Raise taxes to reduce the budget deficit

By Kanes

We do not seem to have had much success in managing our finances. Our expenditure is running far ahead of revenue and consequently our budget deficit is sizeable. It was 10.5 per cent of GDP in 1994. We have managed to reduce it marginally to 9.2 per cent in 1998 but this is still too high. We intend to bring it down to a more manageable figure of 6 per cent of GDP in 1999 but it is very doubtful we will succeed. We had planned to have a budget deficit of 6.5 per cent of GDP in 1998 but we ended up with a deficit of 9.2 per cent. We are likely to repeat this experience in 1999 according to the evidence available. The overall budget deficit of 1999 according to the Budget Speech was to be Rs. 69 billion, but already we have revised it to Rs. 89 billion. If we assume the GDP in 1999 to be the same as assumed in the Budget Speech, then the deficit of Rs. 89 billion will equal 7.7 per cent of GDP. The deficit may be even larger if the actual revenue and expenditure figures fail to correspond with the revised figures. It is also relevant to note that the budget deficit in the first five months of 1999 of Rs. 41 billion is the same as that in the first five month of 1998.

Perhaps the major reason for the large budget deficits in recent years was the high expenditure on security - on the war against terrorism - amounting to 5 to 6 per cent of GDP. Expenditure on security was highest in 1995 - 6.5 per cent of GDP - but has fallen thereafter to 5 per cent of GDP in 1998. Thus, 54 per cent or more than half of the budget deficit in 1995 can be attributed to security expenditure. It has been argued that ending of the war against terrorism would reduce the budget deficit by about 5 per cent of GDP and bring it down to a reasonable level of about 4 per cent. This line of argument, however, forgets that the end of the war is the beginning of reconstruction and rehabilitation of the North and East and the creation of alternative employment to the demobilized soldiers and the former terrorists, and the money now spent on the war will have to be diverted for these purposes. The damage and destruction of national assets such as roads, communications, irrigation schemes, schools, hospitals and administrative buildings, houses and cultivated land by the war are substantial and the cost of repairing and/or replacing them will undoubtedly be high. New projects and programmes to reemploy those who were fighting - numbering thousands - will also need considerable funding. Under these circumstances, ending the war may not result in cutting down the budget deficit.

Why Were Taxes Lowered?

The budget deficit can normally be reduced by increasing revenue and/or cutting down expenditure — certainly not by reducing revenue. Strange as it may seem, this is precisely what we have done. We have allowed a large budget deficit equal to 9-10 per cent of GDP to continue year after year without increasing revenue. On the contrary, we have reduced government revenue in the last four years from 20.4 per cent of GDP in 1995 to 17.3 per cent in 1998 mainly through reducing tax revenue from 17.8 per cent of GDP to 16.0 per cent. In any country, special circumstances require special measures; the rising expenditure on the war against terrorism required additional revenue - additional taxes - and the public would have supported additional taxation for a national emergency without protest. What we did, however, was the opposite: we reduced taxes when the situation demanded higher taxes. Thus, between 1995 and 1998 tax revenue as a proportion of GDP fell as follows: income tax from 2.6 per cent to 2.0 per cent, general sales and turnover taxes from 5.5 per cent to 3.9 per cent, import duties from 3.6 per cent to 2.8 per cent and excise duty on liquor from 0.9 per cent to 0.8 per cent. The fact we are not collecting sufficient tax revenue is demonstrated by the fact that total tax revenue as a proportion of GDP exceeds 40 per cent in several countries like Germany, France, Netherlands and exceeds 30 per cent in UK and Ireland.

