Source : www.livemint.com Date : 2019-09-25

WHY THE BROAD TRAJECTORY OF ALL TAXES IN INDIA IS DOWNWARDS

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Public Finance, Taxation & Black Money incl. Government Budgeting

The focus this year should be on growth rather than the impact of a fiscal stimulus on our deficit

Last Friday, finance minister Nirmala Sitharaman announced the single biggest corporate tax rate cut in Indian history, by bringing down the effective tax rate to about 25% for all domestic companies. For new manufacturing companies set up after 1 October, the rate is down to 15%—among the lowest in major economies.

These cuts, and changes to rescind the levy of a surcharge on capital gains tax, will cost the exchequer over 1.45 trillion. The real loss may be lower, since the new rate applies only to companies that claim no other tax benefits provided under other provisions of the Income-Tax Act. Any spur to economic activity may also improve indirect tax collections after a lag. But one must note the uncanny similarity between the gross revenue-loss figure and the capital and dividend transfers announced by the Reserve Bank of India (RBI) a month ago.

The 1.76 trillion RBI “bonanza" was widely seen as some kind of favour to the government resulting from executive arm-twisting of the central bank, but the net receipts this year will—after deducting the interim dividend already paid last year—amount to just 1.48 trillion. Almost the entire “bonanza" has been put to good use to revive animal spirits in the economy. This is commendable.

The second point worth making is that the overall trajectory of all taxes—direct and indirect—will be downward in the foreseeable future. Reason 1: Growth has to be domestically led when protectionism is growing globally, which makes tax spurs as important as factor market reforms. Reason 2: When the corporate tax rate is 25% at the top end, it does not make much sense to retain the personal tax rate at 30%-plus, including surcharges. While the finance minister has said there is no plan to reduce personal tax rates any time soon, it’s likely to happen at some point.

The personal tax rate structure is skewed—with the rates being 5%, 20%, and 30%. If the top rate is retained at 30%, the logical bottom rate should be 10%, and not 5%. The gap between the first slab and the second is 15%, while that between the second and top slabs is 10%. This is illogical and needs modification. Assuming that the bottom slab is not raised, it is the 20% and 30% slabs that will need reduction to 15% and 25%. In the alternative, the base for each bracket needs raising, which too results in lower taxes. One can assume that when resources permit, everybody’s personal tax outgo will fall.

A stronger reason for expecting tax rates to come down further is the goods and services tax (GST), which impacts small and proprietary businesses adversely. If one is forced to declare a higher turnover to the GST Network, showing personal incomes at low or below taxable limits will be difficult to defend. GST pressure forces proprietary and small businesses to show higher personal incomes. To address this large constituency, which is upset over this double-pressure from GST and income tax, personal taxes in general have to come down.

The announcement of the big corporate tax cut also signals a key government realization: that if animal spirits are to be ignited, the exchequer has to be willing to take a fiscal risk. India cannot

afford growth to fall below 5%, as it will directly impact jobs and incomes. India's fiscal ayatollahs are already wringing their hands in despair about how the massive tax cut will impact the budget deficit, but this is as wrong-headed as the huge interest rate blunders committed by the Monetary Policy Committee (MPC) after demonetization. The MPC targeted non-existent inflation when growth was flagging. It would be equally wrong for today's fiscal fundamentalists to talk about the rising trend in the deficit as some kind of Frankenstein's monster.

There is little chance of the fiscal deficit coming down without a revival of growth. Mathematically, the deficit is the numerator while gross domestic product is the denominator; a shrinking rate of growth will make the fiscal deficit worse, not better. The time to worry about the fiscal deficit would be next year, or even the year after. This year, our only priority should be to get growth up.

Some economists have said—not unreasonably—that the corporate tax cut will address the supply side of growth, but not the demand side. They are right. Logically, a demand side stimulus is also called for. This may be difficult this year. But in the next fiscal, it should be possible to increase rural demand by enhancing the PM Kisan Samman by another 6,000 per annum, thus adding 85,000 crore to rural incomes, in addition to what is available under the MGNREGA make-work scheme. GST tax cuts could take place if growth begins to show an uptick in indirect tax collections by the second half of this year.

Even otherwise, a supply side stimulus like a corporate tax cut can also be used as a demand side stimulus. For that, enlightened companies will have to use the extra money to cut prices and innovate, rather than just swallow it by paying their shareholders higher dividends. The assumption that only the government can provide a demand stimulus is wrong. India Inc should do its bit, now that the government has responded to its cries for help.

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