

Keeping the focus on fiscal consolidation

India has to compare its tax rates not with the more developed economies but with the ones that are closer home



INVESTMENT CYCLE

PRABHAT AWASTHI

When the finance minister rose to present the Budget for FY20, the challenges before the government were generally known — financial market stress, real estate stress and a general refusal of the investment cycle to look up, compounded by the fact that the government revenue growth to address any of these issues have been stymied by the slow growth of the economy.

Within these constraints there is a genuine attempt by the Budget to provide money for bank capitalisation, housing, infrastructure, NBFC stress via a guarantee support, and an emphasis on investment in a number of sectors that are currently a source of forex drain.

The ₹70,000 crore infusion of capital in PSU banks is a positive surprise and so is ₹1 trillion guarantee support for NBFCs subject to implementation. This should go some way in easing stress in the credit markets. Higher tax breaks for housing should increase demand for affordable housing and increase demand support to this beleaguered sector. This is clearly money well spent and a much needed fillip to the investment cycle.

The emphasis on infrastructure continues and we should expect a lot more policy action even outside the Budget as has been the case in the past. In any case, the government has clearly spelt out its priorities in terms of its direction.

A major push to increase free float for equity markets by way of increasing minimum public shareholding and also by resetting the foreign shareholding limits to sectoral caps should raise India's weight in the MSCI index and get more foreign flow into the Indian markets. No doubt, the first reaction of the required minimum free float has been negative due to supply fears; hopefully it will be alleviated when the government spells out the timeframe for the said increase.

It is to be noted that the government itself is going to be supplying a lot of paper for meeting its disinvestment targets. Thus there should be enough time given to increase the free float so as not to crowd out demand for genuine capital needed for growth.

There is a significant emphasis on startups and to alleviate some of the pains with regards to taxation of start-ups. The government has also committed to a general ease of tax compliance which should be a long-term positive.

There is a hint of a bolder disinvestment process going forward by including government controlled institutions in the 51 per cent holding. The general wisdom that PSU disinvestment is not

good politics is getting slowly debunked in favour of better economic principles. This could eventually turn out to be a big longer-term positive.

It is also to be noted that the government seems to be making a few statements about a few longer-term priorities. One of them is about Make in India. Tax concessions seem to be coming back for import intensive industries such as semiconductors, EVs etc. On the other hand, import tariffs/taxes for large import items such as gold, oil and consumer durables are going up. The government seems to be playing a long game to reduce India's trade deficit with the rest of the world, at least in terms of strategic intent.

Finally, it must be said that the Budget is only a statement of government finances. The fact that most of the policy action has happened outside the Budget in the past few years means that one has to look at the Budget more from the strategic intent perspective. There seems to be a lot of that in this Budget. From the emphasis on infrastructure, providing flow of credit, asset creation, Make in India, ease of doing business while maintaining fiscal balance is the general strategic thrust. The action should now shift to the implementation of this strategic intent in terms of concrete actions through various ministries. If the government achieves these objectives, it may turn out to be a Budget that was eventually a growth focused budget.

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Overall, there is no new major populist move in this budget and it continues to pay heed to fiscal consolidation. While the debate may continue on the fiscal math, especially with regard to revenue assumptions, the fact remains that the government also succeeded in driving the risk free rate down by opening up sovereign external borrowing.

The Budget issues that could be debated in terms of approach would be, one, sovereign overseas borrowing and two, the taxation approach. Given that India runs a twin deficit and has in fact seen two episodes of currency wobbliness in the last six years, sovereign overseas borrowing can pose challenges if not handled in a careful manner. Second, rising taxes on equity holders over time reduce the attractiveness of taking risk. It suggests a more socialistic agenda in what should be a right-of-centre government. The steep increase on HNI taxes a similar signal. India has to compare its tax rates not with the more developed economies but with the ones that are closer home.

But for a major increase in the tax rate for incomes over ₹2 crore, this Budget would have gone down as a non-populist, right-of-centre Budget with a firm focus on the investment cycle. Perhaps, as the time passes, the equity market would start seeing it that way.

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A silent fiscal crisis?

