POLICY BRIEF

Ease of Doing Business and Corporate Taxes: Some policy issues in the context of inequality*

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Amidst the growing trends of economic inequality in India, policy makers are continuing to endorse policies to reduce corporate income tax (CIT) rates and provide discretionary tax incentives to corporates in the name of ease of doing business. But evidence suggests, that India's corporate tax rates are moderate in global comparison. Further, tax incentives are mostly ineffective to achieve its desired policy objectives whereas the corresponding revenue loss is huge. Given this scenario, and also considering huge requirement of resources for the social sector, India must phase out the ineffective tax incentives and abstain from slashing corporate tax rates any further.

It is generally presumed that there is a critical link between tax policies and business activities in an economy and further, between ease of doing business and economic performance. After the poor performance (ranking 130 among 190 countries) in World Bank's Ease of Doing Business rankings for 2017, the present government became proactive to leapfrog in the rankings and has already set a target of achieving the 90th rank in the next year. This is definitely an aggressive bid to improve India's image as a business-friendly economy in the eyes of global investors.[1] Intent of making India's business more competitive is commendable; but at the same time, the approach to achieve it is questionable. Actual influence such rankings have on investment decisions and economic performance are also not beyond question.[2] Now, to get the answer, we have to get into the details of the methodology (discussed subsequently) of the analysis of ease of doing business conducted by the World Bank. It should be noted that India's absolute score improved from 53.93 in 2016 to 55.27 in 2017. Out of the 10 indicators used in this analysis, the score improved on 6 indicators, showing that India is increasingly progressing towards best practice. India's achievements in implementing reforms in four of its ten indicators, namely, trading across borders, getting electricity, enforcing contracts and paying taxes is also acknowledged in the 2017 Report. In the individual indicators, India's best performance is on 'Protecting Minority Investors', for which India's rank is 13 out of 190 countries. For other indicators, for 'Getting Electricity', and 'Getting Credit', India's performance is quite good and for these indicators, ranks are 26 and 44 respectively; followed by 'Resolving Insolvency' (136), 'Registering Property' (138), 'Trading Across Borders' (143), Starting a Business (155), Paying Taxes (172), Enforcing Contracts (172), and Construction Permits (185).

So, it is evident that India's poor performance in ease of doing business could be attributable to a number of factors. But, whenever the issue of competitiveness or ease of doing business is debated among the ruling government, policy makers and business groups, much attention is directed only towards corporate tax rates and for many times the debates end up with the solution of reducing corporate tax rates to make Indian business more competitive. However, if we get further into the details of this indicator – 'Paying Taxes', it would be visible that India's performance in this indicator is poor, with the rank of 172 out of 190 countries. But, it should be noted that the poor ranking is not solely for the corporate 'tax rates'. Apart from tax rates, there are several other factors regarding taxation issues contributing in the ease of doing business index. These are: a) total number of taxes and contributions paid, including consumption taxes (VAT, sales tax or goods and service tax), b) method and frequency of filing and payment, c) collecting information and computing the tax payable, d) completing tax return forms, filing with proper agencies, e) arranging payment or withholding, f) preparing separate tax accounting books, if required, and so on. It would also be worth mentioning that some post-filing process issues such as claiming a value added tax (VAT) refund, undergoing a tax audit or appealing a tax assessment have also been incorporated for developing 'paying taxes' indicator in 2017 report. Compared to the paying taxes rank of 157 of 2016, India slips to the rank of 172 in 2017; demonstrating the fact that administrative issues are equally important for improving the ranking. It would also be noteworthy to mention that in the subsequent discussion it emerges that if all the tax exemptions are taken into account, India's corporate tax rate is moderate compared to other countries. So, instead of focusing only on cutting corporate tax rates for making our business

RECOMMENDATIONS

GIVEN THE PRESENT SCENARIO IN INDIA, IT IS NOT THE PREREQUISITE TO CUT CORPORATE INCOME TAX (CIT) RATES, ESPECIALLY FOR THE LARGER COMPANIES, TO MAKE INDIAN MARKET MORE COMPETITIVE. FOR PERFORMING BETTER IN EASE OF DOING BUSINESS RANKING, APART FROM IMPROVING TAX ADMINISTRATION, ATTEMPT SHOULD ALSO BE MADE TO SIMULTANEOUSLY IMPROVING IN SEVERAL OTHER INDICATORS, WHICH CONTRIBUTES IN COMPETITIVENESS.