First, company and maximum individual income tax was reduced from 35 per cent to 30 per cent overall and to 15 per cent in case of firms engaged in agriculture, fisheries, livestock and tourism. Further relief was provided by raising the tax threshold from 60,000 to Rs. 144,000, widening of tax slabs, lowering intermediate tax rates and removing the surcharge on income tax at a loss of Rs. 650 million to revenue. Second, taxes on domestic goods and services were reduced to lower prices to the consumer; even the excise duty on beer which is by no means an essential good - was reduced at a loss of Rs. 250 million to revenue. Third, import duties were reduced generally to reduce consumer prices and to assist industries; the abolition of the 35 per cent duty on textiles imports at a loss of Rs. 750 million was to help the garments exporters. A belated attempt has, however, been made in the 1999 budget to raise excise duties on cigarettes and alcohol and to increase the national security levy, administrative charges and fees, levies on posts and postal rates, but direct taxes on income have not been raised. The increase in indirect taxes while leaving direct income taxes unchanged tends to make the tax system more regressive and shift the burden of financing the war away from those who can to those who can least afford to bear it.

There is little justification for reducing corporate income tax to 30 per cent. First, corporate income tax exceeds 30 per cent in the developed market economies; it is 57.4 per cent in Germany, 53.2 per cent in Italy, 51.6 per cent in Japan, 40 per cent in USA and 35 per cent in UK: these higher tax rates have not discouraged investment in these countries. Second, lower corporate and individual taxation does not seem to have encouraged our private investment, which has virtually stagnated at around 18 per cent of GDP in the last four years 1995-1998. In fact, the 1998 figure of 19.3 per cent of GDP is still lower than that in 1994 of 20.0 per cent of GDP. Relief to taxpayers was unwarranted, as the war against terrorism demanded not a reduction but an increase in taxes, which the taxpayers would have borne as a necessary contribution to the war effort. There are signs that reduced income taxation has tended to increase conspicuous consumption among the rich classes. Third, the reduction of import duties has tended to discourage investment in agriculture and industry, particularly subsidiary food production and textiles.

Not only was taxation reduced when the war effort needed resources, but public servants' salaries were also raised, and this is one major factor causing the large budget deficit. The public servants may have deserved higher salaries in the context of rising cost of living, but this was a general economic problem affecting all sectors of the population, not the public service alone. Increasing salaries is hardly appropriate when defense expenditure was mounting and the budget deficit was yawning. The war situation demands sacrifices and postponement of consumption but the authorities instead of calling upon the people to make sacrifices for a national cause and setting an example from the top, diverted the resources which should have gone to the war effort to raise salaries of the public service and allow them imports of cars at concessionary duty of 25 per cent which means a loss to revenue. To make matters worse, the salaries and allowances of Ministers and Members of Parliament were also raised.

Cutting Essential Public Investment

The strategy adopted by the authorities to save funds for the war effort and to reduce the budget deficit was not increased taxation as shown above, but reducing essential expenditure on economic and social development. Total expenditure of government fell from 29.5 per cent of GDP in 1994 and 30.5 per cent of GDP in 1995 to 26.4 per dent of GDP in 1997 and 1998, current expenditure falling from 21.9 per cent in 1994 and 23.1 per cent in 1995 to 19.7 per cent of GDP in 1998 and capital expenditure falling from 7.5 per cent of GDP in 1994 to 5.7 per cent in 1997 and 6.8 per cent in 1998. Thus, both public investment and current expenditure on maintenance were reduced, and this adversely affected both the economic and social services.

Capital expenditure or public investment in economic services as a proportion of GDP fell from 5.1 per cent in 1994 and 5.4 per cent in 1995 to 4.4 per cent in 1998; investment in agriculture and irrigation declined from 0.9 per cent in 1994 to 0.6 per cent in 1998, that on transport from 2.5 per cent to 1.9 per cent and that on energy from 1.0 per cent to 0.9 per cent. Actually the expenditure on agriculture and irrigation in 1998 in absolute terms was less than in 1995. Thus, public investment on essential agriculture and irrigation, transport and energy has not been adequate in the last four or five years because of the wrong policy of reducing taxation when the situation demanded the opposite. Investment in social services on the other hand, seems to have stagnated in the four years 1994 to 1997 and risen slightly only in 1998. It remained almost constant at 1.3 per cent of GDP in 1994-1997 and rose to 1.5 per cent in 1998. Investment in education remained virtually constant at 0.5 per cent of GDP and on health almost constant at 0.3 per cent of GDP in the whole period. Investment in social services would have been much larger and the number of new hospitals and schools much higher if the government had not denied itself funds by lower taxation.

