ASIA

India’s Surprise Tax Cut Comes at An Opportune Time

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Amid slowing economic growth in India, the Modi government’s surprise corporate tax cuts have come at an opportune time, according to Franklin Templeton Emerging Markets Equity’s Sukumar Rajah. He explains why the fiscal adjustment could improve India’s competitiveness among its regional peers.

India’s proposed corporate tax cut, which slashes the basic rate to 22% from 30% for domestic companies, is a welcome surprise.

The meaningful reduction in corporate rates sends a strong signal to investors that the Indian government recognizes the need to improve India’s economic growth and boost the corporate sector’s competitiveness.

This fiscal change comes at a time where India’s annualized gross domestic product (GDP) growth is slowing. In the second quarter of 2019, GDP grew by just 5%, marking the fifth consecutive quarter of declining growth.[1] India’s growth fell behind that of China, which grew 6% in the second quarter.[2]

In the immediate aftermath of the tax announcement on September 20, India’s equity market reacted positively to the news, while the Indian rupee rallied. We’d also expect earnings to improve in the short term. However, bond markets declined on fears that the Indian government may now have to borrow more to meet the additional expenditure.

From a macro perspective, the proposed stimulus might not cost the government as much as it is made out to be. It’s estimated tax cuts could cost the government around US$20 billion. Though companies who want to take advantage of the new tax rate would not be eligible for other exemptions. We think the net figure of tax revenue foregone is more likely to be close to US$10 billion.

Improving India’s Competitiveness

In our view, corporate tax cuts should likely help boost capital expenditure and attract foreign investments to India. India’s corporate tax rate is now on par with its regional peers that have manufacturing hubs, such as Cambodia, Taiwan, Thailand and Vietnam. And, India’s corporate tax rate is now more competitive than China’s 25% rate.

New, lower corporate tax rates also included new manufacturing companies. Businesses that start operations between October 2019 and March 2023 would be eligible to apply for a 15% corporate income tax rate. This ties in with Prime Minister Narendra Modi’s “Make in India” initiative.

GLOBAL MANUFACTURER VISION FROM "MAKE IN INDIA" SCHEME

The government's "Make in India" program, intended to turn India into a global manufacturing hub, is gradually gaining ground and should likely benefit a variety of sectors, namely the electronics manufacturing sector.

For example, Samsung opened the world's largest phone factory near New Delhi earlier last year, in order to manufacture phones at low costs and improve competitiveness in India's huge smartphone market. In the long term, we could see a substantial rise in the share of locally manufactured products, which would also bode well for India's current account balance.

Sector Implications

Levels of impact will differ from sector to sector, particularly those subject to the highest effective tax rates.

At a company level, a reduction in the tax rate will likely boost cash holdings and increase corporate profitability. We'd expect company management teams to repay debt, pass on cost savings to consumers through lower pricing, or distribute dividends to shareholders through share buybacks.

For cash-rich companies, another potential consideration might be to resume capital expenditure (capex). We think this spending would likely bring a positive multiplier effect on the broader economy in the medium to long term.

As such, we favor high tax-paying companies that could potentially benefit from the structural transformation of the Indian economy.

Companies with existing plans for capacity expansion would directly benefit, but the tax cut alone is unlikely to trigger a wave of fresh capex from foreign companies. We believe the Indian government needs to make more progress on reforms. These include changes to land acquisition laws, labor laws and faster approvals processes to facilitate the revival of the capex cycle.

We also think the Indian government could propose more sector-specific stimulus. For example, the government could offer more housing-related benefits to increase housing demand. These measures won't cost the government a lot, but it could boost discretionary income and impact consumer demand and therefore the economy.

Broadly speaking, the global industrial universe has spare capacity and is staring at a demand slowdown. That said, India has the potential to become a sustainable alternative hub for companies wanting to diversify manufacturing processes away from China.

We'd also expect banking names to receive a boost from companies being able to repay their debts, as a result of increased capital.

For the financial industry, some of the benefits of a lower tax rate might eventually be passed on to consumers in the medium term. Banks with alternative business segments, such as personal loans, credit cards or gold loans could stand to gain the most from the tax adjustment.

As long-term investors, we think India's corporate tax cuts should help spur investment. As India grapples with slowing GDP growth, the Indian government has taken steps to give companies a boost to draw investors and restore confidence in the country's dynamic economy.

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What Are the Risks?

All investments involve risks, including the possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. Investments in fast-growing industries like the technology sector (which historically has been volatile) could result in increased price fluctuation, especially over the short term, due to the rapid pace of product change and development and changes in government regulation of companies emphasizing scientific or technological advancement.

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1. Source: India Ministry of Statistics and Programme Implementation, June 2019.
2. Source: National Bureau of Statistics, July 2019.

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