OFFERING NEW DISCRETIONARY TAX INCENTIVES MUST BE CEASED. AFTER PROPER EVALUATION, INDIA CAN PHASE OUT MAJORITY OF THE EXEMPTIONS/ INCENTIVES, WHICH ARE ALREADY PROVED TO BE INEFFECTIVE IN TERMS OF ACHIEVING POLICY OBJECTIVES ALTHOUGH CORRESPONDING REVENUE LOSS IS HUGE.

AS GLOBAL EXPERIENCE SUGGEST THAT EXEMPTIONS MAY CREEP IN EVEN IN A VERY LOW CIT REGIME, THE EFFORT TO KEEP THEM OUT OR TO PERIODICALLY CLEAN THE TAX REGIME NEEDS TO BE AN ONGOING EFFORT.

* This policy brief draws on the analysis in the working paper titled 'Corporate Tax Exemptions' co-authored by Prof. R. Kavita Rao and Dr. Sacchidananda Mukherjee of the National Institute of Public Finance and Policy (NIPFP).

more competitive, the tax administration should be improved urgently. Also, looking beyond the taxation issues, all round development in other indicators are also a prerequisite to leapfrog in the ease of doing business rankings. However, in the subsequent discussions, the policy brief focuses only on the issues around corporate taxation.

It is a well-established fact that one of the most effective ways for governments to reduce inequality and poverty, while sustaining growth, is putting a well-designed tax system that redistributes income and wealth and provides spending on public goods in place.[3] Further, it is recognised that reducing evasion and tax expenditures (exemptions) or loopholes that largely benefit the rich can simultaneously benefit growth and income equality.[4] These perceptions, to some extent, had also been reflected in the budget speech of Finance Minister (FM), Arun Jaitley when he acknowledged that "taxation is a major tool available to Government for removing poverty and inequality from the society."[5] However, at the same time, FM also mooted for reducing the rate of corporate tax from 30 percent to 25 percent over a period, accompanied by rationalisation and phasing out of various tax exemptions/incentives. On this backdrop, it is imperative to examine judiciously the existing corporate tax rates in relation to other countries and efficacy of various tax exemptions in achieving its desired objectives. Recently, Oxfam India has commissioned a study[6] (Oxfam study 2017, henceforth) on 'Corporate Tax Exemptions', which has brought attention to some key observations on tax exemptions which have far reaching implications. Some of the major issues are discussed subsequently.

STATUTORY CORPORATE TAX RATE (STR) & EFFECTIVE TAX RATES (ETR) ACROSS COUNTRIES – A COMPARISON:

The Oxfam study 2017, observed that presently, the STR in India is 34.6 percent[7] (including cess & surcharges). Globally, there are many other countries, which have STRs very close to India or higher[7] than India. In other words, **India does not appear to be an outlier in this global comparison of corporate tax rate.**

More importantly owing to a number of exemptions and concessions that are provided in the tax regime, the actual tax burden on companies, i.e., **ETR is substantially lower compared to STR.** In 2015-16, the STR in India was 34.6 percent, whereas taking into account all sorts of exemptions, corresponding **ETR was close to 23 percent.**

The findings of Oxfam study are also substantiated by the cross-country study done by the National Bureau of Economic Research (NBER). The NBER's analysis of cross-country comparison of average ETR, for the period 2006 to 2011, shows that India belongs to the group of countries which have **relatively medium ETR, with average ETR of around 22 percent during that period.**

