Editorial

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Will Kelkar's paradigm shift spur growth?

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AT A recent conference in New Delhi, the Chairman of the Task Force on Direct and Indirect Taxes, Dr Vijay Kelkar, stated that the overriding objective of the panel's recommendations was to use taxation as an instrument of putting economic growth on a higher trajectory. This is a big issue and it would be naïve to seek a step-up in growth through the *modus operandi* of taxation alone.

To achieve accelerated growth, a fundamental requirement is that the demand for goods and services should increase at the desired pace. This, in turn, requires not only an increase in the per capita income, but also a more equitable distribution of income. This is the biggest stumbling block.

The income distribution pattern in India is highly inequitable. While a minuscule segment of the population has income running into lakhs of rupees, the earnings of the majority are but meagre. This cannot form a viable basis for 'rapid' and 'sustained' growth. In order to understand why, let us consider the following.

Scenario 1: A person has an annual income of Rs 1 crore, and 100 others earn only Rs 50,000 each.

Scenario 2 : A rich person earns Rs 50 lakh , whereas, income of 100 others is Rs 1 lakh each. Though the total income in both scenarios is the same, at Rs 1.5 crore, the demand for goods and services in Scenario 2 will be more. How?

In Scenario 1, in the group of 100, each person has meagre earnings of about Rs 4,000 per month. With this, he can barely meet expenses on food, education and healthcare. Now, if each one of them gets double this amount (Scenario 2), this will lead to creation of huge demand. On the other hand, the market may not even take note of the reduction in income of the rich man.

In the 1990s, GDP growth was propelled by the rapid growth of industry and services. However, there was significant deceleration in agriculture. This, together with the large-scale displacement of small-scale industries (SSIs), led to a worsening of the employment situation.

It will not be possible to sustain even the current growth rate of 5-6 per cent — much less achieving the target of 8 per cent fixed for the Tenth Plan period (2002-03 to 2006-07) unless the approach to development is 'broadbased' and employment'-oriented.

The proposals of the Kelkar Task Force in the area of direct taxes are directed at about 30 million income-tax payers. And, as they constitute only about 10 per cent of the work-force, one should not really expect spectacular results. Nevertheless, it is worth examining their merits *vis-à-vis* the existing regime.

Consider a person with an income of Rs 1,60,000 per annum. In the existing regime (exemption limit Rs 50,000, standard deduction Rs 30,000 and tax rate of 10 per cent on Rs 10,000 and 20 per cent on incremental amount), he will have to pay a tax of Rs 15,000. As per the Kelkar package — exemption limit Rs 100,000, no standard deduction and 20 per cent tax — his tax liability will be lower at Rs 12,000.

In view of above, after payment of tax, this person has higher disposable income under the Kelkar package than under the existing dispensation. However, the critics may argue that under the latter, he has the option of reducing his tax liability by availing of exemption under Section 88. Indeed, he may not have to pay any tax at all!

So, it could be 'Nil' under the existing dispensation versus Rs 12,000 under the Kelkar package, they would argue. But, they are missing a fundamental point here. A situation of no tax in the former is predicated on the person investing Rs 1.0 lakh as per the diktat of Section 88. He will, therefore, be left with a meagre Rs 60,000 for spending.

With just Rs 5,000 per month, he cannot ensure a decent living. Any rational person will simply not take recourse to investing heavily just to reduce his tax liability when he is not able to meet his current expenditure. Here, we are not talking of cases where the concerned person has 'undisclosed' sources of income.

Savings *per se* may appear to be a good concept. But savings at the cost of current consumption at the bare minimum can prove disastrous. There is no point in saving money for the future when good education for children and health for the family cannot be ensured.

Notwithstanding the above, generally, the salaried earner avails of exemption under Section 88 — in many cases, up to the full permissible limit. He won't mind doing so even if he ends up denying his wife the bare minimum cash needed for running the family, on the one hand, and denying the economy the demand for goods and services, on the other.

At the same time, financial institutions are flush with funds (courtesy Section 88) and do not know what to do with them. They do not come across viable projects where the money can be put to good use. This, in turn, is due to lack of purchasing power with the majority of the population, leading to demand constraints in almost all major sectors.

