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India delivers surprise corporate tax cuts to boost economy

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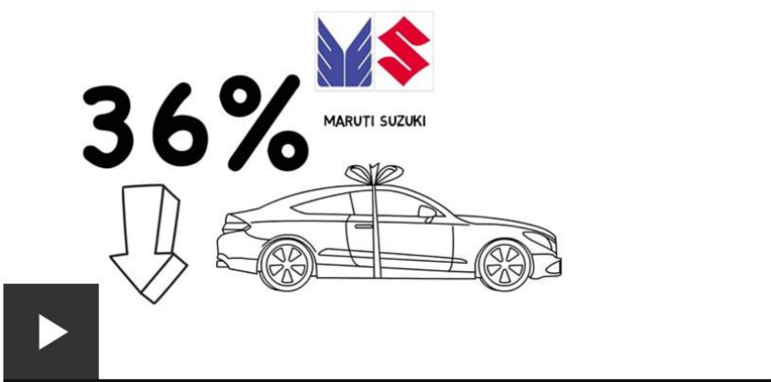

What cars and underwear say about India's slowdown

India has cut its corporate tax rates in an effort to spur investment and boost growth in the country's faltering economy.

Finance Minister Nirmala Sitharaman said the base corporate tax rate would be lowered to 22% from 30%.

The surprise move triggered a stock market rally, with the Sensex index jumping 4.5%.

The tax cuts are the latest measures to boost spending and shore up investment in India.

Under the slate of reforms announced on Friday, India will lower its corporate tax rate to 22% from 30% for companies that don't seek exemptions.

Firms that do receive incentives or exemptions will see their tax rate cut to 25% from 35%.

In addition, some new manufacturing firms will see their corporate tax rate lowered to 15% from 25%.

A Prasanna, head of research at ICICI in Mumbai, said the move would boost investment and employment.

"This is a long overdue and hugely positive move by the finance minister. The new rates simplify the tax architecture and it will give a fillip to investments and jobs," he told Reuters.

- **Viewpoint: How serious is India's economic slowdown?**

India's economic growth is sitting at a six-year low and the government has taken a series of steps to boost the economy.

So far this year, India's central bank has cut rates four times and the benchmark rate currently sits at a near-decade low.

The country has relied on domestic consumption to fuel growth but spending has slowed sharply.

This article talks about how India has implemented an expansionary fiscal policy by cutting the corporate tax rate from 30% to 22% *“in an effort to spur investment and boost growth in the country’s faltering economy.”*

“Expansionary fiscal policy is a policy involving the increase of government spending and/or the reduction of taxation”[1]. In this case, India has cut the corporate tax rate which “is a levy placed on a firm's profit by the government[2]”. When this tax rate is cut, the profit margin of companies increases, and therefore there is an incentive to invest in the company, because return on investment has increased. Increase in investment would then lead to an increase in India’s real GDP (Figure 1).

