

ILLUSTRATION: AJAY MOHANTY



# What can macro policy do?

Long-term structural reforms are required, such as a uniform GST and direct tax rates

**W**e are in a business cycle downturn and in a decline of trend growth. The tools of macro policy can address the business cycle, but their ability to address the overall problem is limited. We have to be cautious about fiscal expansion, given that the initial condition is one of chronic fiscal weakness. The useful path lies in harnessing the situation to push for the required long-term structural reforms in tax policy and tax administration, instead of thinking in terms of discretionary fiscal policy.

There was a great phase of high trend growth in India from about 1991 to 2011. After that, trend growth has declined. Layered on top of the long-term trend is a business cycle phenomenon, of fluctuations in profitability, inventory, and investment that move around the long-term trend. Right now, we also have a business cycle slowdown.

At first blush, it appears that the tools of macro policy, fiscal policy, and monetary policy must ride to the rescue. Monetary policy is already doing this, owing to inflation targeting. The 91-day T-bill rate, which is the best measure of the de facto stance of monetary policy, was at 11 per cent in 2013, when the Reserve Bank of India (RBI) was pursuing an exchange rate objective. Now that the RBI pursues an inflation objective, it stands at 5 per cent. This is a decline of the de facto policy rate by 6 percentage points. As long as the monetary

policy committee carefully peers one year out, and tries to figure out the interest rate that will deliver on the 4 per cent CPI (consumer price index) inflation target, monetary policy will be about right.

What about fiscal policy? Can we cut tax rates sharply and thus improve purchasing power? Or raise spending sharply, to the same effect? There are a few concerns about going down this path. We must keep in mind that the decline in private corporate investment, which has

taken place from the peak of 2007-08 till today, is a large one. Fiscal policy in India can shift its stance by one or two percentage points of Gross Domestic Product (GDP), but the problem is about five times larger than that.

The way in which the government borrows is faulty. Most of the borrowing takes place from captive lenders through financial repression. When the conscription runs out of steam, financial regu-

lators may be asked to push up the forced investments in government bonds, e.g. by raising the statutory liquidity ratio. This would be a reversal of economic reforms, and raise the effective taxation upon formal financial intermediation.

Uncertainty is caused when the economy thinks that tax rates can go up or down, depending on the situation. Private persons require stability of tax policy on multi-decade horizons in order to feel confident about investment plans.

In an ideal world, we would have had a 4 per cent primary surplus in the boom year, 2007-08, which would have created space for a swing of 8 percentage points to a primary deficit of 4 per cent in 2020-21. Unfortunately, fiscal policy in India does not do large surpluses in good times. Consequently, we do not come into this downturn from a position of strength. Nominal GDP growth and the average cost of borrowing of the government are rather close to each other, and there is the possibility of getting into a zone of an increasing debt/GDP ratio.

"Above all, do no harm" is an important adage in macro policy, as it is in most walks of life. Policymakers in India were in a terrible bind in 2001 owing to fiscal stress and in 2010 owing to inflation. These experiences should not be forgotten. We should not add a fiscal crisis or an inflation crisis by 2022 to our list of problems.

How can fiscal policy navigate this situation? A pre-requisite lies in undertaking the public debt management agency and bond market reform, so as to set the stage for a healthy relationship between the government and its lenders, and create the ability to borrow from voluntary lenders on a larger scale. This requires resurrecting the work programme that was initiated in 2015.

We should use this moment to push the required long-term structural changes of tax policy, all of which happen to coincide with lower tax rates. We need to go to a clean and simple Direct Tax Code, with a flat low rate of about 20 per cent for corporations and individuals. We need to go to a universal base, single-rate goods and services tax of 8-10 per cent. Alongside this, we need a new tax administration law, which brings the rule of law into tax administration.

These are the required long-run structural reforms. They should be positioned as permanent structural reforms, and not as fleeting responses to the present stress. This will elicit the desired response of optimism and respect of the private sector. If such changes are positioned as short-term responses to economic stress, the private sector will see them as impermanent, and the full gains to the economy will not be obtained.

There is a role for such sophisticated discussions about how macro policy can help address the slowdown. However, we should not exaggerate what macro policy can do. Monetary policy in India is limited because of the lack of financial reforms which would have given an effective monetary policy transmission. Fiscal policy in India is limited owing to chronic deficits and faulty procedures for borrowing. The standard tools of macro policy, in the Indian setting, have low potency. And, in any case, they can only address business cycle fluctuations; they cannot impact trend growth.

A root-cause analysis of the decline in trend growth from 2011 onwards will take us to the decline in private investment. The root-cause solutions will lie in going to the foundations of private unease, and addressing them. This will take us to the problems of rule of law: In the criminal justice system, the judiciary, tax administration, and economic regulation. It will also take us to the larger problem of economic freedom, of emphasising personal agency and scaling back state activism.



**SNAKES & LADDERS**

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