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India's Budget: Beyond Fiscal Consolidation

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Abstract
India is caught up in a debate between adherence to the FRBM Act and ramping up public investment which shows a tepid trend. India's repo rate policy has been assiduously linked to the glide path enumerated by Urjit Patel Committee. However, these fiscal consolidation concerns overlook the critical need to address distributive justice, minimize increasing trend of Gini index and pay greater attention to adequate allocation to merit goods sectors like primary education, health and sanitation. **The paper underscores the importance of Musgrave's three pronged emphasis on Allocation, Distribution and Stabilization and highlights the centrality of "Total Factor Productivity" (TFP) of Robert Solow as the real thrust area**. The up-coming budget must strike the right balance between fiscal consolidation and allocation prudence to reap the harvest of demographic dividend that awaits India.
Keywords: FRBM Act, Merit Goods, TFP, Demographic Dividend, Glide Path, Gini Index

INTRODUCTION

Fiscal consolidation is the buzz word in India's present eco-system, The RBI Governor by retaining the same repo rate (6.75%) for the next quarter has passed on the fiscal reform initiative to the Finance Minster in the forthcoming budget. Mr. Jaitley is indeed in a quandary. In the just concluded ET Global Business Meet, addressed by both the Prime Minister and the Finance Minister, while the PM underlined the remarkable growth numbers that India has achieved against various production parameters, Jaitley underscored the dilemma whether to stick to the fiscal deficit targets the FRBM Act or opt for massive public investment without unduly bothering about the deficit templates.

This is a classic conundrum, the genesis of which can be traced to USA, when Mr. Bernanke, Fed Reserve Bank Governor adroitly changed the role of the apex monetary institution from that of inflation slaying (Volker) to one of growth with inflation control. Mr. Rajan, an acolyte of Greenspan, has identified inflation control as his central credo. The Urjit Patel Committee had recommended CPI, where food accounts for 50% weightage, as the basis for RBI policy framework. Rajan has linked the repo rate policy to a glide path of 4-6% CPI. The reduction in food inflation from 12% (2010-13) to 6%, despite a sub-optimal monsoon during the last two years is therefore, commendable. The government must be given credit for it as it has not given in to the Kulak lobby and has **increased the MSP by 3.8% as against an average increase of 12% during the last decade.** Prof. Ashok Gulati has been prescient enough to observe that the mismatch between input price increase for wheat & rice (5%) and MSP increase of (12%) has been the most significant factor contributing to the high food prices in the past. The other exogenous factor that has helped India, is the sharp drop in oil prices from $120 per barrel to $30. As it constitutes 37% of our import, our comfortable CAD/GDP is largely due to this oil bonanza. However, these encouraging trends mask the underbelly of serious structural and institutional problems, which Prof. Subramanian, CEA addressed during the mid-year review of India in January, 2016.

MID YEAR REVIEW

Prof. Arvind Subramanian, brings out how India's Macro Vulnerability Index (MVI) was distressingly high at 22% in 2013 (**with inflation 10.2%, fiscal deficit 7.5% (Centre and State combined) and Current Account Deficit 4.4%). This has come down to 15% now, with CPI 6%, current account deficit 2% and fiscal deficit 7%. Mr. Subramanian has underscored the need for ramping up public investment in roads, public irrigation, basic connectivity and power sector reforms. The major challenges that confront the economy are (a) high incidence of stalled projects (7.9%) (b) high debt equity ratio 0.95% (c) low return on assets for the banks (0.5%) (d) high non-performing assets (5.1%) and (e) high incremental capital output ratio (5.9)**. The private sector is a major culprit in this economic slowdown, due to a combination of **"irrational exuberance" (Keynes) and carryover legacy of stressed corporate balance sheet.**
The following table will bring out the trends of our macroeconomic vulnerability during 2014-15 as compared to 2009-10.

Table-1: Trends of Macro Economic Vulnerability

Parameter	2009-10	2014-15
Stalled Projects as % of GDP	6	7.9
Debt Equity Ratio	0.78	0.95
Non Performing Assets	2.1	4.9
Return on Assets (Banks)	0.9	0.5
Incremental Capital Output Ratio	4.1	5.9

Source: Economic Survey, 2014-2015

The burgeoning non-performing assets has also been facilitated by the ineffective Bankruptcy Law which puts a premium on delay, multiplicity of agencies and reluctance of the courts to enforce recovery from the defaulting corporate. On top of it, **Public Private Partnership experiment not taking off**, after its initial heady success in National Highways and Airports, with major reasons being poor contract formulation with very little exit option, weak public sector participation for risk mitigation. The further hiccups are the political standoff on land acquisition bill and **non implementation of Goods and Service Tax**, which could set the road map of a free national market and improve our GDP by 1.5%. **Our weak institutional arrangements** in failing to ensure proper delivery mechanism also contributes significantly to the present supply side bottlenecks.