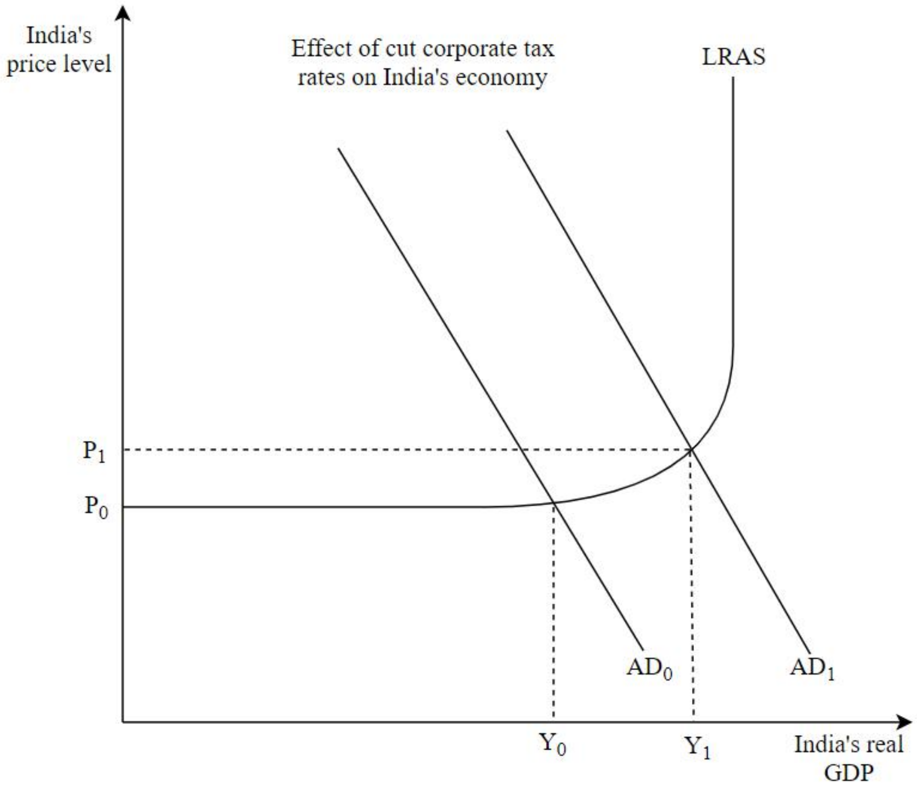

Figure 1

Since there is an increase in investment, which is a component of aggregate demand, the aggregate demand curve shifts right (increases) from AD_0 to AD_1. There is a movement alongside the LRAS curve and the equilibrium point shifts from (Y_0;P_0) to (Y_1;P_1), where $Y_1>Y_0$, which means that due to cut corporate tax rates India’s real GDP has increased and India has moved closer to its potential output level, in that way improving efficiency. Increase in aggregate demand also leads to lower unemployment, because to increase aggregate demand (and produce a higher GDP) more resources are needed, those including labour resources. Also, as a result of the AD increase inflation arises — there is an increase in price level from P_0 to P_1.

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1 Finamore, David. ”Fiscal policy: The role of fiscal policy” in *Economics: Supporting Every Learner across the IB Continuum,* edited by Christian Bryan, page 178. Harlow, Essex: Pearson Education Limited, 2014.

2 Kagan, Julia. “Corporate Tax.” Investopedia. Investopedia, January 29, 2020. https://www.investopedia.com/terms/c/corporatetax.asp

Firms benefit from this tax cut, because they have to pay less money in taxes to the government, therefore their post-tax profit increases. Due to this firms invest more, hire new workers and therefore Indian households also clearly benefit as their household income increases.

Since firms now are more eager to invest, some of the investment could go to research and development. This would improve the current technology, thus either improving productivity or increasing the quality of the products, which, in both cases, would lead to economic growth and outward shift of LRAS.

Additionally, bigger return on investment, could allow the firms to reduce the price of their products, thus increasing their international competitiveness, which could prove to be crucial to increase economic stability as currently *"The country has relied on domestic consumption to fuel growth"*.

Comparing this policy with its counterpart, expansionary monetary policy, which is "expansion of the money supply and a decrease in interest rates to encourage consumption, investment and economic growth"[3], this policy seems more effective, as *"So far this year, India's central bank has cut rates four times and the benchmark rate currently sits at a near-decade low.",* which shows, that cutting interest rates seems to not be working and that fiscal policy is working better in this situation.

However, there are also downsides to this policy. A loser in this situation is India's government, as now they receive less revenue from firms paying the tax. This reduces their ability to spend money on public goods, such as education and transport.

Additional downside to this policy is that it only affects supply-side, it does not deal with the demand-side of the market. Since *"spending has slowed sharply"*, it is possible to argue, that even with lower taxes firms will not start investing more, but rather will just keep the extra profit, because of insufficient demand for their product. Thus it can be argued that expansionary fiscal policy in the form of government spending would work better, because it would directly affect the demand side of the market and would also improve the public sector, however, it is of concern that from too much government spending the crowding out effect would take place, that is, government borrowing would rise the real interest rate, which would then decrease investment — the exact opposite of what the Indian government is trying to achieve.

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[3] Finamore, David. "Monetary policy: The role of monetary policy" in *Economics: Supporting Every Learner across the IB Continuum,* edited by Christian Bryan, page 183. Harlow, Essex: Pearson Education Limited, 2014.

To conclude, cutting corporate tax rates would cause increased profits for firms and improve the life of workers and households, as unemployment would become lower and wages would increase. Additionally, it seems that fiscal policy is the correct move from India's government as monetary policy has been proven ineffective so far. However, it is of concern, that tax reduction only affects the supply-side, and if the demand-side stays unaltered, the tax cut might not be able to boost the economy due to the insufficient demand. This problem could be solved by using expansionary fiscal policy in form of government spending, however, that again raises concerns of crowding out and reduced investment.

Word count: 747

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