Challenges with tax cuts as stimulus

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

ILLUSTRATION: BINAY SINHA

The Budget for 2025-26 is due to be presented tomorrow, and as usual, there are many expectations from the finance minister. One oft-repeated request is to reduce income tax rates. Any policy changes in the Budget need to be viewed in the context in which it is being presented. For the forthcoming Budget, three broad headwinds need to be taken into account.

First, there is an observed moderation in the growth rate. A steady decline in quarterly growth rates has been reported, with growth for Q2 in FY 2024-25 being pegged at 5.4 per cent. The first advance estimates for 2024-25 indicate growth of 6.4 per cent, significantly lower than the 8.2 per cent reported for 2023-24. With real growth in the first half of 2024-25 reported at 6.2 per cent, the advance estimates suggest a pickup in growth in the second half. The slowdown in economic growth has been attributed to a moderation in the growth of both private final consumption expenditure and gross fixed capital formation.

R KAVITA RAO

Second, significant global uncertainties are becoming evident. The new presidency in the United States is bringing in a slew of changes as we speak. A primary driver of these changes is the stated objective of restructuring global supply chains to suit American interests. The range of measures could include tariffs affecting multiple countries. The possible impact of these changes on the global economy—and, by implication, on the Indian economy—is uncertain and largely beyond the Indian government's influence.

Third, these and other factors are resulting in significant capital outflows and enhanced volatility in capital markets. Apart from a sharp fall in stock prices, these have meant a depreciation of the rupee. In the short term, this would have consequences for domestic inflation, placing limits on the Reserve Bank of India's ability to reduce interest rates.

In this context, government policy needs to determine whether the focus should be on a short-term stimulus to the economy or on supporting structural change. To oversimplify, the former could take the form of a tax cut, while the latter could involve a stimulus targeted at specific segments of the economy, particularly those linked to employment generation. These could include a focus on agriculture and/or micro, small and medium enterprises.

In the rest of the piece, an attempt is made to look at the set of options for policy changes within taxation and their likely impact. The context of the Budget is encouraging conversations about the need to reduce income tax on individual taxpayers as a tool for stimulating demand in the economy. For assessment year 2023-24, 99.1 million individuals filed income tax returns or paid income tax through the TDS route in India. Of these, 75.5 million filed a return. Of the latter, 47.3 million filed a nil return, suggesting that less than 30 million filed a return with a positive tax payment. A change in the effective tax rate would provide a stimulus to some or all of these people, all of whom have annual incomes above ₹5 lakh.

There are two issues to consider — first, should the stimulus be provided to all these individuals, or should it be limited to those in the lower income slabs, given that the latter would have a higher propensity to consume out of income? Second, is it intended as a short-term stimulus or a long-term adjustment in tax liability?

Personal income tax in India was forecast to reach 3.6 per cent of gross domestic product (GDP) in the Budget for 2024-25, supporting a gross tax collection-to-GDP ratio of 11.66 per cent for the Union government. A reduction in the effective tax through a change in the tax slabs needs to be understood as a long-term policy change with resulting reduction in the tax-to-GDP ratio. If this is not the goal, then income tax relief can take the form of a temporary rebate in tax liability, which can be revisited annually.

Assuming that the Union government has accepted the idea that a stimulus in the form of taxes is a necessity in the present context, two other tax initiatives can be explored through changes in the indirect taxes systems. First, consider petroleum taxes, especially on diesel. Diesel is an input into a number of activities in the economy. Depreciation of the rupee will increase the cost of crude, which in turn will translate into higher diesel prices, further getting transmitted into higher inflation. A downward adjustment of the cess of diesel could be a useful tool to explore. There are fewer challenges in transmitting lower taxes into lower prices for this commodity.

Another alternative to consider is a reduction in goods and services tax (GST), particularly in Central GST. In popular perception, GST appears to be a regime with little flexibility for individual actors. While competition among states regarding the structure of the GST regime may invoke thoughts of a race to the bottom, the same challenge does not exist for changes in the CGST structure. In principle, it should be possible to reduce the CGST component of GST while leaving the State GST rates unchanged. Since the proposed policy interventions are being viewed as a stimulus to be provided by the Union government, a short-term reduction in the CGST rate could also be a possible policy choice. Given that GST is paid by a broader spectrum of people across the country, a stimulus through this channel could have a larger impact. This would be akin to the excise duty stimulus offered during the global financial crisis and can be reversed to signal an end to the stimulus as well.

Retaining the existing tax rates and focusing on expenditure-side policies also remains a viable policy option. The key in all these cases is to focus on a "short-term stimulus".

The writer is director, National Institute of Public Finance and Policy, New Delhi