A Macro-economic View of the Union Budget 2007

The Union Budget 2007 has been reasonably well crafted by Shri P. Chidambaram. He has not altered the basic direct and indirect tax provisions and that is the right course of action. In the realm of tax policy it is often the case that 'less is more'. But the Budget could have been more responsive to the rural masses by allocating more to a scheme like the NREGS.

Rarely have the macroeconomic fundamentals of the Indian economy have been as good as they were when Shri Palaniappan Chidambaram rose to present the Union Budget on 28th February 2007. In the past four years gross domestic product (GDP) has grown at an average of a little over 8.5 per cent. Gross domestic savings in 2005-06 has moved up to 32.4 per cent from 23.4 per cent of GDP in 2000-01, an increase of 9 percentage points in 5 years. Gross domestic investment in 2005-06 stood at 33.8 per cent, up from 22.9 per cent of GDP in 2001-02, an increase of almost 11 percentage points. If one is to consider the overall incremental capital output ratio (ICOR) of the economy in the range of around 4 then this could lead to a sustained growth rate of 8 per cent plus in the medium run, barring major untoward shocks.

Shri Chidambaram's 2007 budget might not go down as yet another 'dream budget' of the kind he presented a decade back, but it is certainly a deft draughtsman's job. Clearly it is the work of a person who is familiar with the corridors of North Block and perfectly understands the mechanics of budget making.

It is often presumed, mistakenly in my view, that the more you change things around the better it is. Actually in the case of macroeconomic policy making the reverse may well be what we should be striving for. In other words, it may well be desirable to fix the broad contours of monetary and fiscal policy for a reasonable length of time and not have to intervene continuously. There is plentiful evidence of this thinking in Shri Chidambaram's budget.

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With the economy growing at 9.2% in the past year, the Finance Minister has indeed been in the enviable position of being able to 'unfurl the sails and catch the wind', as he mentioned in his budget speech. The Central government's tax to GDP ratio has risen from 9.2 per cent in 2003-04 to 11.4 per cent in 2006-07. We now have a fairly moderate and modern direct tax schedule, informed by the huge body of theoretical and empirical work on direct taxation in the past three decades. The idea of not tampering with the direct tax schedule too frequently is essentially sound. Growth of income and an environment conducive to voluntary tax compliance are ultimately going to yield higher revenues.

This is not to say that we cannot do more, substantially more, to streamline the administrative machinery. The enforcement has to be tighter and persistent defaulters have to be seen to be given exemplary punishment.

Main Thrust

Clearly the main thrust in this budget is on agriculture, education and health. Surely no one should have any issue with this but the story is not as simple as it might seem. All budgeting has to be done with finite resources, so if one emphasizes agriculture there has got to be less for the other sectors. But surely no one should cavil at this! Agriculture now accounts for just 19 per cent of GDP whereas almost 60 per cent of the country's population is dependent on it. Industry and services account for the balance 81 per cent of GDP, catering to about 40 per cent of the population. But more grievously for agriculture, whereas the sector averages a growth rate of about 2.5 per cent the growth rate in the industry and services sector have been in the range of about 8 to 9 per cent. This also means that the inequalities in factor incomes being generated in these sectors are getting accentuated. There have to be correctives,

channeling resources into agriculture, and this is precisely what the FM seems to have attempted.

The other two major thrust areas are education and health. With among the lowest social sector indicators in these vital areas it can hardly be anyone's case the FM has been injudicious in putting more emphasis and also money into these sectors. But of course the question of actual implementation is always another matter. It is one thing to provision a good deal of financial allocation for a particular purpose, but if the system administering and implementing the programme has entrenched interests of the wrong kind, the purpose of additional funds may well be largely nullified. Extensive field level studies in certain parts of India including Uttar Pradesh have revealed that absenteeism amongst village school teachers is rampant, and there is hardly any worthwhile monitoring system in place. More money into village schools in a blanket manner without some crucial institutional changes would obviously prove utterly wasteful. But the original intent of Shri Chidambaram in channelising more money into education and health can hardly be taken issue with.

It is often believed, quite mistakenly, that the annual budget of the Central government can be expected to address all the outstanding problems of the day. There can be no greater wishful thinking than this. The annual budget can at best bring about marginal and incremental changes. The only thing that one might legitimately hope for is that the direction of change is in the desirable direction rather than otherwise.

The Economic Backdrop

The economic backdrop against which one must judge the rural thrust of the budget may be briefly stated. As per the latest figures the shares of agriculture, industry and services in national income are 19, 27 and 54 per cent respectively. Agriculture, however, is the mainstay of about 60 per cent of the population. The difficulty, however, is that whereas the services sector has been growing at an average annual rate of 9 to 10 per cent and industry has been growing just a notch below at an average of about 8 to 9 per cent over the past 7 years, the average growth rate for agriculture has been around 2.5 per cent. There are of course natural limits as to why agriculture cannot grow as fast as the other two sectors in the long haul, but then this also means that the recent growth experience in India is obviously contributing to a sharpening of the intersectoral inequities. There are two policy remedies that immediately suggest themselves.

