Tax and Interest rate reductions

By Analyst

The government has been trying to convince the public that the introduction of the Value Added Tax (VAT) coming along with the removal of GST and NSL should reduce the prices of goods because the total tax the traders have to pay has come down if we take into account the calculation of VAT on the new basis.

Undergraduates learning economics in universities are often set the exercise of determining how the equilibrium price changes when a tax is introduced. Students proceed to analyse the problem using the supply and demand curves or by solving the relevant supply and demand functions mathematically where supply equals demand at the equilibrium price. The analysis concludes that with the tax payable, the supply curve will shift upwards and the new equilibrium price is higher. Conversely when the tax is reduced the supply curve will shift downwards parallel to the old curve and the new equilibrium price is lower.

But this type of analysis is inadequate. The effects of the VAT is to apply to a large number of goods and hence the demand and supply curves of each commodity has to be considered. Economists consider that there is a vector of prices for each and every commodity which will bring about equilibrium in all the commodity markets. The Nobel Prize winning economist Debrieu proved the existence of such a set of equilibrium prices for all commodities and factors of production. That is there is a set of prices under which the aggregate demand for each commodity and each factor equals aggregate supply. But this was proved mathematically.

But while there is a set of equilibrium prices the process by which the economy reaches such equilibrium is complex. Economists generally talk of markets tending towards such a set of prices but cannot identify the particular set of prices which ensure such equilibrium. How will such a set of prices be attained? For this we need to consider economic dynamics, that is how the economy moves when it is out of equilibrium. The simple way to think about it is to consider what happens within a given market when price is such that demand exceeds supply and then upward pressure is exerted on the price. The limit of this process occurring in all markets simultaneously will be to move the price vector to its equilibrium pattern.

The "invisible hand" of Adam Smith leads the market to a state of rest. But this rest will be disturbed with every change affecting demand or supply conditions. So equilibrium is not easily attained simultaneously in all commodity and factor markets. All markets would then be cleared.

New constraints

But there are qualifications, which must be noted. Note that the assumption underlying all the analysis is that every one is a price taker. Arrow, the other economist whose name is associated with the general equilibrium theory of prices (it is called the Arrow-Debrieu theorem) once remarked, "If everybody is a price taker then who changes the price?" Secondly if a market while moving towards equilibrium, will not clear at the going price and hence some economic agents (consumers or producers) will not be able to purchase what they want or to sell all that they wish. Then they will recalculate their demands on the basis of the new constraints, which again destroy the earlier basis for calculation of supply and demand curves.

There is an auction process going on. Which performs the tasks of adjusting the prices until the disequilibria in demand and supply are adjusted. So the theory does not say there is immediate convergence of the prices to the equilibrium prices. So the government should at best wait till the process of adjustment is over to see the ultimate effects of the tax reduction on prices. But the problem is that with time there are other changes coming on so that it is practically impossible to isolate the effects of just one factor namely the tax reduction. This is why economists often refer to the hackneyed phrase "other things remaining the same." But in a dynamic world other things are never unchanged. So the government economists should never have advised the minister that the effect of the tax reduction would be simple. In order to justify their stand they now have to look for scapegoats - the rapacious trader.

There is another destabilising factor, namely the continuing money creation by the Central Bank, which changes money incomes. Surely no demand curve will be unchanged when there is a change of money incomes, which is an assumption underlying the construction of the demand curve. The Central Bank has been creating massive amounts of money in the last two years to fund the election budget deficits of President CBK. Economist says that the effect of increased money supply on the general price level takes about nine months to take effect. So Prime Minister Ranil Wickremesinghe is now seeing the effects of President CBK's money creation and no tax reductions will see any reductions in prices although tax increases will definitely raise prices.

So let not the government assume that because inflation, which is the rate of increase in prices declines, prices will decrease. This is the economic situation unless the surplus money in the economy is mopped up by demonetisations a la Dr. N. M. Perera. Otherwise the government will have to continue actively to privatise and when there are no more assets to sell the government will be forced to reduce expenditure. Perhaps this task will be left to the next government to perform or perish.

Will inflation come down?

Now the Central Bank says inflation is coming down and monetary policy should be relaxed. The Minister of Finance has agreed that interest rates should come down to promote private sector investment. But there is still pressure on the rupee in the foreign exchange market. Share prices have risen by about 50% although the earnings of the companies have declined in each of the last two quarters. With the increase in oil prices and electricity prices, the third quarter export earnings are not likely to be better.

Interest rates are raised by the Central Bank to control inflation and also to bolster the rupee. The downward pressure on the rupee continues as it depreciates against the US$. Industrial exports declined by 18.5% and total exports decreased by 16% while imports declined by 10.7%. The trade balance worsened by 4.2%. All this is for the period Jan-May this year over the same period last year. Investment goods imports declined by 13%. The adverse trade balance is $738 million and Tourist earnings declined by 25%. Net private remittances also were less by 3%. So the external payments situation is far from satisfactory and the pressure on the rupee in the foreign exchange market will increase rather than reduce.

The most important factor which affects our domestic inflation is the depreciation of the rupee and the rupee has continued to depreciate showing that there is excess demand in the economy. So it is not appropriate to reduce interest rates not at least until there are definite indications that the inflation monster has been killed.

Then there are the wage demands of the plantation sector. They too will increase inflation since the wage demands exceed any productivity increases. How then can anybody believe that inflation will come down. Monetary policy should be with an eye to what is likely to happen and not on what has already happened. It's time the government decided what should be the rate of inflation. The New Zealand government fixed a target of 0-2% and charged the Governor of the Reserve bank to maintain the target. The Reserve Bank of New Zealand achieved it due to the sagacity of the governor. Our Central Bank has been creating inflation not curbing it.

It seems funny that while most other prices are being deregulated and exposed to market forces, the Central Bank should continue to fix the price of money-interest rates. Will the Central Bank know better than the market what should be the correct price? Our national savings ratio to GDP is very low and we need to promote more savings, which require higher interest rates and not lower. Could it be that the Central Bank is seeking to protect he banking system? The private banks are said to have 15-20% bad loans, which have not entirely been written off. Some banks are floundering in a liquidity crisis.

Will interest rates come down for the SMEs?

Anyway reducing interest rates will not reduce the interest payable by the small and medium scale enterprises which form the backbone of the economy. The banking cartel will see to it that the reduction is confined to the prime-lending rate and all others will have to pay hefty risk premium for their loans. The banks are better off lending to the government or to the stock market. The credit risks of the big guys have not been assessed properly by the banks in the past, particularly the state banks, and the reduction in interest rates will mean a reversion to the earlier practices of political lending.

The banks will show less care in assessing credit risks when interest rates are low for their margins then increase and they will be tempted to be generous. Since there is a lender of last resort in the Central Bank some economists argue that this promotes moral hazard that make banks lend recklessly hoping that they would be bailed out by the Central Bank. We saw how one banker built a financial empire not realising that it is more difficult to maintain an empire than to build one through leveraged borrowing. Its share is now at Rs. 2 and the investors who bought its shares and corporate bonds are now holding worthless paper.

In any case the reduction of interest rates will not trickle down to the small and medium enterprises, which are the backbone of the economy.

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