EDITORIAL: BUSINESS STANDARD

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CHALLENGES WITH TAX CUTS AS STIMULUS

The ascent of Hindi middlebrow Beyond personal income tax, the govt can consider two other measures to stimulate demand, but the focus should remain on delivering only a short-term boost.

Introduction

1. **Budget Presentation:**
   The **Budget for 2025-26** is due to be presented, and there are high expectations from the finance minister, particularly regarding potential **income tax rate reductions**.
2. **Context of Policy Changes:**
   Any policy changes in the Budget must be viewed within the broader **economic context**, which includes challenges such as slowing growth, global uncertainties, and capital market volatility.

Economic Context and Challenges

1. **Moderation in Growth Rate:**
   - **Decline in Quarterly Growth:** There has been a steady decline in quarterly growth rates, with **Q2 FY 2024-25 growth pegged at 5.4%**, indicating a slowdown in economic activity.
   - **First Advance Estimates:** The first advance estimates for **2024-25** project growth at **6.4%**, which is significantly lower than the **8.2%** growth reported in **2023-24**.
   - **Growth in First Half of 2024-25:** Real growth in the first half of 2024-25 was **6.2%**, suggesting a pickup in growth in the second half of the year.
   - **Reasons for Slowdown:** The slowdown is attributed to a moderation in **private final consumption expenditure** (consumer spending) and **gross fixed capital formation** (investment in infrastructure and assets).
2. **Global Uncertainties:**
   - **U.S. Presidency Changes:** The new U.S. presidency is implementing policies aimed at restructuring global supply chains to align with American interests.
   - **Potential Tariffs:** These changes could include tariffs affecting multiple countries, creating uncertainty for the global economy.

- **Impact on India:** The potential impact of these changes on the **Indian economy** is uncertain and largely beyond the control of the Indian government.

3. **Capital Outflows and Market Volatility:**

- **Capital Outflows:** There have been significant capital outflows from India, leading to a **sharp fall in stock prices** and **depreciation of the rupee**.
- **Inflationary Pressures:** The depreciation of the rupee could lead to higher domestic inflation, as imported goods become more expensive.
- **RBI's Constraints:** This situation limits the **Reserve Bank of India's (RBI)** ability to reduce interest rates, as higher inflation requires tighter monetary policy.

Policy Focus: Short-Term Stimulus vs. Structural Change

1. **Short-Term Stimulus:**

- The government could focus on providing a **short-term stimulus** to boost demand in the economy.
- This could take the form of **tax cuts**, particularly income tax reductions, to increase disposable income and encourage spending.

2. **Structural Change:**

- Alternatively, the government could focus on **structural reforms** to support long-term growth.
- This could involve targeted stimulus for sectors like **agriculture** and **micro, small, and medium enterprises (MSMEs)**, which are critical for employment generation.

Options for Income Tax Reduction

1. **Current Scenario:**

- For **Assessment Year 2023-24**, **99.1 million individuals** either filed income tax returns or paid taxes through the **Tax Deducted at Source (TDS)** route.
- Of these, **75.5 million** filed returns, and **47.3 million** filed nil returns, meaning only **30 million** filed returns with positive tax payments.
- A reduction in **effective tax rates** could stimulate demand among taxpayers earning above **₹5 lakh annually**.

2. **Key Considerations:**

- **Targeting the Stimulus:** Should the tax cuts focus on **lower-income slabs**, where individuals have a higher propensity to spend their additional income?

- **Duration:** Should the tax cut be a **short-term measure** to provide immediate relief, or a **long-term adjustment** in tax liability to support sustained economic growth?

3. **Impact on Tax-to-GDP Ratio:**
   - Personal income tax is forecast to contribute **3.6% of GDP** in 2024-25.
   - Reducing effective tax rates could lower the **tax-to-GDP ratio**, which may have long-term fiscal implications and require careful consideration.

Alternative Tax Initiatives

1. **Petroleum Taxes:**
   - Diesel is a critical input for many economic activities, including transportation and agriculture.
   - A **reduction in diesel cess** could help mitigate inflationary pressures caused by rising crude oil prices due to rupee depreciation.
   - Lower diesel prices would reduce costs for businesses and consumers, providing a broad-based stimulus.
2. **Goods and Services Tax (GST):**
   - A **reduction in Central GST (CGST)** could provide a stimulus across a wide range of goods and services.
   - Unlike State GST (SGST), changes to CGST can be implemented unilaterally by the Union government, making it a flexible policy tool.
   - This approach would be similar to the **excise duty stimulus** introduced during the **global financial crisis**, which was later reversed when the economy recovered.

Expenditure-Side Policies

1. **Retaining Existing Tax Rates:**
   - The government could choose to retain existing tax rates and focus on **expenditure-side policies** to stimulate the economy.
   - This could involve increased spending on infrastructure, healthcare, education, or other sectors to boost demand and create jobs.
2. **Short-Term Focus:**
   - The key is to ensure that any stimulus measures are **short-term** and targeted effectively to address immediate economic challenges without compromising long-term fiscal stability.

Conclusion

1. **Economic Headwinds:**
   The **2025-26 Budget** must address significant economic challenges, including slowing growth, global uncertainties, and capital market volatility.

2. **Policy Options:**
   The government has several policy options, including **income tax reductions**, **petroleum tax adjustments**, and **GST rate cuts**, each with distinct implications for demand stimulation and fiscal health.

3. **Balancing Act:**
   The government must carefully balance **short-term stimulus** measures with **long-term structural reforms** to ensure sustainable economic growth and stability.

4. **Targeted Approach:**
   A targeted approach, focusing on sectors like agriculture and MSMEs, could provide both immediate relief and long-term benefits by generating employment and boosting productivity.

5. **Fiscal Responsibility:**
   While providing stimulus, the government must also ensure fiscal responsibility to maintain macroeconomic stability and investor confidence.

By addressing these challenges and leveraging the available policy tools, the government can navigate the current economic landscape and lay the foundation for sustained growth and development.

Source: https://www.business-standard.com/opinion/columns/budget-govt-faces-choice-between-economic-stimulus-and-structural-reforms-125013001657_1.html