The half-yearly review of MOF brings out the distressing performance in regard to tax collection, particularly in the area of indirect taxes. The major defaulter has been service tax which is a fertile area for tax evasion, as most of the entities (94%) are in the unorganized sector. The following table will bring out the tax buoyancy expectation and short falls expected in revenue realization during 2015-16

Table-2: Tax buoyancy & Revenue Shortfall: 2015-16 (Rs. Crores)

Parameter	Tax buoyancy	Shortfall in Collection
Custom Duty	1.3	15664
Excise Duty	1.6	23453
Service Tax	3.0	32287
Corporate Tax	1.1	9539
Personal Income Tax	1.3	16075
Overall	1.5	105084

Source: Mid Year Review: Ministry of Finance, GOI

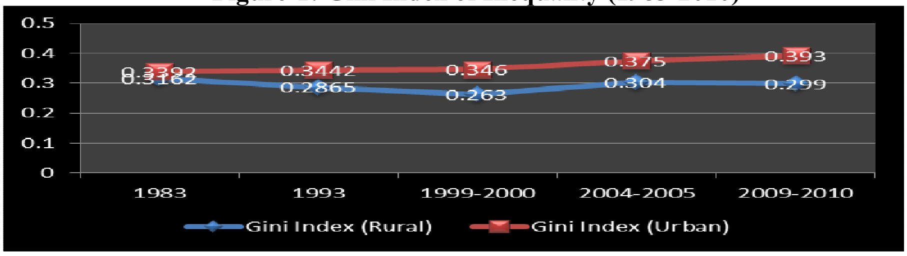
This would clearly demonstrate that we have fallen short by at least 10% in terms of revenue collection. One of the major challenges would be how to stem endemic tax evasion and parking of funds in tax havens by large corporate. To ensure that the service sector (which contributes 57% in GDP but pays only 12% in terms of tax collection) contributes in a commensurate manner in tax collection, the informal sector must be mainstreamed. As the Economist rightly puts "**India's challenge is how to formalize its informal sector".**

THE MISSING LINKS

While the review Ministry of Finance rightly underscores the myriad concerns that shows scant improvement in investment sentiments and tax collection, it fails to flag same of the serious issues like **increasing inequality and poor quality of public education and health services that bedevil India. Concomitantly the problem of un-employability of Indians in the global platform and lack of adequate skill sets seriously the employment potential of the unemployed in the service sector and high skill manufacturing activities.** Economists like Piketty, Stiglitz and Atkinson, therefore, stridently call for a relook at the tax policy of countries that favour the super-rich and advocate steep increase in corporate tax and wealth tax substantially. This will improve tax collection and arrest the accentuation of income inequality that afflicts both developed countries like USA and India. An IMF research paper (June, 2015) clearly demonstrated how high tax rates on top income bracket does not affect the incentive to invest. Mr. Jaitley's reduction of corporate tax to 25%, in the last budget bowing to the regressive recommendation of Arthur Laffer in the 1970s & the corporate lobby cannot be more ironic given our very low Tax/GDP (10.2%), compared to 16% in most EMDEs.

India after liberalization is experiencing a sharp increase in inequality, particularly, in the urban sector as the following graph would show.

Figure-1: Gini Index of Inequality (1983-2010)



Source: Central Statistical Organization, India, Census, 2011

This is largely due to the fact that the employment opportunity, which is better in the urban sector, is extremely skewed. Quite typically, rising opportunity of jobs in the service sector is contributing to this urban inequality. Solow's pious hope that "a rising tide will rise all boats" has not fructified. Prof. Stiglitz rightly cautions all democratic countries against the tendency towards unfettered market. To quote him "**unfettered markets will lead to more monopoly power, more abuses of the financial sector, and more unbalanced trade relations" as India experiences. While delivering the Deshmukh Memorial lecture Prof. Stiglitz has also underlined the importance of regulation, the need to encourage competition and to be cognizant of the toxicity of shadow banking**. While India was not greatly affected by the global financial crisis of 2007-08, because of its inadequate exposure to the global financial market, it cannot be complacent about the potential dangers that our increasing zest for globalization entails. The importance of **making proper assessment of credit worthiness of potential borrowers and the dangers that accompany asymmetry information in the housing and financial sector also cannot be overlooked**. The lowering of interest rate may not lead to a commensurate lowering of lending rate by banks or help increase in credit availability to the needy. This is what is precisely happening in India, when the reduction in repo rate of 1.25% by the RBI during 2015 has been matched by only 50% reduction by different banks. Stiglitz also bring out how in US and European Union, monetary policy has contributed to the **growing inequality and has not served the people in the margins of the society well.**