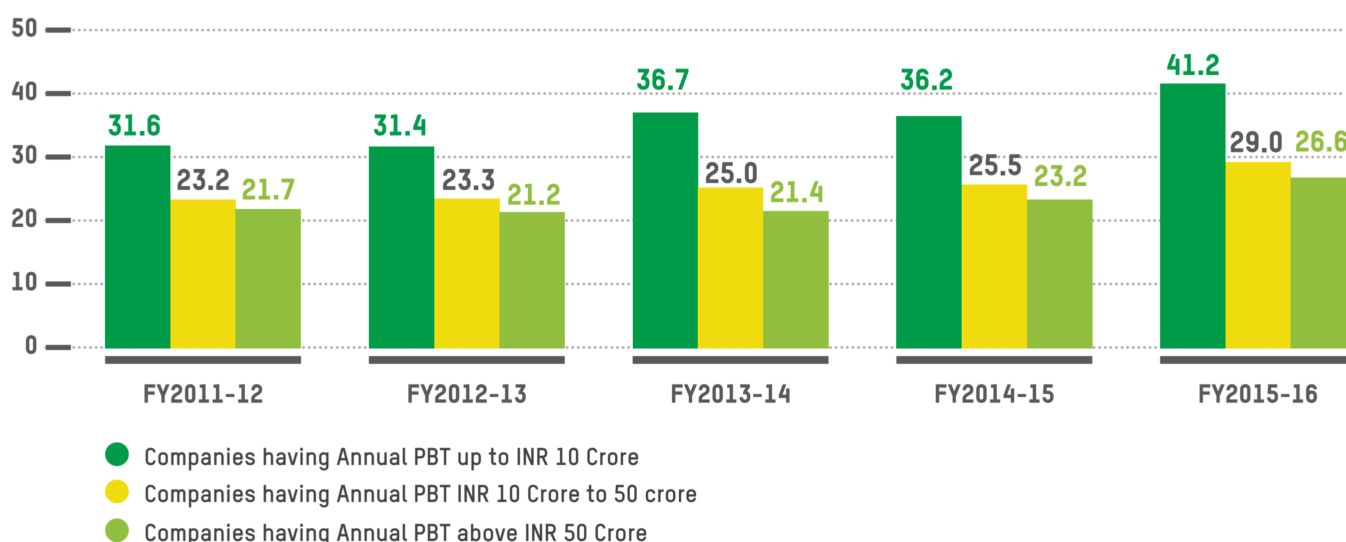
COMPARISON ACROSS COMPANIES IN INDIA:

Apart from the national level STR & ETR, a comparison of ETRs across companies classified according to their annual profit before tax (PBT) could also give more specific inferences. **The Oxfam study 2017 shows that smaller companies face higher ETR as compared to larger companies.**

The study also shows that companies having annual profit before tax (PBT) up to INR 10 crore[8] face higher ETR (see Figure 1). The ETR for these companies has gone up from 31.6 percent in 2011-12 to 41.2 percent in 2015-16. An increase in ETR by 5 percent by every two years is observed for small companies, as compare to 2 percent (4 percent in 2015-16) for medium companies.

A comparison of STR and ETR across two broad groups of companies show that small companies face ETR which is higher than STR. This is due to the fact that for these companies PBT is lower than income considered for the purpose of corporate income tax liability.[9] For companies having annual PBT up to INR 10 crore, increase in ETR during 2011-12 to 2014-15 is observed, even if STR remains unchanged, and this is due to divergence between growth rate in income and PBT. Though the statutory tax rate is higher for companies having annual PBT above INR 10 crore, their ETR is lower as they derive larger benefits from existing tax exemptions.

FIGURE 1: COMPARISON OF EFFECTIVE TAX RATES (ETR, %) ACROSS COMPANIES BY SIZE[6]



Source: Statement of Revenue Forgone, Union Budget; various years.

