Passive incomes in corporate returns

Companies opting for financial investments over physical assets is a matter of concern

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The Indian economy has faced a number of shocks in recent years — both strategic and exogenous. These are argued to have had an impact on the structure of the economy and on the forms of organisation of economic activity. For instance, it is suggested that these shocks may have resulted in a negative impact on the unorganised or informal sector, implying an expansion in the formal sector. Given the challenges in measuring the scale of economic activity in the informal sector, such hypotheses are difficult to test. However, recently initiated efforts for gross domestic product (GDP) base revision, along with supporting primary surveys, could provide some insights into this issue.

If one were to focus solely on the formal or tax-paying segments of the economy, data revealed from income tax returns does provide a window into some emerging trends in the economy. One prominent emerging trend is an increase in the share of passive incomes. Defining salary and business income as active income and all other sources as passive incomes, it can be seen that the share of passive income in total reported income has increased from 16 per cent in assessment year (AY) 2016-17 to 24 per cent in AY 2023-24. This includes incomes from house property, long- and short-term capital gains, and other sources such as interest receipts and dividends. Long-term capital gains, in particular, saw a sharp increase from 2.36 per cent to 8 per cent.

Active capital markets and the rapid evolution of fintech through easy access to information and ease of investment, in addition to small ticket sizes, have enabled a significant expansion in the investor base. This, in turn, is reflected in the increase in the number of Demat accounts and in retail investments. The Economic Survey 2023-24 indicates that retail investors account for over 15 per cent of market capitalisation in Indian stock markets, directly and indirectly through SIPs or systematic investment plans.

In this context, one would expect that individual returns should reflect this dynamism in the incomes reported for income tax purposes. The share of income from long-term capital gains for individuals does increase from 1.83 per cent to 4.08 per cent. Considering all passive income, the increase is from 14.8 per cent to 16.8 per cent during this period.

To explain the sharp increase in the share of passive income, one needs to look at the other major contributor to economic activity — the corporate sector. For the corporate sector, the share of passive income has increased from 16.6 per cent in AY 2016-17 to 30.7 per cent in AY 2023-24. This sharp rise is primarily driven by increases in long-term capital gains and other incomes.

SHARE IN TOTAL INCOME (%)

	Individuals		Companies	
	AY 2023-24	AY 2016-17	AY 2023-24	AY 2016-17
Passive income	16.78	14.80	30.67	16.59
LTCG*	4.08	1.83	10.82	3.27
STCG*	0.70	0.49	1.57	2.12
Other incomes	10.92	11.31	17.75	10.25

Long-term capital gains; short-term capital gains

Between AY 2016-17 and AY 2023-24, income from business for companies has increased at an average rate of 14 per cent per annum, significantly lower than 35 per cent growth reported for long-term capital gains.

The surge in capital gains and in incomes from other sources for corporations could indicate a shift in corporate preferences in favour of financial investments, rather than physical or what are often referred to as productive investments. The sharp increase in stock market valuations during this period — average annual growth of over 12 per cent — alongside muted demand for goods and services attributable to economic shocks could induce such a shift. Poor recovery in private capex in the post-Covid period seems to reflect the challenges of this new evolving scenario.

An issue of concern in this emerging context is whether a sustained bull run in the capital markets could act as a hurdle to encouraging real sector investments in the economy.

Real sector investments depend on the availability of moderately-priced financial resources — usually bank loans. A reduction in the financial savings of households, as well as better public financial management, can reduce the funds available through the banking channel. If there is a systematic shift in household behaviour towards investment channels away from the banking system, this problem could be further compounded.

On the other hand, given the relatively long gestation lag for real investments compared to financial investments, the expected returns for the former would need to be higher. These two factors could nudge corporations, at the margin, to opt for financial investments over physical investments.

Is this a concern? The medium-term growth of the Indian economy has, thus far, been supported by capital formation by the government. The Union government has substantially increased capital outlay over the last five years, from 1.6 per cent to 3.2 per cent of GDP, and this is budgeted to increase to 3.85 per cent of GDP in 2024-25. With central government debt at 58.1 per cent, interest payments corner over 37 per cent of revenue receipts. A reduction in deficits and debts is, therefore, an important medium-term priority.

A shift in focus towards private investment is required to sustain the growth momentum. This should be a concern for policymakers. It is tempting to ask whether there is a need to pour some sand in the wheels?

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