A COMPREHENSIVE ANALYSIS OF THE ECONOMIC AND TAXATION ASPECTS OF SAVINGS

By Fagun Sahni
From Symbiosis Law School, Noida

ABSTRACT

Savings has been a controversial topic since the introduction of *laissez faire* in mainstream Contemporary Economics. Economists have conflicting opinions about savings, wherein some believe it to be the backbone in times of economic difficulty and the thread by which the middle class hangs, whereas on the other hand capitalist economics criticise this quite so literal 'micro' thinking and cite mathematical proofs of macroeconomics stating that savings are irrefutably harmful to the economic structure, growth, as well as progress of any nation. Despite of this, Indian households have been determined to save individually outside the financial spheres with the most common mode of savings being in form of Gold, Silver, and Debentures respectfully. Another salient feature of this saving is that it has been constantly increasing since 1951. It has perhaps been the most constant thing for the better half of a century as not a single year has seen a decline. Certain economists approve of this formula whereas other believe this to be the only hurdle India has on its way to challenging USA's Gross Domestic Product (GDP) which is the quintessence of Economic Stability and more importantly 'Strength'. Whereas GDP can sometimes be misleading, for example, even though USA has the highest GDP in the world, it is in fact the Spanish state of 'Barcelona' that has the highest 'Per Capita' GDP; i.e., highest GDP per person. Thus, if the population of Barcelona was equivalent to that of USA, it would theoretically have the highest GDP in the world. It is inconsistencies like these that gives the microeconomists a standing chance against the mathematical novelty of the macroeconomists. This is called the *Paradox of Savings* or *Paradox of Thrift*. This paper will therefore focus itself upon this paradox and evaluate, objectively, the rationales of both groups and attempt to reach at a conclusion. It is most certainly to be noted here that centuries have past without a definite solution and this paper makes no claims of containing breakthroughs. The evaluation shall be made with respect to Indian Laws in force, especially the taxation laws, in particular the Income Tax Act, 1961, amended by Indian Finance Act, 2020.

INTRODUCTION

Indian Income Tax Act, 1961, amended by the Finance Act, 2020 (*henceforth* referred to as IT Act) is the standing authority on taxation in India. Even the implementation of Goods and Services Tax Act (GST Act) has not affected the prowess of this Statute.[1] As the GST Act governs taxing of goods produced and services rendered, the IT Act governs the income earned. It is therefore the law of the land determinant of taxation upon Income from Salary, Profit or gains from Businesses or Profession, Income from House property, Capital Gains, or income from any other sources. The act is not a simple legislation but contains tax brackets,

[1] Tran-Nam, B. (2019). The Goods and Services Tax (GST): The public value of a contested reform. In Luetjens J., Mintrom M., & Hart P. (Eds.), Successful Public Policy: Lessons from Australia and New Zealand (pp. 235-256). Acton ACT, Australia: ANU Press.

exemptions, deductions, and reliefs. It was for this reason that a wise man said:

"a lay man seeks an increase in the Salary, a Tax lawyer makes its employer cover the tax payable."

This is also an option that lies with a salaried individual to have this embedded in his employment contract that his tax liability will lie with his employer and his salary would be what is known as "*pure salary*".

It is therefore correct to say that taxation affects, if not all of our decisions, then most certainly all of our financial decisions. And there is virtually no difference when it comes to savings. We tend to keep ourselves aware of the recent trends in Taxation policies and update our saving methodology in accordance to the same. We optimize our Provident Fund savings, insurance schemes, pension plans, etc.

However, evidence exists in the realm of economics, that savings are generally bad for the Economy of the nation, with statements made to the effect that excess savings 'handicap' the economy.[2] The rationale is, that money flow in the economy increases expenditure capacity of the individuals, more expenditure results in increase in supply of goods and services, which leads to creation of jobs, and lastly this leads to increase in income which results in increase in expenditure and this keeps on growing exponentially.

On the other hand, it is very reasonable to assume that an individual may suffer economic and financial ups and downs throughout his career or life. It may be an unforeseeable accident, loss of job, losses in business, etc. In these times, it is the individual's savings that protect him from becoming bankrupt and having to declare insolvency.

In light of these arguments, whether Indians should save or not? Or more importantly, should the taxation policy of the Indian Government encourage savings, or discourage them?