First, the pace of agricultural growth has to be accelerated. But this can only come about by giving a significant boost towards increasing agricultural infrastructure such as minor and medium irrigation projects, watershed management schemes, and initiatives to check soil erosion and land degradation. This will bring about the much-needed corrective by enhancing agricultural productivity. The second is the explicit idea of transferring surplus agricultural labour into industry, particularly into the manufacturing sector. This is precisely the manner in which industrial development occurred historically in England and continental Europe. India's growth experience appears to have been somewhat at variance from the standard developmental experience in that a significant shift of economic activity has occurred directly from agriculture to services without the process going adequately through the intermediate stage of industrial expansion.

This path has had one particular unfortunate fall-out and it pertains to the employment potential in the services sector. Unfortunately, this sector, especially in its high-end information technology (IT) sector, has highly limited possibilities in terms of labour force absorption, unlike in manufacturing where there is scope for employment for a wide class of low and semi-skilled workers. The unemployment problem in the country is particularly acute now, and the expansion of the service sector is unlikely even to scratch at the surface of the mammoth dimensions of the problem. The solution to the problem lies in creating such conditions that industry, and particularly its dynamic segment manufacturing, is able to substantially absorb the masses of labourers who find themselves to be surplus in the agricultural farmlands. This is one area where the Chinese seem to have admirably succeeded, by expanding the manufacturing sector and by making this the sheet anchor of their dynamic growth experience over the past two decades.

Taxation

For the loyal and dedicated readers of this journal there must be much interest on the taxation

proposals in this budget. I should begin by saying that my perspective as an economist may be totally at variance with that of the accounting professionals. As a student of public finance, I am interested in examining how the finance ministry has been able to mobilize resources by resorting to alternative forms of taxation and other channels of mobilizing non-tax revenues. It is a matter of some satisfaction that the tax to GDP ratio for the Centre has moved up from 9.2 per cent in 2003-04 to 11.4 per cent in 2006-07. This would bring the tax to GDP ratio in the country at large to around 16.5 per cent, which was the percentage at the beginning of the reform process in 1991. After the progressive implementation of the recommendations of the Tax Reform Committee headed by Professor Raja Chelliah the tax to GDP ratio in fact dipped initially and has only now reached the pre-reform figure. This was owing principally to reduction of customs and rationalization of Union excise duties across the board.

By far the most profound reform initiated by the then Finance Minister Dr. Manmohan Singh was in the realm of direct taxation. The idea was to broaden the tax base to the extent possible and to choose moderate rates. This was in keeping with the large body of theoretical findings from the research of the Nobel laureate James Mirrlees, now a Professor at Cambridge University. Around the late 1960s the personal income tax schedule had many points of graduation and the top marginal tax rate in fact was as high as 97.75 per cent. Surely this defied basic reasonableness on the part of tax policy formulators. But the idea of using a highly progressive personal income tax schedule was the cornerstone of the core socio economic policy of the left liberals. Indeed personal income tax was one of the ten points of the Marx's Communist Manifesto. The idea was that there is nothing more potent than a markedly progressive income tax schedule to effect distributive justice. The actual impact was of course anything but the intended result. Confronted with such penal rates of tax, not only the income earners at the topend would routinely avoid tax, but there was an unconscionably high degree of tax evasion as well. This was resorted to by all and sundry, but it was particularly acute amongst small shopkeepers and self-employed professionals.

The logic of the Mirrlees' prescription, made in his classic contributions around the early 1970s, of broadening the base and choosing rates not exceeding about 35 to 40 per cent at the margin was essentially in accord with basic intuition. In fact this was in the ultimate analysis more potent in terms of bringing about equity than adopting a highly progressive income tax schedule with penal rates at the top end.

Shri. Chidambaram has had the good sense to not tamper with the basic rate schedule of personal income tax, which retains the structure of 10, 20 and 30 per cent marginal tax rates. The issue of stability in taxation is not a matter of small importance. Indeed one may very reasonably hold the view that in the sphere of taxation, sometimes 'less is more'. This is to say that the less tampering one does with a tried and tested and reasonable tax structure, the better it is.

