

More populism, or a revival effort?

Any move towards economic revival will have to substantially increase spending on infrastructure this year

Let me wish all the readers a very happy and prosperous and a non-disruptive 2017! The prime minister's address to the nation on New Year eve perhaps is a precursor to the budget. There have been a number of announcements, including the expansion of low-income housing scheme, interest relief on housing loans, credit guarantee and hike in cash-credit limit to MSMEs, for pregnant women and senior citizens. Interestingly, while these announcements have a "feel good" factor, they do not add much in terms of expenditures.

With the government's decision to advance the budget date by a month, to February 1, the policy focus has now shifted to the budget. The general public has passed through unprecedented hardship on account of cancellation of specified bank notes, and the coming days will see hardships lessening progressively as the economy gets remonetised. But, state elections are on the horizon and the government has to show its compassion, and the concerns and the prime minister's address to the nation are only part of this agenda. One can expect another bout of populism in the budget, one that will depend on the amount of money the government is able to garner from demonetisation which is determined by the extent to which the cancelled notes are not returned to the banking system and the additional tax revenue collected from the detected illegal transactions.

This year's budget has some distinct changes in the structure as compared to the past. First, the budget date has been advanced by a month which will, hopefully, help in its better implementation. It will also provide greater certainty on the volume of transfers to the states which will help in the latter's budget making. Second, the abolition of the plan/non-plan distinction would help in looking at the sectoral allocations holistically and avoid distortions such as inadequate allocation to the maintenance of assets in order to show high plan expenditures. Third, the report of the NK Singh Committee reviewing the FRBM will be submitted and the fiscal

targets will perhaps be guided by its recommendations. It remains to be seen how the committee will make the target counter-cyclical and whether it will recommend the target range rather than a specific number. Finally, the merger of the Railway budget with the main budget could create some difficulties and it remains to be seen how borrowing by the Railways will be insulated from the general budget.

The investment climate in the country is far from optimistic; sectors like construction, trade and tourism and small-scale industry have suffered from both loss of employment and compression in demand. The weak demand situation has worsened the already bad investment climate. The excess cash that has been deposited after demonetisation has resulted in increased savings, albeit forced, and also increased financial sector savings. The increase in lending space has, in turn, increased the possibility of lowering of interest rates, but it is doubtful whether this can revive private investment in the prevailing poor investment climate and the twin balance-sheet (of banks and corporates) problem. The Financial Stability Report brought out by Reserve Bank last week has raised alarm bells on the increasing non-performing assets of the scheduled commercial banks and particularly, public sector banks. With the American economy looking brighter and the Fed raising the interest rate, there has been considerable outward flow from foreign institutional investments. The maturing of NRI investments has further exacerbated the outward flow of foreign exchange to lower the exchange rate. In this environment, the budget will have to be



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crafted with considerable skill to revive the economy and further the cause of reform.

With substantial portion of the demonetised notes of ₹15.3 trillion returning to the banking system, the fiscal gains may not be large. It could be anywhere between ₹75,000-90,000 crore, depending on whether the black wealth held in cash is 5-6%. The voluntary disclosure scheme too has not brought in much additional revenues. Nor has the special scheme for dispute resolution. The pursuit of doubtful cases after demonetisation could bring in additional revenues but that will crucially depend upon capacity of income tax administration. On the downside, the compression in demand will lead to deceleration in GDP and correspondingly tax revenues.

Despite the above apprehensions, conforming to fiscal deficit target may not be a concern for the finance minister this year. However, that is not comforting enough. The most important thing for the government is to revive the investment climate. In the prevailing environment of subdued private investment, kick starting the revival process would require substantial increase in public sector investment. Therefore, the government will have to tread carefully between wiping the tears of disruption and kick-starting the revival of economic activity. Public investment at the Union level has shown a steady decline and is estimated at just about 1.6%; any move towards economic revival will have to substantially increase spending on infrastructure this year.

On the taxes side, it is almost certain that GST cannot be implemented from April 2017. However, there is

much that the Central government can and should do before the actual implementation. There is no reason to continue with over 300 exemptions in excise duties and the list must be pruned in this budget. Furthermore, there is no rationale for continuing with so many tax rates, some ad valorem and some specific. Many of the items can be brought into the tax net in this budget and the rate structure can be broadly aligned to the rates decided in the GST Council. It may even be desirable to reduce the threshold of excise duties by ₹50 lakh from the prevailing ₹1.5 crore.

The finance minister had promised to phase out tax preferences and reduce the rate to 25% in the next few years. This budget presents an opportunity to clean up the tax preferences and bring in competitive rates. One of the major constraints in the development of futures trade in the commodities is the Commodities Transaction Tax (CTT). Broadening and deepening the formalisation of the commodities and financial markets require that both CTT and Securities Transaction Tax must be abolished. The transaction taxes increase the transaction costs of conducting businesses, and in the case of commodities, the CTT has hindered the development of the exchanges by shifting businesses to other countries. The loss of revenue from this is just about ₹7,000 crore, but the loss to the economy on account of this is manifold, and there is no reason to persist with these taxes. There is a need to rationalise the taxation of financial sector and bring in uniformity in the treatment of investments in all financial instruments to avoid altering the after-tax rates of return on different instruments. Similarly, formalising the real estate market could be served at least partially by abolishing the capital gains tax on real estate transactions. Of course, reduction in stamp duties is even more important, but that would require the states to act.

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