BASIC TENETS

It has now become mind-numbing whether the Indian taxation policy must encourage savings or not. Sufficient economic data and evidence exists to support both the notions. It has thus become extremely important to know whether savings is indeed as important as we have been taught by our parents, or is humanity's worst invention after WMDs. Interestingly, radical Keynesians have referred savings to as the WMDs of economy.

The case AGAINST Savings

This is perhaps best explained through Keynes Multiplier formulas,[3] which are as follows:

As we know, Income (Y) = Consumptions + Savings. Or in more precise terms, due to the great number of subjects which are a part of the economy, and all of their individual savings and consumption cannot be known individually, therefore their Marginal Propensity is calculated:

Income (Y) = Marginal Propensity to Consume (Consumption/ Income) +

[2] Smithies, A. (1951). Reflections on the Work and Influence of John Maynard Keynes. *The Quarterly Journal of Economics*, 65(4), 578-601.

[3] Harrod, R. (1946). John Maynard Keynes. *The Review of Economics and Statistics*, 28(4), 178-182.

Marginal Propensity to Save (Savings/ Income).

Now, Keynes found out that Economic multiplier is 1/ 1-MPC, or 1/ MPS.

Therefore, if income is ₹100, Consumption is ₹90, and savings are ₹10, then the MPC is 90/100 = 0.9, and MPS is 10/100 = 0.1; economic multiplier becomes:

1/1-MPC, or 1/MPS

∴ 1/1-0.9, or 1/0.1

= 10.

According to Keynes, and almost all economics of the modern economics school find this to be true, and further profess that:

Aggregate Demand = Income x Multiplier

∴ 100 x 10

= 1000.

This means that the estimated growth in Aggregate demand will increase 10 times, if saving is reduced to only 10% and consumption is 90% of the income. The requirement is that 90% of the income is circulating back in the economic stream and is thus a source of someone else's income, who in turn is spending it and so on. This results in a multiplier of sorts and increases the Aggregate demand 10 folds. An increase in savings stagnates the multiplier, so if savings increase to 20%, the multiplier would be 5. And thus, the AD will be 500, exactly half of what it was before.

The most interesting part of the multiplier is, what if Marginal Propensity to Save reduces to zero? What happens to the multiplier then?

Well,

Multiplier = 1/MPS

∴ 1/0

= ∞

Thus, Keynes and other modernists propound that if savings are reduced to zero, the economy will grow infinitely by increasing the aggregate demand on an infinitely increasing pattern. The example of United States of America is cited wherein the policies of Presidents such as JF Kennedy, and R. Nixon who awarded enormous tax rebates to increase consumptions and imposed higher taxes on income from interest on savings, actually resulted in more economic growth than any planned implementation of more complex schemes.[4]

The case FOR Savings

It must be noted here that the notion that savings our important is much more prevalent amongst the majority. It might only be the lack of numerical explanations and general reliance on pragmatic logicism, but the masses prefer that they save at least a small part of their income.[5]

In fact, the reasons for savings are less economical, and more common-sensical. It is absolutely possible, and moreover, probable, that one would face financial trouble at least once in his lifetime. Loosing a job, or suffering losses in business are extremely common. In light of all these very real problems one might individually face, it is

[4] Kirshner, J. (2009). Keynes, Legacies, and Inquiry. *Theory and Society*, 38(5), 527-541.

[5] Cronqvist, H., & Siegel, S. (2015). The Origins of Savings Behavior. *Journal of Political Economy*, 123(1), 123-169.

simply not worth to go to through the troubles for theoretical economic growth.

And this is exactly the reason why Indian savings have been constantly growing since India's independence. Even the year 1991, which brought radical changes in the Economic structure by introducing the New Economic policy of Liberalization, Privatisation, and Globalization did not witness a decline in savings.

Taxation Policy and Savings in India

It has all come down to whether Indian policies are adherent to the Keynesian notions or the more logical notions of savings. The answer, is perhaps more complicated than the question posed itself. Because on the one hand, it is unarguable that Indian policy is to support savings, and by extension, individual financial stability.

However, IT Act has certain "Deduction" under various sub-parts of Section 80 of the Act. These deduction, *prima facie* support in-flow of money from household savings into the economy by awarding benefits in equity products, Pension schemes etc.

However, the above statement is not completely correct. Because it only appears that Indian policy is discouraging household savings and encouraging commercial savings, but in fact this is not the case. These deductions under Section 80 (Section 80C, 80CCC, 80CCD etc.) are actually promoting *'Smart Household Savings'*. This policy has been carefully devised to secure the interests of both parties.

