TAX CUTS : ECONOMY

NEWS: *Why the tax cuts are a one way gamble*

WHAT'S IN THE NEWS?

The latest Union Budget introduces **major income tax cuts**, primarily benefiting the **middle class** (roughly **2-3% of the population**). The government aims to stimulate economic growth by increasing disposable income. However, the move also carries risks, as it assumes **high-income growth will offset revenue losses**. If this assumption fails, the government may face **spending cuts**, potentially leading to **a slowdown and a K-shaped economic recovery**.

Key Budget Announcements on Taxation

1. **Income Tax Relief:**
    - **Tax-free income limit increased** from **₹7 lakh to ₹12 lakh** under the new tax regime.
    - **Exemption limit for high earners** (₹12L+) raised from **₹3 lakh to ₹4 lakh**.
    - **Marginal tax rates reduced** across all slabs, benefiting salaried individuals.
2. **Revenue Impact:**
    - **Estimated revenue loss:** ₹1 lakh crore (~8% of direct tax collections).
    - **Expectation:** Increased earnings and economic activity will compensate for the shortfall.

Government's Assumption: Higher Growth Will Offset Revenue Loss

The Budget predicts **a 14% rise in direct tax collections**, despite an **8% reduction in tax rates**. However, to meet this revenue target, **income levels would need to rise by 24%**, which is **more than double India's projected nominal GDP growth (10.1%)**.

Possible Ways to Achieve the Target:

- **Increase in high-income taxpayers** due to job creation or rising salaries.
- **Higher tax buoyancy**, meaning **more people paying taxes despite lower rates**.
- **Stronger compliance and reduced tax evasion** with digital tracking mechanisms.

Challenges in Achieving This Goal:

- **Uncertain job market:** Without strong employment growth, income levels may not rise as expected.
- **Weak corporate investment:** Companies may not expand hiring and salaries as predicted.
- **Global economic slowdown:** External shocks could limit India's growth potential.

The Risk: What If Incomes Don't Grow as Expected?

If tax collections fail to meet projections, the government will have to **cut spending**, affecting key welfare programs.

Budget Deficit and Fiscal Constraints:

- **2024 Revised Estimate: 4.8% of GDP**
- **2025 Budget Estimate: 4.4% of GDP**

- **Impact of a lower deficit target:**
  - **Less flexibility to increase spending during slowdowns.**
  - **Fiscal Responsibility and Budget Management (FRBM) Act restricts overspending**, leading to **pro-cyclical policies** (amplifying economic fluctuations instead of stabilizing them).

If Revenues Fall Short, Two Scenarios Arise:

1. **Government cuts spending** (Fiscal contraction) → Slows down growth → Further reduces tax revenue.
2. **Government increases borrowing** (Deficit financing) → Raises fiscal deficit → Increases inflation and debt burden.

Concerns Over Fiscal Consolidation vs. Economic Growth

Key Concern:

- If a **4.8% fiscal deficit failed to boost economic growth**, can a **4.4% deficit achieve it?**

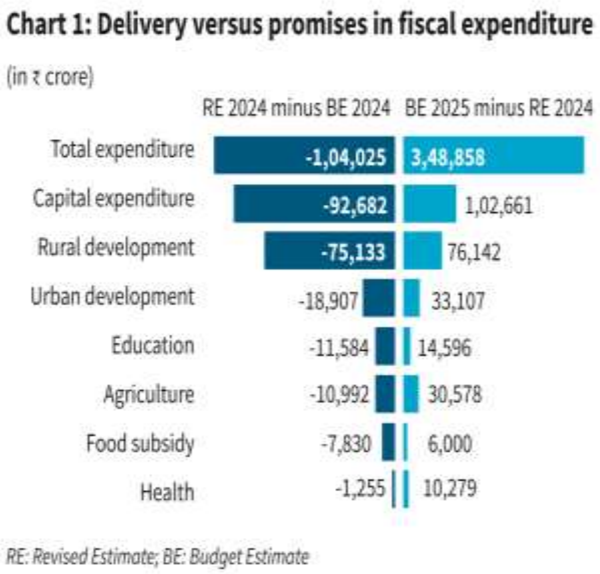
Government's Dilemma:

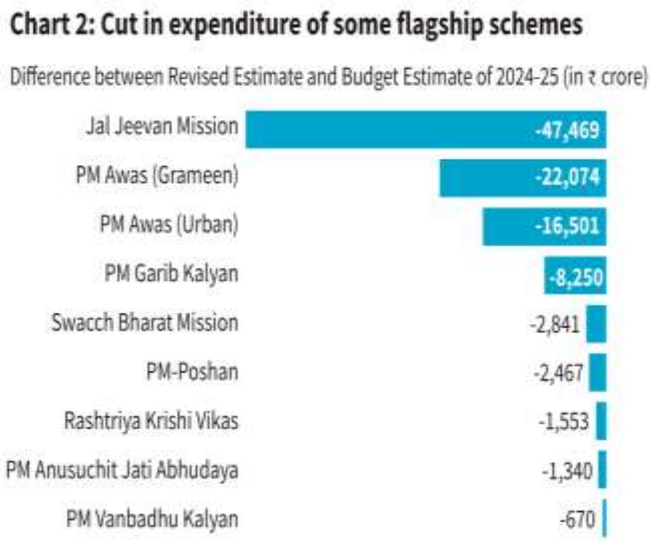
- **Corporate investment remains weak** → Private sector is not driving growth.
- **Exports are slowing down** → External demand is uncertain.
- **Government is relying solely on tax cuts** to drive demand, but without other economic drivers, the plan might fail.

Impact on Government Spending:

- **Past budget trends show that when tax revenues fall, social sector spending is cut first.**
- Even **flagship schemes linked to the Prime Minister saw budget cuts** in the 2024 Revised Estimates.
- **Welfare programs for the poor and disadvantaged could be the biggest losers.**

K-Shaped Growth: Uneven Economic Impact





What is K-Shaped Growth?

- **K-shaped growth** occurs when **some sectors and income groups recover and thrive**, while **others struggle and decline**.
- **Widening gap between winners and losers** in the economy.

Real-World Example:

- **During the COVID-19 pandemic:**
  - **Tech companies, stock markets, and digital businesses boomed.**
  - **Small businesses, tourism, and low-income workers suffered severe losses.**

How Tax Cuts Can Worsen K-Shaped Growth:

- **Middle class and high-income groups benefit** from tax cuts → Higher disposable income.
- **Lower-income groups face reduced government support** → Reduced spending on welfare schemes.
- **Result:** Economic inequality increases, with benefits concentrated at the top.

Source: https://www.thehindu.com/business/Economy/why-the-tax-cuts-are-a-one-way-gamble/article69179571.ece