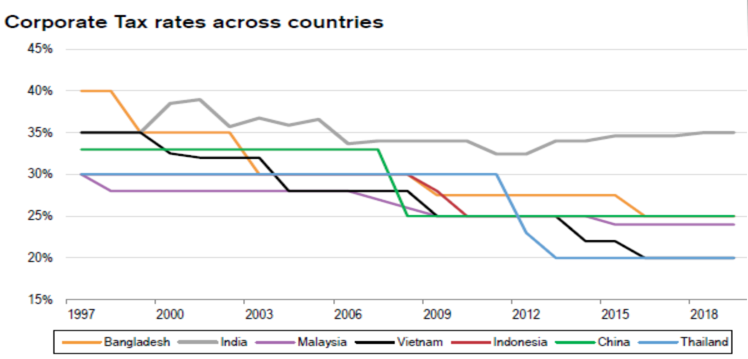
Sept 21, 2019

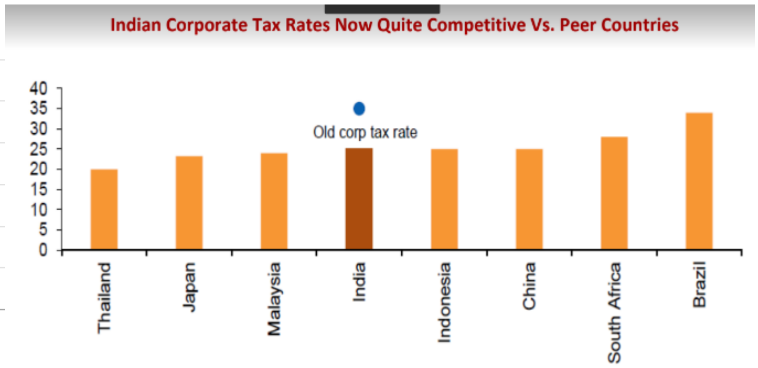
Impossible trinity of spurring structural growth rate - Fiscal/Current Account Deficit- reducing Cost of Capital - Has the elixir arrived?

The Fiscal Stimulus of lowering of taxation by 10% to 25.2% for corporates, and the new 17.2% tax as an incentive for starting new units has cheered the equity market. The market witnessed one of the highest gains in recent history. The move is going to revitalize the manufacturing sector, bring down the cost of capital and attempt to capitalize on the friction in the global economy due to the trade war. Vallum Team (Four Participants) strongly debated the consequences of yesterday move over the weekend. I am glad to reproduce the discussion notes.

Participant 1:

This is a historic move and the global tax-cutting trend began two decades ago when Ronald Reagan and Margaret Thatcher implemented bold tax cuts, in the 1980s. The U.K. and U.S. economies blossomed in response; the rest of the world took notice. Across the globe, tax rates began to come down. **The eastern economies made tremendous progress due to the introduction of flat tax of 15-20% post 2005. In early Sept this year, Thailand dangled 50% tax cut for manufacturers, who were fleeing China from trade war fears,** if they are able to complete the project within stipulated time frame.





In 1953 [Japan's] capital gains taxes on equities were eliminated. In 1955, interest income was made tax-free and dividends were taxed at 10%. In 1950, the 55% income tax bracket started at income of 500,000 yen. In 1957, the threshold had been raised to 10 million yen and other brackets were similarly raised. The hyperinflationary yen was pegged to gold in 1949. The result was a white-hot stock market and one of the greatest feats of wealth creation of the past century. Tax revenues rocketed. I believe India is on similar cusp of things and policy makers have taken very timely bet on this issue.