In addition to a relative reduction of public investment there has been a relative reduction in current expenditure in the maintenance of existing economic and social services of the country.

Government's Fiscal Operations

as % of GDP

	1994	1995	1996	1997	1998
Total Revenue	19.0	20.4	19.0	18.5	17.3
Tax Revenue	17.2	17.8	17.0	16.0	14.5
Income Taxes	2.6	2.6	2.7	2.4	2.0
Sales & Turnover Taxes	5.6	5.5	4.9	4.9	3.9
Import Duty	3.9	3.6	3.3	3.0	2.8
Total Expenditure	29.5	30.5	28.5	26.4	26.4
Current Expenditure	21.9	23.1	22.8	20.7	19.7
Social Services	8.2	8.6	7.7	6.7	6.3
Education	2.6	2.4	2.1	2.0	2.0
Health	1.3	1.3	1.2	1.1	1.0
Economic Services	1.1	1.2	1.1	0.8	1.0
Agriculture & Irrigation	0.4	0.6	0.5	0.4	0.5
Transport	0.3	0.3	0.3	0.2	0.3
Energy	0.1	0.1	0.1	0.1	0.1
Capital Expenditure	7.5	7.4	5.7	5.7	6.8
Economic Services	5.1	5.4	4.1	3.6	4.4
Agriculture & Irrigation	0.9	0.9	0.6	0.4	0.6
Transport	2.5	2.8	1.6	1.5	1.9
Energy	1.0	0.7	0.8	0.8	0.9
Social Services	1.3	1.5	1.3	1.3	1.5
Education	0.5	0.5	0.6	0.5	0.6
Health	0.3	0.3	0.3	0.3	0.4
Budget Deficit	-10.5	-10.1	-9.4	-7.9	-9.2
Expenditure on Security	4.6	6.5	5.8	5.1	5.0

(Source: Central Bank Annual Report 1999)

Current expenditure on social services fell from 8.6 per cent of GDP in 1995 to 6.3 per cent in 1998; that on schools fell from 2.4 per cent to 2.0 per cent and that on health fell from 1.3 per cent to 1.0 per cent of GDP. Current expenditure on economic services declined from 1.21 per cent of GDP to 1.0 per cent between 1995 and 1998, expenditure on agriculture and irrigation falling from 0.57 per cent to 0.54 per cent, on transport from 0.30 per cent to 0.29 per cent and on energy from 0.15 per cent to 0.07 per cent. Thus, the brunt of the war effort was borne by the country's economic and social services; instead of raising tax revenue, funds were diverted to the war efforts from economic and social investment and maintenance.

Reappraisal Needed

Large budget deficits caused mainly by expenditure on security now and by reconstruction and rehabilitation after peace is restored, cannot be reduced without increasing revenue by higher taxation. Income taxes on corporations and individuals can be raised without causing any disincentive to investment; we have already shown that income taxes are higher than ours even in developed market economies. The causal link between income tax and investment is somewhat tenuous. For example, tax increases on the rich in the US in 1993 did not result in reduced investment or recession as argued by those who opposed the measure. Higher import duties are needs to protect our domestic agriculture and industry in any case and as our tariff rates bound at GATT are about 50 per cent, there is enough room to raise them further. It is rather difficult to understand the recommendations of the Tariff Commission to reduce import tariff even below existing levels when frustrated local farmers and industrialists are clamouring for protection. Few will dispute the need for higher excise duties on cigarettes, which cause cancer, heart attacks and other diseases, as well as on alcohol - particularly at a time of national crisis. In addition, the value added tax should be raised on luxury and semi-luxury goods consumed by the highe[r] income groups and the surcharge on income tax which was introduced in 1989 specifically to raise funds for the war effort but removed in 1996, should be restored. If the reduction and removal of taxes and increase of salaries in recent years gave the wrong signals to the publi[c] — that the war against terrorism could be main[tained] without much sacrifice on the part of th[e] people - time has come to disabuse them of th[e] view and to place the actual financial pictu[re] before them.