The government is in fact, only discouraging the household savings that stagnate the economy, for example, savings in terms of Gold which are only one-time expenditures, and then are not used perhaps for lifetimes. Similarly, saving actual cash at one's residency, popularly referred to as *rainy day cash* is actually a stagnating factor. Whereas if the same is saved in terms of Provident Funds, or pension schemes, then the Government can re-invest the same money in various possible sectors, *inter alia* infrastructure, expansion projects, etc. which in turn generate jobs, and increase spending capacity of the population as a whole.

In fact, when demonetisation took place on the fateful eve of 8th November, 2016, the government offered the opportunity to declare cash saved in households and offered special deductions on investment of the sum. The primary aim of demonetisation, however, was eradication of black money, which is income on which due tax liability has not been paid in the allotted time. But in spite of this, several offers were given on investment of cash saved upon which taxes had been paid in the respective Previous Years when the tax became due.

CONCLUSION

The only correct remark to make at this point would be that a Government must equate both Economic principles, as well as individual stability whilst devising the economic policies. An outright *laissez faire* policy discouraging smallest of household savings (the traditional notion of household savings, i.e., savings outside floatation in an economy) is in my opinion perhaps even unconstitutional. The constitution grants the Fundamental Right to Choose, which is an extension of the Divine Right to Free Will. To make policies which force a person's hand into making decisions he is unlikely to, is restricting his right of free will. and even though this is a policy decision, and the Supreme Court is reluctant in exercising judicial review over policy matters, I am abundantly confident that this will not become a hurdle if such a policy is enforced. Thus, the government being conscious, devises policies that do not discourage traditional savings, but only promote and encourage savings in the forms of PFs, Investments etc. It might seem irrelevant, unimportant, or maybe unnecessary; but it is noteworthy that adoption of an outright *laissez faire* policy is against constitutional norms as well. And it has only little to do with the 42nd amendment adding the word “Socialist” in the preamble of the Constitution of India and much more to do with the *Basic Structure* of the Constitution which prevents extreme capitalism and risking individual financial stability in the name of economic growth or theoretical money multipliers, even if evidence suggests it to be the most utilitarianist alternative. One of the major reasons for this, is that it only works if whole, or a significantly large amount of the population reduces its savings, a few individuals hardly make a dent. Thus, an implementation of such a policy requires the government to impose restrictions on savings in form of gold or cash, which as per our findings appear to be Unconstitutional.

Thus, it is for the aforementioned reasons that despite several criticisms and dissentient opinions of some economists and taxation experts, the policy of the Indian Government with respect to household savings commands nothing but acceptance as well as admiration. It can be said that a godly balance between the microeconomic and macroeconomic philosophies has been struck and it appears that this balance might be the only possible solution, or the closest thing to a what we can call a solution, to the paradoxes of savings.

REFERENCES

1. Tran-Nam, B. (2019). The Goods and Services Tax (GST): The public value of a contested reform. In Luetjens J., Mintrom M., & Hart P. (Eds.), Successful Public Policy: Lessons from Australia and New Zealand (pp. 235-256). Acton ACT, Australia: ANU Press.
2. Smithies, A. (1951). Reflections on the Work and Influence of John Maynard Keynes. *The Quarterly Journal of Economics*, 65(4), 578-601.
3. Harrod, R. (1946). John Maynard Keynes. *The Review of Economics and Statistics*, 28(4), 178-182.
4. Cronqvist, H., & Siegel, S. (2015). The Origins of Savings Behavior. *Journal of Political Economy*, 123(1), 123-169.
5. Kirshner, J. (2009). Keynes, Legacies, and Inquiry. *Theory and Society*, 38(5), 527-541.
6. Solow, R. (1956). A Contribution to the Theory of Economic Growth. The Quarterly Journal of Economics, 70(1), 65-94.
7. Simon, H. (1959). Theories of Decision-Making in Economics and Behavioral Science. The American Economic Review, 49(3), 253-283.
8. Kaldor, N. (1957). A Model of Economic Growth. The Economic Journal, 67(268), 591-624.
9. Watkins, G. (1933). Economics of Saving. The American Economic Review, 23(1), 61-81.
10. Patrick, H. (1966). Financial Development and Economic Growth in India. Economic Development and Cultural Change, 14(2), 174-189.
11. Bouyon, S. (2016). Policy Options for European Household Saving. Journal of Economic Integration, 31(1), 134-165.

*****