REVENUE FOREGONE FOR TAX EXEMPTIONS & ITS EFFICACY: TRENDS IN INDIA

The impact of exemptions/incentives on revenue collection is summarised through an estimate of the revenue foregone within the budget document. As per the revenue foregone statement, in the Financial Year 2015-16, Government has foregone INR 76,859 crore due to various exemptions/ incentives.

It should be noted that exemptions/incentives provided in India are not standalone; several countries across the globe provide incentives under corporate tax. But, the pertinent question is, whether the exemptions could achieve its expected policy goals. Like several other countries, India also provides tax exemptions/incentives on account of research and development, accelerated depreciation and special regions/zones, and many other sectors. Few of these exemptions could be analysed for more precise insights. In India, out of the total revenue foregone in 2015-16, two of the major incentives are **accelerated depreciation benefits and benefits provided to SEZs**; together, these account for more than 60 percent of the gross revenue foregone. Two other incentives which each accounted for over INR 10,000 crore of revenue foregone in the year 2015-16 are incentives given for **investments in R&D and power sector units.** An attempt has been made in the Oxfam Study 2017 to identify the objective and formulate an appropriate hypothesis to be tested to assess whether the objective is being satisfied. For this purpose, four major exemption schemes are being examined.

SPECIAL ECONOMIC ZONES (SEZS):

Revenue foregone statement shows that corporate tax incentives enjoyed by the SEZs is the second largest after accelerated depreciation. The SEZ Act 2005 was legislated in India with an objective to generate world class infrastructure that can support production and more importantly exports from India. Rao et al.[10] (2016) explored the effectiveness of the SEZ policy based on its impact on the aggregate economy. **Their analysis does not suggest that the policy introduced any statistically significant change in the performance of the Indian economy either in terms of the level of aggregate investment or exports. Further, the study shows that given the level of investment, it would appear that employment generation in SEZs is considerably lower than in the manufacturing sector in the domestic tariff area.** 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. Further, there are no measurable indicators of the quality or quantity of infrastructure generated within the SEZs to allow for any analysis of this objective of the proposed policy.

RESEARCH AND DEVELOPMENT (R&D):

Companies operating in India are offered tax incentives in the form of super deduction for incurring revenue and capital expenses on R&D with different rates of deduction to in-house research and to outsourcing of research. The success of these incentives could be measured in terms of increase in income from intellectual property for the country or higher profits for companies which spend more on R&D expenditure etc. Rao et al. (2016) shows 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 from 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.**

REVENUE FORGONE FOR TAX EXEMPTIONS/INCENTIVES

	2013-14	2014-15	2015-16
REVENUE FOREGONE (INR CRORE)	57,793	65,067	76,859
(AS % OF TOTAL CORPORATE INCOME TAX LIABILITY)	(22.4%)	(21.8%)	(21.5%)
TOTAL CORPORATE INCOME TAX LIABILITY (INR CRORE)	257,858	298,205	357,968

Source: Statement of Revenue Forgone, Union Budget; various years.

AREA BASED EXEMPTIONS:

Area Based Exemptions are basically fiscal incentives to encourage investment in 'backward' areas, which fail to attract investment on their own merit. These incentives have been a combination of tax incentives and subsidies (capital, interest and/or transport subsidies). An analysis carried out by Rao et al. (2016) concludes that **this scheme seems to be partially successful since it seems to have brought in some economic activity into some of the incentivized states. However, the fact that all incentivized states did not benefit equally suggests that these incentives need to be accompanied by other interventions to make these destinations attractive to the investor.**

ACCELERATED DEPRECIATION:

