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Union budget: right priorities, flawed macroeconomics

There was a strong need to stimulate investment and revive growth, so the Union budget should have been expansionary

DEEPAK NAYYAR
is emeritus professor of economics, Jawaharlal Nehru University, New Delhi. He served as chief economic adviser, government of India, from 1989-91, and as vice-chancellor, University of Delhi, from 2000-05.

The presentation of the Union budget 2017-18 earlier this month coincided with a conjuncture that was complex if not difficult. It had to contend with the negative economic consequences of demonetization announced three months earlier. It had to reach out to people in the five poll-bound states, particularly Uttar Pradesh, to rally support for the Bharatiya Janata Party (BJP), without violating the election code of conduct. It had to confront the persistent recession and fragile recovery in the world economy, juxtaposed with a political backlash against globalization that has unleashed mounting pressures for protectionism in industrialized countries. These concerns did exercise a significant influence on the thrust of the budget, which can be read between-the-lines even if it could not have been made explicit.

There are three clear messages. First, this budget is more about politics than about economics in terms of both symbols and signals. It is reflected not only in the allocations made and schemes announced but also in the direct tax concessions, seeking to compensate those who were probably hurt by demonetization. Second, the essential theme that runs through the speech is the concern of the government for the well-being of the poor and the vulnerable, or the excluded. They might not have a voice in the economy as their share in national income is disproportionately low, but their importance in our electoral democracy is directly proportional to their share in the population. Third, there is a repeated stress on fiscal prudence, manifest in restricting the fiscal deficit of the Central government to 3.2% of gross domestic product (GDP). The unstated objective is to provide comfort to international financial markets and large international firms, who were disturbed by demonetization, and shore up international confidence.

The broad arithmetic of the budget is instructive. In the budget estimates for 2017-18, GDP growth is projected at 11.75% in comparison with revised estimates for 2016-17. Tax revenue, in the aggregate, is projected to increase by about 12.2%, which is plausible. Income tax is slated to increase by 25%, which is clearly over-optimistic. However, corporation tax, as well as indirect taxes (made up of excise duties, customs duties and service tax), are expected to increase by 9%, while non-tax revenue is projected to decrease by 14%. The finance minister also announced significant increases in expenditure allocations for many sectors and schemes. Yet, the fiscal deficit is projected at 3.2% of GDP.

This paradox might be explained partly by the practice of overestimating revenue and underestimating expenditure, to produce a number in conformity with the target. For instance, miscellaneous capital receipts are budgeted to increase by 60%, to Rs72,500 crore, through disinvestment. And there are other examples. The real explanation lies in expenditure adjustment. In the 2017-18 budget estimates, the total expenditure of the Central government as a proportion of GDP is 12.7%, which is lower than 13.4% in the 2016-17 revised estimates. In absolute terms, it is only 6.5% higher. Thus, after adjusting for inflation, in real terms the increase in government expenditure during 2017-18 will be negligible.

The allocations and outlays in the expenditure budget rightly emphasize agriculture, rural development, infrastructure and social sectors (including education and health). In the budget estimates for 2017-18, as a proportion of total expenditure, agriculture accounts for 2.7%, rural development for 6%, infrastructure for 18.5% and social sectors for 9.1%—this adds up to 36.3%. Given that expenditure on interest payments, subsidies and defence—pre-emptive claims—is 37% of the total, this allocation is commendable. It is also necessary and desirable. Similarly, allocations for the welfare of Scheduled Castes, Scheduled Tribes, other vulnerable groups, women, children and the North-Eastern region make up almost 15% of Central government expenditure. Clearly, economic priorities and political concerns coincide in these allocations for sectors and schemes.

The problem is with the level of expenditure, so that high shares in the total do not mean as much as they would have otherwise. Expenditure on agriculture, rural development, infrastructure and social sectors has changed little in proportional terms as compared with the preceding year. It was almost 35% of the total in the revised estimates for 2016-17. There is a problem with the mix of revenue and capital expenditure as well. The finance minister has stressed that capital expenditure is slated to increase by 25%. Yet, capital expenditure as a proportion of GDP, at 1.83%, is marginally lower than it was at 1.86% in 2016-17. Moreover, the share of capital expenditure in total expenditure is just 14%, while the share of revenue expenditure is 86%. This mix of consumption and investment expenditure is bad news, just as it would be for a firm or a household.

