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A step for the high growth strategy

Watch for the reward-to-risk ratio faced by private persons

SNAKES & LADDERS

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The most important problem in Indian macroeconomics is the decline in private investment. The decisions of private persons are shaped by the reward and risk from investing. When a business got ₹100 of profit before tax, the cash that went to the shareholder, under certain assumptions, was ₹43. With the reduced rate of corporate income tax, this goes up to about ₹48. This move is in the right direction. More needs to be done, to change the risk/reward analysis of private persons, to get back to high-growth arrangement. The greatest fiscal risk comes from low economic growth.

The part of aggregate demand that moves the most in Indian macroeconomics is corporate investment. There were two booms in recent decades, peaking in 1994-95 and 2007-08, and there are low values in the late 1990s and in recent years. To get back to growth, it is essential to get back to strong private investment.

How do private persons (domestic or foreign) make the decision to invest, either in a new firm or in the expansion of an existing firm? They look at the prospective reward-to-risk ratio, of the cash that is finally delivered back to the shareholder. For the moment, let us assume that a company gets to ₹100 of profit before tax. How much consumption does this give the owners? When various parties take a bite out of this ₹100, this reduces the benefits obtained by the owners, and thus reduces the reward-to-risk ratio.

By making certain assumptions about the exact values of CSR, corporate income tax, dividend distribution tax, and then the personal income tax paid by the owner, we estimate that before the Friday announcement, ₹100 of profit before tax would have yielded ₹43 to the owner. After Friday's announcement, this goes up to about ₹48 to the owner. The announcement has given a gain of about five percentage points. This is a useful progress.

When this shareholder goes on consume this ₹48 by purchasing goods and services, the government takes a next bite out of this through goods and services tax (GST).

Alongside, this is the question of risk, which comes in three parts. All investments face ordinary business risk, and this is perfectly fine. In addition, in the Indian environment, there are two additional components of risk. Firms face policy risk of events which can adversely impact their business model. As an example, in the Aadhaar case in the Supreme Court, firms who had built systems using Aadhaar were deprived of this infrastructure. Similarly, firms who had built systems using information from credit bureaus were recently deprived of this information access.

The third component of risk comes from the agencies. The Indian legal system contains numerous agencies, with high investigative powers, many threats of imprisonment, and weaknesses in the rule of law. Going to jail is a showstopper, but even if that is not in the picture, the expenditure on lawyers takes one more bite out of the cash flow. For a firm with a top line of ₹100 crore and a net profit of about ₹5 crore, payments to lawyers of about ₹1 crore a year are a large expense. Only when a firm reaches ₹1,000 crore of revenue does it feel safe about such legal expenses.

The private sector should be asked to bear normal business risk, and reap the fruits from innovating, taking business risk, and building a business. To the extent that the fruits of the labour are transferred to the government or lawyers, and to the extent that the business is vulnerable to policy risk and the agencies, this deters investment.

Policy makers can impact upon the reward-to-risk ratio by reducing tax rates, reducing policy risk, reducing the threat of the agencies, and reforming the legal system.

So far, we have focused on the desire of private persons to invest. Once the problems of the reward-to-risk ratio of private persons are addressed, private persons will nurture investment ideas. The next hurdle that they face is of a financial system that will fund investment projects. Both engines of the Indian financial system — banks and financial markets — are currently limping. Restoring the health of the financial system is required, in the high-growth strategy.

The high-growth strategy is thus a combination of changing the reward-to-risk ratio as seen by private persons, coupled with restoring the health of the financial system. The Friday's action is one element of the high-growth strategy.

There is the question of fiscal risk associated with reduced tax rates. We have to look beyond the short-term impact of this one decision, at the big picture. In Indian macro policy, there are only two choices for an environment of fiscal stability. Fiscal stability can be obtained through high growth coupled with loose fiscal policy. Alternatively, it can be obtained through low growth coupled with tight fiscal policy.

We have to ask which of these two scenarios is more palatable. The traditional answer in India was to have loose fiscal policy coupled with high growth. To return to this configuration, we need the high growth strategy. The Friday action is one move towards the high growth strategy.

The short-term budgetary impact of cutting tax rates will be smaller than what meets the eye. The distortion associated with a tax goes up in proportion to the tax rate squared. When a tax rate comes down, the distortion imposed upon the economy goes down, which bolsters growth. When a tax rate comes down, the effort made by private persons to evade the tax goes down. When a tax rate comes down, the power of the tax administration goes down.

For all these reasons, simple proportionality is never found when tax rates change. When a tax rate is raised, the tax revenues obtained always disappoint. When a tax rate is reduced, the reduction in revenue is smaller than what meets the eye. This gives cause for optimism in anticipating a relatively modest impact upon fiscal soundness.

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