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Big bang steps

With fiscal and monetary levers being pulled simultaneously, expect economic growth and corporate profit to accelerate

Akash Prakash September 23, 2019 Last Updated at 23:31 IST

The finance minister surprised almost everyone on Friday with her announcements on corporate taxation. The government has taken the decisive step of reducing tax rates by 10 percentage points to 25 per cent for all domestic companies. For new manufacturing investments, companies can avail of a tax rate of 17 per cent, provided the new assets become operational by March 31, 2023. There were some other less significant changes for share buyback programme that was announced earlier, as well as for the removal of surcharge on capital gains on buying and selling of equities. The total cost of these tax breaks was estimated to be Rs 1.45 trillion. The magnitude and speed of corporate tax relief is unprecedented for India. Overnight, we are now comparable to most countries in Asia. This was clearly an unexpected move, and markets rejoiced by promptly rising over 5 per cent on Friday. On further reflection, it becomes clear that this is a major policy move. Investors have to think through the long term impact — and it is not just the rise in corporate earnings. Here are some of my takeaways.

1. The government has finally moved past the "*suit, boot ki Sarkar* " jibe of the Congress. It is no longer scared of being seen to be wooing businesses. Money-making, if done ethically, is to be celebrated and not vilified. This is a big step in correcting the perception that the government had moved too far to the left and was not pro-business.

This tax break is targeted at corporate India, and improving corporate confidence. The government recognised that there was risk aversion among corporate leaders. The decision to decriminalise certain offences in the companies Act is another step in this direction. No amount of reduction in interest rates will catalyse investments if business leaders lack belief.

Illustration: Ajay Mohanty

India will become a more attractive destination to set up and run a business as a result of these steps. Instead of giving a relief in GST rates, which would have given a boost to consumption, the finance minister has improved the earnings and cash flows of corporate India, hoping that these companies will gain confidence and, in turn, hire and invest. While more needs to be done to ease the hassles of running a business in India, this is a massive step. Tax rates can no longer be the reason to not invest in India. Corporate India must now stop complaining and instead step forward and bet on the economy and growth normalising. The time for cynicism and doubts about the government having any interest in corporate India must end. Companies will hopefully use this windfall to make investments for the future, be it in people, pricing, technology, brand building or plant and machinery. Ultimately, domestic investments must drive our economy; foreign direct investments can only be the icing on the cake.

2. This is a huge bet on growth. We will miss the fiscal targets for this year for sure, but even going forward, the only way this step makes sense for the government is if growth comes back strongly. Prime Minister Narendra Modi needs funds for his social programmes. With these new tax rates, unless growth accelerates strongly, he will not get the revenues he needs to fund these social schemes. These tax cuts should put to rest any doubt about whether the government cares about economic growth. Everyone is now aligned on one thing: Rapid economic growth is a necessity. Better still both the fiscal and monetary authorities are finally on the same page.

3. The bears worry about the fiscal deficit. It is true we may see a fiscal deficit of 3.7-3.8 per cent of GDP this year. However, as an equity investor I can live with that if growth strengthens and earnings accelerate. I would prefer a higher fiscal deficit with stronger GDP and earnings growth and a little higher inflation, than an obsession with 3.3 per cent (fiscal deficit), with no inflation and weak growth. The fiscal overshoot will also put pressure on the government to monetise assets faster and more strategically. Strategic divestments will come back on the table. They may be far more aggressive than anyone now thinks. We may see a faster roll out of direct benefit transfer, in the area of food and fertiliser subsidies, as pressure to optimise expenditure gains ground. The fiscal constraints this step imposes will encourage more reform.

4. We should see an 8-10 per cent rise in profits after tax for the listed corporate sector. The initial benefits may be lower as some companies will not move to the new regime and others will have to mark down deferred tax assets. More importantly, the new tax regime will raise the normalised return on equity and free cash flow metrics for corporate India. The benefits are for perpetuity and should therefore raise the theoretical multiple for the market.

5. These steps only further strengthen the ongoing consolidation in corporate India. The strong will get even more powerful and the weak will fade away. After all, the biggest beneficiaries of these steps are the companies which pay the highest absolute amounts and highest rates of tax. Weak companies, which are not profitable, get no benefit at all. In industry after industry the weaker players with weak governance or stretched balance sheets are being swept away, creating space for market share gains for the better run companies. The clean up of corporate India will only accelerate post these cuts.

6. In the short term, the economy will remain weak. Q2 earnings will be horrible; consumption demand will take time to recover; the NBFC crisis is not over; you will see no immediate pickup in investments; jobs growth will remain weak. People will argue that this is a blunt stimulus measure, it would have been better to cut income taxes or GST. Others will argue that companies will just sit on the gains.

However, sentiment has turned in my opinion. So have markets, as they lead the economic cycle. The government has shown that it will listen, and that the economy and corporate India matter. The lurch to the left in economic policy-making has been arrested. It has also shown that the government has the willingness to make big bets even in the economic sphere. Investors thought that monetary policy was the only lever the government had at its disposal to revive the economy. We were wrong. No one expected a stimulus of this magnitude. We now have both the fiscal and monetary levers being pulled simultaneously. Over the next 18 months, expect both GDP and corporate profits to accelerate. We may have hit bottom in both.

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