Some minor tinkerings have been done. For example, the threshold limit of exemption in the case of all assesses has been increased by Rs. 10,000, thereby giving each assessee a relief of Rs. 1000. There has been much criticism of the FM's move of raising the dividend distribution tax from 12.5 to 15 per cent on dividends distributed by companies. Surely this is one move, which would affect, albeit only marginally, only the top end income earners and as such could not possibly hurt the cause of equity. And certainly there was no reason why the dividends distributed by money market mutual funds and liquid mutual funds should ever have enjoyed concessional tax rates giving rise to huge arbitrage opportunities. This budget proposes to end this distortion by raising the dividend distribution tax on dividends paid by such entities to 25 per cent for all investors. It is also right to bring the Employees' Stock Option Plan (ESOP) under the purview of the Fringe Benefits Tax (FBT).

I believe that all of the above measures, relatively small and incremental, are moves in the right direction. The real stumbling block on the path of direct taxes is of course tax administration and enforcement. It is here that the government now needs to channelise its main attention. With the top marginal rate at 30 per cent there is every reason why one should expect a heightened degree of voluntary tax compliance. This also means that the defaulters be stringently and demonstrably taken to task.

Some recent data on Central tax collections, contained in the Economic Survey 2006-07 (page 23) reveal a number of interesting developments.

On the eve of the initiation of economic reforms in 1990-91 direct taxes were a mere 1.9 per cent of GDP. By 2006-07 direct tax collections stood at 5.1 per cent of GDP, of which corporation taxes comprised 3.2 per cent, now the single biggest revenue earner, having now beaten the regular biggest ticket item, Union excise, which has now been relegated to the second place. This is also very broadly in accord with the original intent of the Chelliah Committee, which had set out to reduce the relative importance of indirect taxes vis-à-vis direct taxes. But as mentioned earlier, much more needs to be done in the sphere of tax enforcement in the sphere of personal income taxes.

As regards indirect taxes there have been wide ranging reductions in tariffs. For non-agricultural products the peak rate has been reduced from 12.5 to 10 per cent. This will surely go some way towards making our goods more competitive in the international market. This is particularly so in a context where we face rather tough competition from China in virtually the entire spectrum of standard manufactured items where they have a cost advantage by a factor of almost a quarter to a third of the price. Duties on most chemicals and plastics have been reduced from 12.5 per cent to 7.5 per cent. Duties on steel seconds and defectives have been halved from 20 to 10 per cent. Customs duties on polyester fibres and yarns and raw materials such as DMT, PTA and MEG have all been reduced across the board from 10 per cent to 7.5 per cent. Further, in tune with the general approach towards direct taxes where the rate structure has been left untouched, there has been no change in the general CENVAT rate or in the service tax rate.

Some Shortcomings

Lest it be concluded that we have given an unalloyed approval to the budget of Shri Chidambaram, it is time now to look some of its rather indefensible aspects. To begin with, I would say that if the FM was truly thinking in terms of bringing about a systemic change in the nature of attention to be now put into agriculture then even though he has tried to allocate more financial resources he actually could have done much more in a concrete sort of way. For example, consider the National Rural Employment Guarantee Scheme (NREGS). The NREGS, as we all know was launched in February 2006, and has just completed a year. The pace and the quality of its implementation have varied from state to state. The allocation for this in the current year is Rs. 12,000 crores, which is marginally more than the allocation of Rs. 11,300 crores last year.

This is rather unfortunate. This is especially so since the coverage of the scheme is supposed to increase from 200 districts last year to 330 districts in the current year. The NREGS has the potential to make a material difference to the unemployment and the poverty scenario in the country at large. But unfortunately the mandarins of the Finance Ministry continue to look at this as a wasteful scheme, and take recourse to the standard stonewall reasoning that they have finessed over the decades. The reasoning is that since the NREGS is a demand driven scheme carrying a legal guarantee of employment the budget allocation has to be supplemented according to need. Yes it is demand driven. So what? What prevents the learned functionaries from North Block from making careful projections of the demand for the scheme in the coming year especially when we know, at a minimum, that the reach of the programme has increased by 65 per cent. Why is there such a lackadaisical approach to this vital scheme that can make a material difference to those at the bottom end, on the brink of survival?

Unfortunately we have nothing else to thank other than a mindset, which has the concern of the rural poor totally out of the mental radar of our well-heeled bureaucrats. The tragedy of 15 farmers killed in Nandigram and the massacre of 55 policemen in Dantewada, Chhattisgarh recently should alert us to the reality that unless the state becomes responsive to the needs of the common masses the very basis of our polity is under dark clouds. Perhaps there is too much concern over achieving growth rates of 9 per cent or more. If the pursuit of some truly people-centric policies should mean a loss of the growth rate by a notch or two, I believe we should have the courage to accept this. Even from the point of view of some of the fundamental precepts of development economics it is not obvious that the special economic zone (SEZ) route to development is the best path or even the most relevant path of development for a poor agrarian tract. It is time our Finance Ministers paid heed to these broader political economic imperatives. ❐