Not with a bang

FM springs no surprises. Nor responds adequately to slowdown in private investment

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BUDGET 2017 TOOK place under the shadow of demonetisation. What would the follow-up actions be, especially as the outcomes from demonetisation have been disappointing compared to its stated objectives? The budget has proved to be a quiet affair. We are left with relief that erratic actions have not been taken. At the same time, there were few steps that would address the biggest concern about the economy — the slowdown in private investment..

Before the budget speech, there were several scenarios which were being talked about. Would the budget propose other radical measures like a banking transaction tax or the removal of income tax proposed by Artha Kranti? Would the budget try to soothe demonetisation's pain by sending transfers and tax breaks to the affected? Would the fiscal deficit be increased to alleviate its contractionary impact?

The demonetisation experiment was a negative shock to the economy. Some people were proposing that this should be offset by a fiscal expansion. The finance minister (FM), however, stuck to a modest fiscal deficit. This makes sense for many reasons. First, a larger fiscal deficit could have hurt India's credit rating. A fall in ratings could have lead to a flight of capital and a rupee crisis. Second, providing a fiscal stimulus would be tantamount to accepting that the negative demonetisation shock has consequences beyond the present quarter. This may not be something the government is ready to admit. In terms of providing a positive shock by expanding expenditure, the capacity of the state to spend funds effectively is limited. The budget speech did well in not announcing big subsidy programmes. There was a sharp increase in the expenditure of MNREGS. This may be consistent with the increased utilisation of MNREGS owing to demonetisation that appears in the initial data. It has to be kept in mind, however, that the prime minister's speech on December 31 announced many traditional subsidy programmes. The overall emphasis on subsidies is larger than meets the eye.

At a conceptual level, perhaps demonetisation and the associated political strategy is more about being anti-rich than being pro-poor. In the past, populism in India has involved inventing subsidy programmes that help the poor. This government has tried to make poor people happy by pointing to the distress of the rich. Perhaps this would imply that the budget would also take actions which could be positioned as being anti-rich, such as raising tax rates or avoiding reforms. There could have been a number of measures that fitted the bill, such as a wealth or inheritance tax. It is not clear what the impact of these would have been. The FM proposed a surcharge on income between Rs 50 lakh and Rs 1 crore.

When faced with economic difficulties, another way through which fiscal policy can be expansionary is to cut taxes. One long-standing area for Indian fiscal reform is bringing down the corporate tax rate. In Union budget 2015, the FM promised that the Indian corporate tax rate will be brought down to 25 per cent. One concern for not doing this for the corporate sector may have been the risk of being called pro-rich. Another may have been the uncertainty that removing exemptions could have introduced at this time. The rate could not have been cut for large corporates that contribute to most of the corporate tax collections, without removing exemptions, or it would have led to a dip in revenues, something the government cannot afford at this point.

A compromise has been achieved by proposing a lower, 25 per cent tax rate for small companies whose income is under Rs 50 crore per year. At a political level, this can be seen as reaching out to small businesses. One can also hope that they would help to improve compliance by smaller companies.

Similar moves are visible in personal income tax, where tax rates were cut at low incomes and increased at higher incomes. These moves are consistent with the populist, anti-rich stance. Respect for Indian policymaking capacity was at a low after demonetisation. Expectations for the budget speech were low. The pessimists expected an escalation of erratic measures crafted by non-experts. The prevailing mood seemed to support doing things that were bold and that no reasonable country had tried before. Fortunately, the budget did not propose a universal basic income, a banking transaction tax, a cash transaction tax or any other untested idea.

In terms of institutional reform, the budget speech was necessarily silent on the big story: The Goods and Services Tax. A sound GST is one with a low single rate, comprehensive coverage and a single administration. Many compromises have already been made which ensure this will not come about. The extent to which a sound GST is delivered will have a major impact on the coming years.

On financial sector reform, some old policy initiatives are gradually going towards execution. The abolition of FIPB was long overdue and is a welcome step. The Resolution Corporation will deal with the failure of financial firms.

In summary, while the FM should be given brownie points for staying on the conventional path and not giving any big surprises, he also did not respond adequately to the serious slowdown in private sector investment India has seen in recent decades.

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