The proposals of the Kelkar Task Force show us a way out of this 'trap'. After paying the tax, the person in the above example will have Rs 1,48,000 in his hands. This works out to Rs 12,333 per month, a fairly reasonable amount to meet current consumption needs. This, in turn, will give a big boost to the demand for goods and services.

The above is not to suggest that the person will not save at all. Depending on his priorities, he can always set aside some money for savings. He can also decide 'freely' where to put the money and how much. Under Kelkars' package, he will become the master of his own spending, unlike under the existing regime, where Section 88 calls the shots.

Currently, a person with an income of Rs 80,000 per annum and above pays tax. Under the Kelkar Formula, persons with earnings in the range of Rs 80,000-100,000 will not have to pay tax. Further, by proposing a modest tax of 20 per cent for income up to Rs 4 lakh, against the existing 30 per cent on income in excess of Rs 1.5 lakh, the package will leave more cash in the hands of the majority of tax-payers.

> The Kelkar Task Force proposals for direct taxes will, it is hoped, facilitate the efficient allocation of resources. In the area of indirect tax also, the idea is to remove end-use based exemptions and make incentives transparent by way of duty cuts. The aim is that these measures will contribute to 'rapid' and 'sustained' growth.

Currently, interest on housing loan up to a maximum of Rs 1.5 lakh is allowed as deduction from the income. The Task Force recommendation for withdrawal of this facility is 'retrograde'. Apart from hitting the salaried earner, this will affect construction activity and, in turn, employment. Housing being a basic necessity, this should be treated differently from other exemptions.

Financial institutions, such as IDBI, ICICI, IFCI, LIC, and so on, may feel uncomfortable under the Kelkar regime. This is because they will lose a 'captive' source of funds. But they should take this in their stride. Instead of riding piggy-back on the exemptions under the Income-Tax Act, they should garner funds from the salary-earners on their own strength.

It is well-known that huge loans given by FIs have turned into NPAs. This is largely because due diligence was not exercised when granting the loans. Indiscriminate exposure in the steel sector without proper research is a case in point. Now, if the FIs do not get easy money, they will be careful while giving loans.

For decades, the Government has used fiscal incentives as an instrument of promoting development of infrastructure, backward areas, R&D, and so on. And, yet, the progress on all these fronts has been highly inadequate. Generally, the projects do not fructify because these are either ill-conceived or do not get approvals in time, or because the policy environment is uncertain.

There are other structural problems too. For instance, in the power sector, most of the projects promoted by private companies remain stuck for want of fool-proof arrangements for security of payments. This is because of the legal requirement that they can sell power only to the SEBs, which are bankrupt. Against this backdrop, there is no point in giving them a 'tax holiday'.

The recommendation of the Task Force for doing away with the fiscal sops for infrastructure projects merits consideration. The Ministry of Finance may, however, take a suitable view on whether these should be withdrawn prospectively or retrospectively, keeping the FDI angle in mind.

The Government should provide a 'conducive' and 'stable' policy environment besides giving timely clearances. With this, promoters will invest in infrastructure projects even without fiscal incentives.

In the power sector, elimination of electricity theft and subsidies alone can make a big difference.

While taking away exemptions, the Kelkar panel has recommended reduction in the corporate tax to 30 per cent and withdrawal of minimum alternate tax (MAT). This is clearly a more 'efficient' and 'transparent' way of giving support. With this, resources will be put to use only in projects that are fundamentally sound. This will also help rein in NPAs.

The levy of tax on dividend is an anachronism from the past. This results in taxing the profits twice. The Kelkar panel has recommended abolition of dividend tax, which will remove this anomaly. This, together with removal of tax on long-term capital gains on equity investment will enthuse investors to put their savings in the capital market.

In the area of indirect tax also, the Task Force recommendations are guided by the principle of removing end-use based exemptions and making incentives transparent by way of reduction in duties. As in its proposals for direct taxes, this too will facilitate the efficient allocation of resources. This will, it is hopes, contribute to 'rapid' and 'sustained' growth.

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