LESSONS FROM BIG FIVE

Smith, Ricardo, Keynes, Friedman and Solow constitute the Big Five in economic thinking. Adam Smith's magnum opus Wealth of Nations (1776), celebrated the Midas touch of free market. For Smith, "the market forces, as if by an invisible hand, will promote the welfare of all". David Ricardo, the astute financial broker, took this spirit forward to champion free trade through his comparative advantage trade theory. This inked the architecture of globalization. Keynes' General Theory (1936), another magnum opus, in the backdrop of the Great Depression 1930s and FDR's strong endorsement through New Deal Programmes gave Keynesian fiscal policy and deficit financing an iconic and infallible status; post second war. However, the pangs of oil crisis brought cost push inflation to the centre stage in the 1970s catapulting Milton Friedman and his hawkish monetary policy as the panacea for economic stability. However, it was Robert Solow (1956) who underlined the critical importance of **Total Factor Productivity in which efficiency of labour and capital through technology, innovation and research could generate increasing returns to scale. His equation $Y=A \times K^{\alpha} \times L^{\beta}$ (where Y is the output, A is scale of production, K & L are factors of production and α & β are factor efficiencies)** has improved our understanding of the power of technology and factor efficiency. This is one of the prime reasons why USA is a global hegemon after World War II.

BEYOND FISCAL CONSOLIDATION

It is in this backdrop, one reads Prof. Musgrave seminal contribution to public finance (1973) with great pleasure and nostalgia. Musgrave is credited with a public policy that stands on the tripod of **right allocation, distributive justice and stabilization.** While economists underscore the importance of fiscal consolidation, there is a need to supplement it with **adequate pubic allocation for quality primary education instead of harping on 'universal access'.** The ASER (*Annual Status of Education Report*) brings out the dismal **story of poor educational outcomes in government schools, its high dropouts (27%) and gravitation towards expensive private schools (30%).** This is indeed a sad commentary of our public apathy to quality education at the grassroots which has cascading impact. Quality education will be the key to India's journey as a super power of Asia. Solow's emphasis on improving factor efficiency cannot be more timely. The remarkable growth story of China is attributable to TFP (Total Factor Productivity) as also of Japan and South Korea.

SOCIAL SECTOR AS A CRITICAL COMPLEMENT

Mr. Jaitley must be careful about adequate allocation to social sectors which are critical complement to skill upgradation and quality of life. His last budget reduced allocation in ICDS (Integrated Child Development

Scheme) by 50%, despite the fact that this scheme is at the heart of **nutritional support to 7 crore children and 1.5 crore lactating mothers.** The following table would explain the concerns.

Table 3: Allocation to Merit Goods in Rs. Cr.

PROGRAM	2014-2015	2015-2016	% Change
School Education	46850	42219	-0.1
Higher Education	23700	20855	-7.9
Integrated Child Development Scheme	16316	8000	-49.0
Women & Child Development	18588	10382	-55.8
Swachha Bharat	11938	6000	-50.2

Source: India's Budget Document-2015-2016

It would, therefore, absolutely expedient for him to restore the trend of central allocation in 2014-2015 in the upcoming budget and increase our share of GDP to 6% in education as against 3%; as was recommended by Kothari Commission (1966) and Knowledge Commission (2009).

THE WAY FORWARD

Budgeting is not merely juggling of numbers and "art of the possible" as Mr. Jaitley often alludes to. Shorn of distributive justice and genuine sense of compassion, it can be an instrument of **accentuating income inequality and dispensing undue favours to the already privileged**. Piketty and Stiglitz bring out how crony capitalism has made USA a bitterly divided society despite its demonstrable prosperity. India's public policy must encourage its private sector to unleash its "animal spirits". But it needs to be properly regulated. Further, **Prof. Dreze aptly observes "Sending rockets to Mars and running bullet trains but remaining a third world country as far as social services like education is concerned seem to be an odd view".** Budget, for each stakeholder is driven by their self interest. **Unfortunately it does not follow Smithosian principle of optimality**. The economic architecture of a budget must take cognizance of the social construct of a society and **ink the vision of a just and shared prosperity. The upcoming budget must strike the right balance between fiscal discipline, distributive justice and proper allocation balance between social sector and economic infrastructure.**

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