of Rs 800 crore in the revenue yield. However, those expectations proved to be too optimistic and the anticipated increase in the revenue did not come about. Naturally, the present finance minister feels disappointed and proposes raising of the tax rate by 5 per cent and reducing of the depreciation allowance from 33.33 per cent to 25 per cent.

That the phenomenal growth in the output, value added and profits of the corporate sector in recent years is not being shown up in the corporate tax collections is well known. The revenue yield has registered a further decline last year due to large amount of refunds and poor performance of oil companies. Therefore, the big question is - are the new proposals capable of bringing about significant upward shift in the sagging corporate tax buoyancy or are they in the nature of corrective steps that are intended to merely put back the revenue growth on its past growth path and prevent further decline? To what extent can the present rise in the corporate tax rates affect the investment growth in the private corporate sector? What would be the additional tax burden likely to be caused by the anticipated inflation of about 15 per cent, both on account of devaluation and import curbs, on corporate growth? What kind of structural changes can be expected with these new proposals? These are some of the questions that need some close analysis.

Revenue Growth.

As a matter of fact, the falling trend in the corporate tax revenue over the last two decades has been a source of anxiety in recent years. Although the yield from this source grew faster (at an average rate of 14.4 per cent per annum) than the Gross Domestic Product (GDP) excluding agriculture and allied activities (which grew at a rate of 12 per cent) during the 70s, the growth of the tax revenue has slackened during the 80s, and at 12.5 per cent per annum was not commensurate with the corresponding growth of the GDP at 13.5 per cent per annum. Thus, the yield from this tax has proved to be less buoyant during the 80s compared to the 70s. The retarding trend is more distressing in the wake of the consistently poor performance of its other major complement of direct taxes, namely, the individual income tax.

The tax changes brought about last year were more in the nature of simplifying and rationalising the tax structure and cannot be regarded as capable of additional revenue yield. This was obvious to any discerning student of economics. The rate reduction of 10 per cent by any standard over compensates the abolition of investment allowance, especially with the more liberalised depreciation allowances. Thus, it was difficult to expect significant jumps in the revenue yield. That the budget estimate of additional revenue expected of this source last year was, perhaps, an over-statement of the net effect of the twin strategy underlying the tax proposals and that these figures reflected either an exaggerated impact of abolishing the investment allowance / deposit scheme, or were based on the mistaken assumption of an outright negative relationship between the corporate tax rate and the tax yield, was already pointed out by some studies. One of them assayed in detail that the net revenue effect of the tax proposals. Following the calculations, an optimistic estimate of the tax yield for 1990-91 works out to be Rs 5100 crore. The study also pointed out that the required reduction in the statutory tax rate that could compensate for the abolition of the investment allowance was about 5 to 6 per cent and that the 10 per cent reduction was quite generous.

Considering the above, the proposed 5 per cent rise in the tax rate in this year's budget should be regarded as a corrective step aimed at putting back the tax yield trend on its past track. And the estimate of additional revenue yield of the order of Rs 1300 crore also appear to be a plausible expectation.

Impact on the Growth of Corporate Investment

The most common way of looking at the likely inducement effect of the budget proposals on corporte investment is through the cost of capital approach which is based on the following: In a rational world, which the corporate sector is presumed to be, the major factors that guide the investment decisions are; (a) the likely future demand for the output generated, and (b) the likely rate of return on the new investment. Given the demand, investors expect a minimum rate of return from the additional investment, which, if not ensured, will opt for alternative investment opportunities. The required minimum rate of return can be interpreted as a notional cost associated with the investment, which might differ from company to company depending upon various factors, such as equipment price, rate of economic depreciation, debt-equity structure, tax rate and the associated unit value of tax deductions, and so on. Students of financial management are well aware of the role of such notional or 'user cost' per unit of capital in project evaluation studies. Corporate tax pushes up the cost of capital and tax incentives such as investment allowance has the opposite effect. ;A study brought out on the subject by the National Institute of Public Finance & Policy (NIPFP) (J V M Sarma & H K Sondhi, 1989 Investment Allowance - A Study, NIPFP, New Delhi constructed the average of the user cost of capital for the Indian corporate sector for the period 1960-61 to 1981-82, based on certain plausible assumptions.)