Accelerated Depreciation was introduced to encourage capital formation in the economy. As per the provisions in the Company's Act, there are permitted rates of depreciation for different assets that a company might buy. The provision for accelerated depreciation allows companies to claim a higher rate of depreciation for some classes of assets when income is computed for purposes of determining the income tax liability. As is evident from the statement on revenue foregone for India, the revenue foregone on account of accelerated depreciation is substantially higher than that associated with any of the other incentives provided. It should be noted that most of the other incentives can be availed by only a sub-group of taxpayers, but since investment is essential for every company to exist, accelerated depreciation can be claimed by all companies at some point in their lifecycle. In this sense, this incentive could be considered more equitable than other incentives. However, it is also important to note that these incentives might have two other consequences. First, the acceleration in depreciation provisions would be more easily available to older companies while for the new companies, the provision can only increase carry forward losses in the short run, which cannot be considered a benefit. Second and more important, these incentives coupled with perceived costs of hiring labour might induce the choice of more capital intensive technologies, which in turn would mean relatively lower levels of employment generation corresponding to given levels of capital formation. For a labour intensive economy where growth is perceived to be constrained by the availability of capital, incentives like these could be perceived as creating an undesirable bias in favor of capital.

To evaluate the efficacy of this incentive, on the basis of summary statistics of Annual Survey of Industries 2013-14, the Oxfam Study 2017 found that for small (having Net Value Added, i.e., NVA upto INR 5 lakh per worker) and large (having NVA INR 50 crore per worker and above) factories capital intensity is higher. High capital per worker for factories with low value added may be due to the fact that these factories are new entrants and yet to be under revenue stream. Since new factories (startups) invest substantially in capital stock though their outputs take time to reach the market place, fixed asset per worker is higher for them.

Except for big factories, capital per worker is lower for medium factories as a result they cannot avail the benefits as much as big factories.

The above **analysis suggests that one cannot unequivocally establish that tax incentives are an effective way of achieving the policy goals. Further, the benefits from incentives are not uniformly accessed by all companies – a larger proportion of benefits accrue to the larger and older companies.**

RECENT POLICY INITIATIVES OF THE GOVERNMENT & FUTURE POLICY OPTIONS:

In the Union Budget 2017-18 speech, the Finance Minister acknowledged that inequality exists in the effective tax rate of corporate tax for companies and mentioned that 2.85 lakh (in 2015-16) Medium and Small Enterprises (MSME) making profit of less than INR 1 crore pay effective tax rate of 30.26 percent while 298 companies making profit above INR 500 crores pay effective tax rate of 25.90 percent although the MSMEs occupy bulk of economic activities and provide maximum employment to people.[11] On this ground his proposal for reducing corporate tax (CIT) rate for MSME companies is justified and it should be noted here that expected revenue foregone for this measure would be only INR 7200 crore while 6.67 lakh companies (out total 6.94 lakh companies filing returns in 2015-16) could be benefitted.

In the Union Budget 2016-17, the Finance Minister promised to reduce CIT rate to 25 percent with withdrawal of all exemptions. But, given India's moderate STR and ETR at present, as analysed above, reducing CIT rate to 25 percent across the board would not be a good policy move. If CIT for only small companies are reduced, this could benefit a large number of companies whereas corresponding revenue foregone would be a minimal amount. However, for larger companies, reducing CIT is not justifiable as this move would incur huge revenue loss for the government and above all, average STR and ETR in India is relatively moderate in global comparison. It would also be worth mentioning here that "taxing profits of companies, particularly large, successful corporations, is one of the most progressive forms of taxation. It raises more income for national budgets, and when this revenue is invested in public services, it reduces inequality because it redistributes the income by putting 'virtual income' in the pockets of poor people. This equips people with the essential tools and skills to escape poverty, such as good health care and education."[12]

In the light of the above discussion, it is recommended that after proper evaluation, India can phase out majority of the exemptions/incentives, which are already proved to be ineffective in terms of achieving policy objectives although corresponding revenue loss is huge. Offering new discretionary tax incentives must be ceased immediately. Lastly, there is apprehension that even if India moves to lower tax regime of 25 percent of CIT, it is not possible to abolish all exemptions completely as global experience suggest that exemption may creep in even in very low CIT regime and the effort to keep them out or to periodically clean the tax regime needs to be an ongoing effort.