The story about revenue receipts is less significant. Even so, it deserves mention. The changes are in the sphere of direct taxes. In personal income tax, for incomes from Rs2.5 lakh to Rs 5 lakh, the first slab, the tax rate has been reduced from 10% to 5%. The revenue foregone is Rs15,500 crore. In corporation tax, for micro, small and medium enterprises with an annual turnover of up to Rs50 crore, the tax rate has been reduced from 30% to 25%. The revenue foregone is Rs7,200 crore. These tax concessions seek to mollify those who have been hurt by demonetization. In conformity with the message of pro-poor politics, there is a new surcharge of 10% for incomes from Rs50 lakh to Rs1 crore raising Rs2,700 crore. The economics of an entry point tax rate at 5% which jumps to 20% for the next slab, and the politics of a surcharge not shared with states, are both flawed. There is little change in the sphere of indirect taxes in anticipation of the goods and services tax (GST).

The projected increase of 25% from personal income-tax collections, despite these concessions, is not quite credible. The faith in the income-tax department to realize this objective represents a triumph of hope over experience. In fact, the finance minister accepts that "we are a largely tax non-compliant society". Given this reality, arming income-tax officials with more discretionary powers could foster corruption rather than compliance. It might even unleash "tax terrorism" on citizens. Thus, a new provision in the Finance Bill, amending Section 132—to say that a tax authority will not have to disclose to any person or any authority or the appellate tribunal why it has "reason to believe" that there is a basis for conducting a search and seizure operation—is indeed worrisome.

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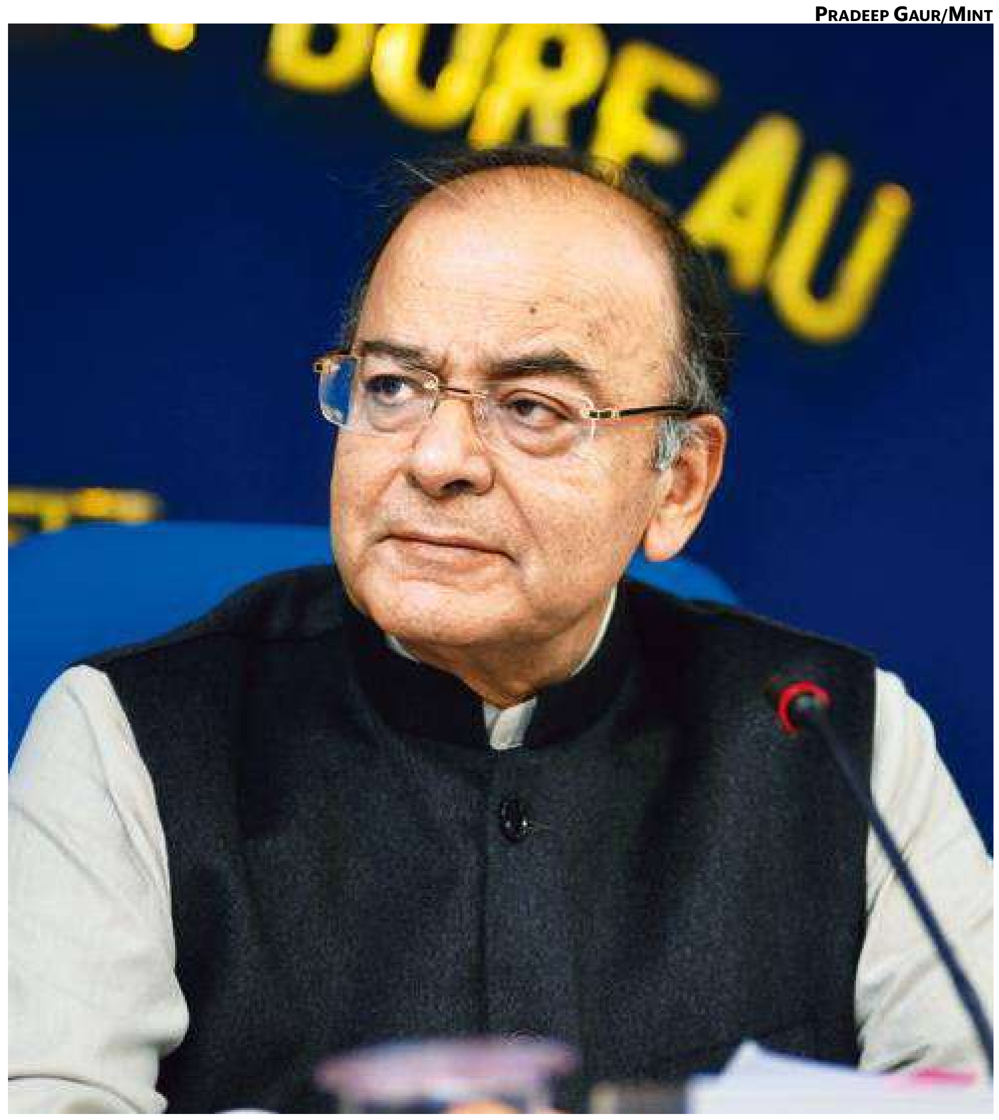