The ability of government to shrink the expenditures in 2019–20 would severely strain attempts to maintain fiscal discipline



THE FISCAL FRAMEWORK

RATHIN ROY

This year's Budget speech was the first I have seen that, in my memory, has no paragraphs on the fiscal situation which, along with the tax proposals, is at the core of any Budget. However, it outlines the contours of government economic policy more generally, and does it well. It also directly addresses concerns regarding the banking and financial sectors with concrete proposals to tackle the currently troubled situation.

In my previous column (*Some medium-term fiscal arithmetic*, June 7), I argued that the Centre's fiscal space was severely constrained. It is for this reason, perhaps, that the speech avoids any mention of the macro-fiscal situation. This is understandable: It has not been the tradition in India to confront such difficulties openly.

The macro-fiscal numbers presented with the Budget documents suggest "business as usual". (*see table*) The total expenditure as per cent of GDP continues to shrink from 13.34 per cent in 2014-15 to 13.2 per cent in 2019-20. Revenue receipts increase by only 0.35 per cent of GDP in the same period. Collectively, this has allowed government to secure a fiscal deficit-GDP ratio

BUSINESS AS USUAL

	2014-15	2018-19 BE	2018-19 RE	2018-19 ES*	2019-20 BE
Total expenditure (% GDP)	13.34	13.0	13.04	12.2	13.2
Fiscal deficit (% GDP)	4.1	3.3	3.4	3.4	3.3
Revenue receipts/GDP	8.83	9.18	9.18	8.2	9.3
Tax-GDP ratio	7.25	7.88	7.88	6.9	7.81

BE: Budget Estimate; RE: Revised Estimate; ES: Economy Survey; * CGA data

of 3.4 per cent in the 2018-19 (RE) compared with 4.1 per cent in 2014-15. Thus fiscal consolidation has been secured by consistently reducing the size of the Central government and modestly increasing the revenue-GDP ratio.

This was looking good until I read Table 1, Chapter 2 Vol II, of the Economic Survey (ES). There, the provisional accounts for 2018-19, as reported by the Controller General of Accounts (CGA), has presented data that is very different from those in the revised estimates (2018-19 ES in Table). According to the CGA data, the revenue-GDP ratio is 8.2 per cent, a full percentage point lower than reported in the revised estimates. But the ES pegs the fiscal deficit at 3.4 per cent, the same as in the revised estimates. How is this done given the stunning shortfall in the tax-GDP ratio? Well, the total expenditure-GDP ratio reported in the ES is 0.85 per cent of GDP lower than the 2018-19 (RE). The remaining 0.15 per cent is secured by assuming a slightly higher GDP growth rate than that used in the 2018-19 (RE).

This is worrying. If the survey is correct, it is most certainly not business as usual. The Central government would have shrunk by 1.1 per cent of GDP since 2014-15. Our revenue performance

would be dismal compared to previous years. The ability of government to shrink the expenditures by 0.85 per cent of GDP in 2019-20 (as opposed to increase it by 0.15 per cent relative to RE 2018-19) would severely strain attempts to maintain fiscal discipline. For the 2019-20 (BE) to be credible, revenue receipts would need to rise by a whopping 1.1 per cent of GDP, where the Budget allows for just a 0.12 per cent increase.

The CGA is the authorised institution to issue fiscal accounts. If their numbers, as reported in the ES, are way off the mark, then this would cause a collapse in the credibility of the fiscal accounts. But I have full confidence in the fiscal accounts. However, if they are accurate, this would mean that the Budget numbers presented severely underestimate the magnitude of the unstated fiscal crisis that we went through in 2018-19, which cannot be conceivably be fully reversed in 2019-20. At the heart of the crisis is a shortfall in tax revenues which, as the ES makes clear, is mainly due to a shortfall in GST revenues (but also personal income tax revenues), compared to the numbers presented in the RE.

For the rest, the share of central sector schemes is projected to increase

A path to \$5-trillion economy

The Budget focused on redistribution of wealth with tax administration reforms

The build-up to this year's Union Budget witnessed unparalleled optimism and ambition from industry following an "unambiguous" mandate by citizens reaffirming faith in the Modi government. To set the ball rolling for the New India under Modi 2.0, this year's Budget was presented by India's first full-time female Finance Minister (FM), Nirmala Sitharaman. From 1970, it has been a tradition that the serving FM carries a hardbound briefcase. However, this tradition was broken since the FM opted for a *bahi-khata*, instead of a briefcase.

