Editorial.

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No time to cut rates

Revenue collections by the central government have been so buoyant this year that people have already begun talking about reducing tax rates. The possibility of lower rates being announced in the upcoming Budget has been around in the media for some weeks now. This position has now had significant weight put behind it in the form of the Prime Minister's Economic Advisory Council Chairman C Rangarajan's recommendations to the finance minister that he must consider cutting taxes in order to stimulate demand. The council's assessment is that GDP growth during 2008-09 will be at around 8.5 per cent, the slowdown from this year's anticipated 8.9 per cent being attributable in part to the manufacturing sector. Among other measures available to offset this tendency, a reduction in excise tax rates is seen as a good way to bring down production costs, while also taking advantage of the tax buoyancy. As long as the Fiscal Responsibility and Budget Management Act's targets on the fiscal deficit are met, there is merit in thinking of tax rate reductions. In fact, given the overall inefficiency of government expenditure, it makes eminent sense to plough the excess back into the private sector, where it is more likely to be spent productively.

The council's recommendations are based on its perception that the economy is going into a cyclical downturn, which a fiscal stimulus would help neutralise. There are other recommendations relating to cutting tax rates, both direct and indirect, which are based on a longer-term view of fiscal buoyancy. In these, the typical argument is that structural changes in tax administration and enforcement have contributed to a significant expansion in the tax base, which allows the government to spread the burden of taxes more widely and provide relief to the traditional tax-paying segments. While both the cyclical and structural views are valid, the temptation to cut taxes immediately in response to the revenue bonanza of 2007-08 should be resisted. There are several threats on the fiscal front, which could collectively put the central government back on the tightrope as far as controlling the fiscal deficit is concerned. To name just a few, the interest payment on the market stabilisation bonds, which are used to sterilise foreign exchange reserves; the interest payment on the oil bonds, which are being issued to oil marketing companies in lieu of raising petroproduct prices; the impending recommendations of the Sixth Pay Commission; the impact of rising food prices on the subsidy bill ... the list can go on.

In order to protect the credibility of the government's commitment to fiscal responsibility, it is critical that the government take a long-term view of tax reform, which takes full advantage of the structural changes without exacerbating the risk of slippages. The goods and services tax has been proposed as an integrating framework for indirect taxes at the central government level. To make this work, a large number of exemptions that are currently available would have to be streamlined, if not eliminated. Against this backdrop, any decision to change rates should be made within the GST framework, taking into account the time frame set for it. The economy has just emerged successfully from a long process of fiscal adjustment, but it is important to remember that there are still many miles to go. The finance minister would be well advised to retain his commendable focus on long-term fiscal reforms.