NOTES

1 Jain, D. (2017, April 14). Is our obsession with the World Bank's ease of doing business rankings justified? Livemint. Retrieved 16 August 2017, from http://www.livemint.com/Politics XafZM08fKCCLisScwmqSaP/Is-our-obsession-with-the-World-Banks-ease-of-doing-busines.html

2 Take the example of China, widely regarded as the biggest economic success story in recent history. The country has never even figured among the top 50 countries (it is ranked 78 among 190 countries in 2017 rankings) in the Ease of Doing Business rankings but has consistently attracted investments from all around the globe. In the latest rankings, surprisingly, Bhutan and Tunisia rank ahead of China. However, in terms of any socio-economic indicators, China is far ahead of those countries. China is not an isolated example. Examples of several other countries could be cited from the report.Jain, D. (2017, April 14). Is our obsession with the World Bank's ease of doing business rankings justified? Livemint. Retrieved 16 August 2017, from http://www.livemint.com PoliticsXafZM08fKCCLis ScwmqSaP/Is-our-obsession-with-the-World-Banks-ease-of-doing-busines.html

3 IMF (2015). Fiscal Policy and Long-Term Growth, Policy Paper. Retrieved 29 June 2017, from https://www.imf.org/external/np/pp/eng/2015/042015.pdf

4 O. Blanchard. and C. Cottarelli. C. (2010). Ten Commandments for Fiscal Adjustment in Advanced Economies. Retrieved 29 August 2017, from https://blogs.imf.org/2010/06/24/ten-commandments-for-fiscal-adjustment-in-advanced-economies/

5 Budget Speech, February, 2016, para 117. Retrieved 17 March 2017, from http://indiabudget.nic.in/budget2016-2017/ub2016-17/bs/bs.pdf

6 Rao. K. and Mukherjee. S. (2017). Corporate Tax Exemptions, Working Paper, Oxfam India, New Delhi, June 2017.

7 KPMG's Corporate Tax Table. Retrieved 17 March 2017, from https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html

8 1 million is 10 lakh and 10 million is 1 crore. 100 lakh is 1 crore and 100 crore in 1 billion.

9 A company is liable to pay tax on the amount of income computed according to the provisions of the Income-tax Act 1961 (ITA), but the profit and loss account of the company is prepared in accordance with the provisions of the Companies Act. The discrepancy between PBT and taxable income may arise due to (i) differences in the amount of expenses taken into account in the computation of PBT and the deductions allowed in the computation of taxable income, and/or (ii) the payment of minimum alternative tax, applicable to companies reporting book profits but not paying corporate tax.

10 Rao. R. Kavita., S. Tandon. and S. Mukherjee. (2016). Corporate Tax: A brief assessment of some exemptions, Working Paper, National Institute of Public Finance and Policy (NIPFP). Retrieved 17 March 2017, from http://www.nipfp.org.in/media/medialibrary/2016/03/WP_2016_165.pdf

11 Budget Speech, 2017, Para 155. Retrieved 17 March 2017, from http://indiabudget.nic.in/ub2017-18/bs/bs.pdf

12 Oxfam (2016). Tax Battles: The dangerous global race to the bottom on corporate tax, Policy Paper. Retrieved 29 June 2017, from https://www.oxfam.org/sites/www.oxfam.org/files/bp-race-to-bottom-corporate-tax-121216-en.pdf It would also be worthwhile to mention that 'Low corporate tax rates or further tax giveaways are promoted because they are supposed to attract investment. Yet evidence shows that corporate tax rates are not the main consideration for companies when seeking where to invest. There are several other reasons why companies choose to invest in a country, according to the World Economic Forum's Global Competitiveness report (available on https://www.weforum.org/reports/the-global-competitiveness-report-2016-2017-1/). The most important are the quality of the country's infrastructure, the availability of an educated, healthy workforce, and social stability. Corporate tax contributions are vital to ensuring the revenue for these investments.

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