Following this approach, the average user cost of capital for the year 1991-92 with the existing corporate tax structure can be reckoned at 26.5 per cent of the equipment price. Raising of the statutory tax rate by 6.5 per cent and Reduction of the tax depreciation allowance from 33.33 to 25 per cent is likely to push up the cost-price ratio. In the face of the likely inflation rate of say 15 per cent, the cost price ratio could go up to 28.3 per cent, that is by 1.8 per cent. The results of a regression relating the marginal investment with user cost shows that the inducement effect was such that a one per cent drop in the cost of capital is capable of causing roughly a 0.34 per cent rise in the corporate capital stock growth over and above what could have taken place otherwise. The results further show that this effect is not instantaneous, and in a single year, the capital stock growth would change only by 0.068 per cent. Thus the inducement effect appears to spread over five to six years. Since the net increase in the cost of capital caused by the new tax proposals is 1.8 per cent, the resultant change in the capital stock growth would be 0.122 per cent in a single year. To get an ideà, the size of the induced investment of the private corporate sector for 1991-92 can be estimated, using the official estimates of capital stock figures for 1981, to be around Rs 2523 crore.

The new budget proposals also have the potential to alter the relative cost of financing new investment through borrowing because of the interest tax which makes the loanable funds costlier although precise estimates of such a shift are not available.

The reduction in the depreciation allowances from 33.33 to 25 per cent can also be expected to further increase the revenue. An idea of the rise in the revenue due to this effect can be obtained from the statistical data maintained by the income tax department based on the assessment records. An analysis of this data shows that during the year 1988-89 the statutory rate of 57.5 per cent was reduced to an average effective rate of 35 per cent. The 22.5 per cent gap between the two rates is accounted by losses carried forward (5%), deductions under Chapter VIA of the Income tax Act (3%), investment allowance (4%) and depreciation allowance (10%). With the reduction of 8.33 per cent, the statutory rate could be expected to be lowered by 7.5 per cent.

The revenue gain due to reduction in the depreciation allowance needs to be qualified by the expected reduction in the new investment plans. If the corporate earnings rate is taken to be at 25 per cent and the tax rate at 57.5 per cent, the revenue loss for the current year works out to be Rs 360.03 crore. Thus the estimate of corporate tax yield needs to be corrected downward to that extent.

Inflation Effect.

The impact of inflation and other aspects relating to the equity and efficiency can be studied by summarising the potential tax gap between pre- and post-tax returns on the marginal investment over its expected life time. The potential tax gap, also known as marginal effective tax rate (METR) depends basically on average economic life of a capital asset, structure of financing, statutory tax rate, nature of tax deductions and allowances, interest rate and inflation. If the rate of inflation is zero, and if the rate of tax depreciation is the same as the real or `economic´ depreciation rate, then marginal effective tax rate would be the same as statutory tax rate on corporate profits. Inflation pushes up the METR while tax allowances cause a dip. In other words, tax allowances provide a relief from the upward push of inflationary burden. The METR is a convenient tool not only to examine the stimulatory potential of a tax system, but also can be used to gauge the potential compensation provided by the tax allowances for inflation.