Participant 2:

It is commendable that policymakers have withstood the intense pressure and daily trials by the media over the last six months to use short term measures to spur consumption. Secondly, the government's ideology to create long-lasting capital assets rather boosting consumption is reflected with tax incentive. Finally, resorting to the long term solution of enhancing manufacturing and industrial activities **should catapult Foreign Direct Investment (FDI) in the country in the medium to long term, significantly.** As per an OECD research paper, FDI elasticity to tax rates in 3.72, so for every 1% cut in tax rate FDI goes up by 3.72%**.** India in the year 2018-19 received US$ 44.4bn as FDI. India is attractively positioned amidst trade war situation between US-China, Japan-South Korea due to its huge domestic markets, availability of good quality engineering pool and now favourable tax policies. Currently, manufacturing has shrunk to 16% of GDP and has remained stagnant for long time while the government has the vision to take this sector to 25% of GDP by 2022. The below mentioned table also highlights achievement of efforts of policymakers over the last few years:

	Business Impact of rules on FDI		**Effect of taxation on incentives to invest**		**Global competitiveness index, value**	
Country	**2017-2018 Rank**	**Improvement in rank over 5 years**	**2017-2018 Rank**	**Improvement in rank over 5 years**	**2017-2018 Rank**	**Improvement in rank over 5 years**
Portugal	7	72	109	30	42	9
Hungary	46	38	41	94	60	3
Czech Republic	16	51	36	88	31	15
Iceland	114	23	48	84	28	3
Japan	27	31	45	41	9	0
India	**74**	**19**	**24**	**20**	**40**	**20**

The release of additional equity for corporates by lower taxation will act as fiscal stimulus to counter the current cyclical slowdown. The company can decide to put this to judicious use based on its insight and assessment. Some money may get competed away and some of it will accrue to shareholder. For many companies this will bring down the excess cost of debt due to higher resulting equity in the business.

Participant 3:

Capital Market and Asset reflation solve many problems for banking sector and the economy. Initially, the policymakers misunderstood the role of buoyant capital markets in solving the problem of banking sector, job creation and channelizing economic activity, especially scarce equity capital in a capital starved economy. This raised a lot of scepticism and led to an ideological debate amongst various constituents about whether our road to progress passes through cobbled street of socialism or narrow lane of capitalism. I believe with recent measures and responsiveness the **debate is firmly settled that incentives of the government are aligned with the capital markets as, with the divestment exercise, it is one of the biggest beneficiaries.**

Expected progress of Corporate India Balance Sheet due to Buy Back/Dividend/Tax

Phase I Next 0-24 Months

a. Deleveraging due to taxation on taking capital out from corporate entity till demand revives
b. Cost of capital falls for the corporates due to better Debt/Equity ratio

Phase II –Decade

a. Healthy Balance Sheetswill triggers Merger &Acquisition
b. Revival of Capex by Private Sector
c. Large Dosage of FDI in Services, Manufacturing by Global Corporations

Participant 4:

The total taxation loss of Rs. 150,000 cr p.a. on corporate taxation base of Rs 740,000 cr is too huge to ignore. **The cheerful stock market does not make economic sense.** The tax incentive for new manufacturing is one of the finest measures, but I fail to understand how economic slowdown, problem of liquidity post de-monetisation and GST by SME- MSME, unsold inventory of Real estate, shift of purchasing power of small business to technology platforms is helped by this move. **This is a transfer of wealth from taxpayers to large organised corporates which was not warranted.** There is no free lunch in a society. With weakening fiscal situation, cost of capital will go up over next few years. We are unintended beneficiary of global negative interest rate. We should have used this Fiscal bazooka to upfront the capital expenditure, for creating high end value added industry. I think the policymakers are having a leap of faith that they will recover this money thru aggressive divestment. Selling PSU at 5-8% dividend yields? I do not see any effort to get strategic partnerships or complete sellouts in the last few years.

Let's looks at what China has achieved with fiscal incentives in Research & Development (R&D):

Over the past 18 years, China's annual R&D spending grew more than 30-fold, from $9 billion in 2000 to $293 billion in 2018—making China the world's second-largest R&D investor after the U.S. In relative terms, China's R&D spending-to-GDP reached 2.2% in 2018, up from 1.5% in 2008, when GDP was smaller. This ratio has considerable room to continue rising under Beijing's new tax incentive scheme, launched recently. Between 2010 and 2015, Chinese firms accounted for 38% of worldwide growth in R&D spending and 80% of worldwide growth in patent applications. The economic impact of such activity is significantly higher than giving capital in the hands of corporate as we have done yesterday. The tax incentives and buy-backs have contributed 50% of rise of S&P Earnings not the economic growth. I see struggle to meet the tax collection.

Now Vallum Debates shifts to who will foot the bill of ice cream and desserts.