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The limitations of the budget considered so far lie in what has been said or done. But there are some important negatives implicit in what remains unsaid or undone. There is little to address the problem of jobless growth. There is almost nothing for the manufacturing sector despite the rhetoric about "Make in India". And the problem of falling exports is simply ignored.

For me, however, at this juncture the most serious drawback of this budget is in its underlying macroeconomics. There is a downturn in the domestic economy following demonetization, which could get worse. The world economy could impose further constraints if protectionism mounts in industrialized countries. In this situation, growth in output and employment can only come from a revival of domestic consumption and domestic investment. That is the essential logic of countercyclical macroeconomic policies.

It becomes even stronger in the present context in India. The rate of inflation, at less than 4% per annum, is low. The current account deficit in the balance of payments, at less than 0.5% of GDP, is modest. The GDP growth rate is higher than in most other countries. In fact, the finance minister's budget speech claims credit for each of these, as sound macroeconomic fundamentals. Of course, inflation has come down largely because of a sharp drop in world prices of commodities, particularly crude, while the current account deficit has been reduced by the domestic economic slowdown, particularly in investment and in manufacturing.

Even so, there is hesitation in using monetary and fiscal policy to stimulate the economy. It would seem that monetary policy is no longer available to us because the orthodoxy of inflation targeting in the Reserve Bank of India stubbornly resists any lowering of interest rates despite the fact that inflation rates have dropped sharply. The use of fiscal policy to revive consumption and stimulate investment in the economy is frowned upon by a fiscal conservatism that has captured thinking not only in the government but also in the media.

It is not clear what the fuss is about. The fiscal deficit is 3.2% of GDP. The revenue deficit is 1.9% of GDP. The effective revenue deficit, which is the difference between the revenue deficit and grants for the creation of capital assets, is just 0.7% of GDP. The primary deficit is down to a negligible 0.1% of GDP. The deficit fetishism simply caters to the sentiment of financial markets and credit-rating agencies.

There are only two ways that the budget could have done better: either increasing borrowing by the government, which would have enlarged the fiscal deficit, or increasing revenue receipts through taxes, but there were concessions on direct taxes. If, as a proportion of GDP, either government borrowing, or tax and non-tax revenue, were 0.25% higher, each would have provided Rs42,000 crore extra for the budget. Both together could have provided Rs84,000 crore more for expenditure on agriculture, rural development, infrastructure and social sectors, without increasing the fiscal deficit.

In sum, my concerns about the Union budget arise from its macroeconomics. There was a strong need to stimulate investment and revive growth, for which it needed to be expansionary. Yet, it is contractionary.

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