It is observed that in India, the METR is generally lower than the STR (or neutral METR), although there were sporadic instances when METR was higher than the STR. Over the years, the gap between statutory and marginal tax rates which stood at about 20 per cent upto the end of 70s has come down steadily, which is indicative of a trend towards neutral taxation. Major factors responsible for causing the gap have been; tax depreciation, capital allowances (development rebate, initial depreciation, investment allowance and investment funding scheme). Particularly, when tax depreciation rate remained at 10 per cent upto the end of 70s the effect was negligible. The higher tax depreciation rate after 1982, had resulted in a reduction in the tax burden. In recent years, however, the reduction has been substantial as the rate of tax depreciation is jacked up to 33.5 per cent. While the reduction in the tax burden due to tax depreciation was negligible that due to the grant of capital allowances was not. There has been a 12 to 20 percent reduction in the tax burden that can be regarded as due to such allowances. Inflation has caused the effective tax rate to be 12 to 40 per cent higher than the STR during the last two decades. However, the gap has been lower in 80s as compared to 70s indicating higher compensation provided for inflation through taxation. The effect of higher rates of tax depreciation and continued policy of granting capital allowances till 1988 happen to overcompensate for the higher tax burden caused by the inflation. With the abolition of major tax incentives and reduction in the rate of tax depreciation allowances, some parity is achieved now. Further the reduction of depreciation allowance is a step towards reducing the excess capital intensity.

Table 1.
Growth of Corporate Tax Revenue

	1961-70	1971-80	1981-89	1961-89
Annual average growth (%)				
Corporate tax revenue	7.22	14.4	12.5	12.34
Gross domestic product	11.33	12.1	13.4	11.97
Corporate tax buoyancy	0.65	1.17	0.94	1.02

Table 2.
Marginal Effective Corporate Tax Rate (METR)
as Compared to Statutory Rate (STR), 1970-91.

year	METR	STR	gap
1970	0.54	0.55	-0.01
1971	0.54	0.55	-0.01
1972	0.59	0.56	0.03
1973	0.65	0.58	0.07
1974	0.63	0.58	0.05
1975	0.38	0.58	-0.20
1976	0.43	0.58	-0.15
1977	0.50	0.58	-0.08
1978	0.38	0.58	-0.20
1979	0.60	0.59	0.01
1980	0.59	0.59	0.00
1981	0.56	0.59	-0.03
1982	0.28	0.51	-0.23
1983	0.41	0.51	-0.10
1984	0.44	0.58	-0.14
1985	0.41	0.53	-0.12
1986	0.41	0.53	-0.12
1987	0.22	0.53	-0.31
1988	0.22	0.53	-0.31
1989	0.54	0.58	-0.05
1990	0.48	0.48	-0.00
1991	0.54	0.53	0.01

Table 3.
Factors causing the gap between STR and METR

Year	Deprn eff.	Infln eff.	Investt All. eff.	Composite eff.	Net eff.
1970	0.00	0.07	-0.10	0.03	-0.01
1971	0.00	0.07	-0.11	0.03	-0.01
1972	0.00	0.09	-0.10	0.04	0.03
1973	0.00	0.13	-0.10	0.05	0.07
1974	0.00	0.12	-0.14	0.07	0.05
1975	0.00	-0.02	-0.15	-0.02	-0.19
1976	0.00	0.03	-0.21	0.03	-0.14
1977	0.00	0.06	-0.20	0.05	-0.08
1978	0.00	0.00	-0.19	0.00	-0.19
1979	0.00	0.11	-0.19	0.08	0.01
1980	0.00	0.11	-0.18	0.08	0.00
1981	0.00	0.09	-0.20	0.07	-0.03
1982	-0.06	0.04	-0.19	-0.01	-0.23
1983	-0.07	0.11	-0.25	0.11	-0.10
1984	-0.07	0.09	-0.24	0.08	-0.14
1985	-0.06	0.07	-0.16	0.04	-0.12
1986	-0.07	0.08	-0.17	0.04	-0.12
1987	-0.21	0.09	-0.17	-0.03	-0.32
1988	-0.21	0.09	-0.17	-0.03	-0.32
1989	-0.21	0.10	0.00	0.07	-0.05
1990	-0.20	0.13	0.00	0.07	-0.00
1991	-0.16	0.12	0.00	0.06	0.01

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