● CORP TAX RATE CUT

GIVEN HOW, IN INDIA, THERE SEEMS TO BE LITTLE IMPACT OF THE CORPORATION TAX ON WAGES, THE CUT MAY NOT MEAN MUCH FOR LABOUR

What impact will the tax rate cut have?

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INDIA HAD REDUCED the corporation tax rate from the peak of 30% to 25% for small firms in FY17, and to 22% for all firms in FY20. However, the new rate of 22% is applicable only to those corporate firms, which "will not avail any exemption/incentive". This tax cut is a bold step, given that India has one of the highest "statutory" corporation tax rates in the world, which, in turn, adversely affected its competitiveness.

In an open economy, who bears the brunt of corporation taxation—capital or labour? Why should a tax on capital affect labour? Economists often debate about the macro-economic channels of corporation tax incidence—whether higher corporate taxes lead to lower capital formation and, in turn, lower labour productivity and wages, thereby shifting the tax burden to workers. However, empirical evidence is "inconclusive" about how corporation tax burden is shared between capital and labour.

The macro-criticality of the corporation tax incidence was highlighted in a paper published by the International Monetary Fund earlier this year, Corporate Taxation in the Global Economy. The shifting of corporation tax burden through its cross-country spillovers and the vulnerability due to base erosion and profit shifting activities (BEPS) were discussed in the report. The design of empirical research on corporation tax incidence are of two types. One set of analysis based on cross-country models examines the effects of capital and labour mobility from high-tax countries to low-tax countries, to know whether there is any "voting with feet". The corporate capital moves from high-tax countries to low-tax ones, reducing the capital-labour ratio in the former and leading to a lower marginal product of labour and lower wages. At the same time, low-tax countries experience higher capital-labour ratios, a higher marginal product of labour, and hence higher wages. The second set of studies are based on single-country design, where the effects of corporation taxation "over time" on capital and labour are analysed. The latter set of studies are also carried out either at corporate/firm level or at subnational government levels.

In India, as corporation tax rates do not vary across states, it will be interesting to analyse the effects of taxation across time and across heterogeneous labour categories. A recent study in the context of Germany—by Clemens Fuest of CESifo in Munich and his team—found that the average "pass-through" of corporation taxation on wages was of the extent 51%. They found that labour bears a substantial share of the corporation tax burden. Their results showed that higher corporation taxes reduce wages most for the low-skilled, for women, and for young workers.

More analysis on corporation tax incidence can be found in Alan Auerbach's paper on "what we know from economic theory and evidence about corporate tax incidence". One of the few papers in the Indian context is by Parthasarathi Shome in Oxford Economic Papers, in 1978, which explores the effect of a marginal change in the corporation tax on wages in the economy. In a general equilibrium setting, his findings suggest that a part of the burden of corporation taxes are shifted to labour.

Using the Prowess IQ database provided by the Centre for Monitoring Indian Economy (CMIE), we can examine the corporation tax incidence in India. "Preliminary" evidence from a recent paper by Samiksha Agarwal and this author showed that corporation tax incidence is more on capital than labour in India. If so, the budgetary announcement in Union Budget FY19—the first announcement on corporate tax cut by the Modi government—to reduce the corporation tax rate to 25% for those firms with turnover up to ₹250 crore was the right step forward. Any tax reforms for the corporate sector will, therefore, have redistributive effect on small firms. However, we flagged in our paper that the lack of significant impact of corporation tax on labour needs to be interpreted with caution in the context of India. With perfect mobility of labour, business taxation may not affect wages. However, the channels of corporation taxation on wage determination may be relatively weaker in India. This prima facie lack of "pass-through" of business tax on wages in India needs further research. It may depend on other wage determination mechanisms, not alone on taxation policies. If there is lack of a significant link between corporation taxation and wages, it may also due to "profit shifting" arrangements. However, this demands further research on whether the incidence of corporate taxes on wages is lesser due to "income shifting" to avoid taxes or other wage "bargaining" mechanisms. Clemens Fuest and his team highlight in their study that gigantic and, in particular, foreign-owned firms can avoid taxes by "shifting profits" across jurisdictions or even abroad, and if this is relevant for a country, one should observe smaller effects of corporation tax changes for these firms on wages.

Now, let us unpack and differentiate between the "statutory" tax rate and the "effective" corporate tax rates. The analysis shows that the corporate firms with profits before taxes (PBT) above ₹500 crore contribute to 60.63% of corporate tax revenue (see graphic). However, it is also evident that the effective corporate tax rate is only 22.88% for these big corporate firms with PBT greater than ₹500 crore, as compared to 29.37% effective tax borne by the small companies with profit before tax (PBT) up to ₹1 crore.

It is interesting to recall here that Pinaki Chakraborty, in his ex-post Union Budget analysis in 2016 in *EPW*, had highlighted that any tax reform in corporate sector to rationalise the tax structure without tax exemptions would also mean effective tax rate going up for those paying lower than the intended statutory rate. In that sense, the corporate tax cut "effective" is only 2.7% and not 8%. The estimated revenue impact of ₹1.5 lakh crore, if that comes to pass, can reduce the tax-transfer share to the states—as highlighted by Kerala finance minister, Thomas Isaac—and, in turn, affect the state's fiscal space.

It is important to wait and watch if the fiscal stimulus through tax policies have relatively better multiplier effect on the economy than expenditure stimulus. As fiscal rules—maintaining the threshold fiscal deficit-to-GDP ratio at 3%—are often attached to fiscal discipline and economic growth, it is highly unlikely that the government will announce a stimulus package through boosting public expenditure. However, it is imperative to explore the path of public expenditure stimulus, given the corporation "effective tax rate" reduction on the economy is only to an extent of around 2%, and the "structural reforms"—including corporation tax rate reduction—can take a long time for the intended results on the macroeconomy to show.

Effective tax rates of corporate sector in India

Profit before taxes	Share in total: Profits before	Share in total: income taxes (in %)	Share in total: Corporate income Tax (in %)	Ratio of total income to profit before taxes (%)	Effective tax rate (%) (profit to tax ratio)
Less than Zero	0	0.58	0.47	—	—
Zero	0	6.54	2.81		
0-1 Crore	2.73	3.38	3.25	95.39	29.37
1-10 Crore	6.76	7.54	7.4	85.44	26.99
10-50 Crore	9.17	9.08	9.48	76.26	25.52
50-100 Crore	5.16	5.01	5.26	74.83	25.14
100-500 Crore	15.55	14.56	15.12	72.00	23.97
Greater than ₹500 cr	60.63	53.31	56.21	67.66	22.88
All Companies	**100**	**100**	**100**	**76.94**	**24.67**

Source: (Basic data) Budget Documents, Ministry of Finance, Budget Division, Government of India