The theme for the Budget was a categorical statement by the FM that it is well within India's capacity to become a \$5 trillion economy. Historically, it took India over 55 years to reach \$1 trillion economy. Whereas the New India filled with hope, trust and aspiration, in five years of the Modi government added \$1 trillion to the economy. Presently, the Indian economy stands at \$2.7 trillion and the aim is reach \$3 trillion by the end of this fiscal year. To corroborate her statement, the FM cited from *Chanakyaniti* (a collection of aphorisms) *sutra* "Kaarya purusha kare na lakshyam sampa dayate" which means "with determined human efforts, the task will surely be completed".

The Economic Survey, unveiled on the Budget eve, emphasised "blue sky thinking", highlighting an ambitious agenda of applying principles of behavioural economics to achieve 8 per cent sustained GDP growth, to make India a \$5-trillion economy by 2024-25.

At the tax policy level, the government put forth tax proposals that aim to stimulate growth, incentivise electric vehicles, affordable housing, encourage domestic manufacturing, reduce disputes, encourage start-ups by releasing entrepreneurial spirits and gearing towards promoting dig-

ital economy. For the corporates, the FM started her direct tax proposals by stating that widening of lower rate of 25 per cent to certain class of companies. Presently, the rate is only applicable to companies having annual turnover up to ₹250 crore, which the Budget has proposed to widen to companies having annual turnover up to ₹400 crore. This will cover 99.3 per cent of the companies, to compensate for loss, two additional slabs of surcharge has been introduced to tax super rich individuals having income above ₹2 crore. To boost



THE TAX AGENDA

MUKESH BUTANI

economic growth and promote Make in India, the government has proposed to launch a scheme to invite global companies through a transparent competitive bidding process for setting up mega-manufacturing plants in sunrise and advanced technology areas and provide them investment linked income tax exemptions (section 35 AD). This seems in line with investment linked tax holiday for mega projects entailing capital outlays and promote employment generation.

Start-ups in India are pillars for the New India and their continued development needs to be invigorated. To tackle the angel tax issue, the Budget has provided a big sigh of relief to start-up investors who file requisite declarations in their returns

which will no longer be subjected to scrutiny in respect of valuations of share premiums. The issue of establishing identity of the investor and source of funding will be resolved by putting in place a mechanism of e-verification. With this, funds raised by start-ups will not require any scrutiny from the Income Tax department and for pending assessments of start-ups, CBDT shall notify an action plan.

Proposals for widening and defending of tax base include a provision for deeming gifts as income, made by persons being residents to persons outside India, which were claimed to be non-taxable. It has been clarified that treaty benefit, if any shall not be impacted.

An anti-abuse provision by way of 2 per cent withholding tax has been provided for cash withdrawals above ₹1 crore (for each bank) for business purposes, to discourage unwanted flow of cash and track its trail.

What is more encouraging for me personally is administrative reforms to strengthen the tax assessment procedure by introduction of faceless e-assessments. The existing system of scrutiny assessments in the Income Tax department involves personal interaction, besides endless documentation, which leads to undesirable practices. To streamline the procedure, instill greater accountability and give shape to the vision of the Prime Minister, a scheme of faceless assessment in electronic mode, without disclosing the name, designation or location of the assessing officer, has been proposed to be launched this year. To start with, the Budget has proposed such e-assessments shall be carried out in cases requiring verification of certain specified transactions or discrepancies, based on data mining exercise.

On the indirect tax front, a dispute resolution cum amnesty scheme, the Sabka Vishwas Legacy Dispute

resolution Scheme, 2019, has been proposed for resolution and settlement of legacy cases of central excise and service tax which have got subsumed in GST. The relief under the scheme varies from 40 per cent to 70 per cent of the tax dues for cases other than voluntary disclosure cases, depending on the quantum of tax under disputes. The scheme provides relief from payment of interest and penalty and tends to address disputes at all appellate forums up to the Supreme Court. This will unlock the dispute resolution capacity allowing them to focus on new GST law.

On regulatory policy, the Budget scores well by making a further increase in the FDI investment limit with a proposed hike of the FDI limit for insurance intermediaries to 100 per cent (from the current 49 per cent). For aviation, media, animation and insurance sectors, the FM was clearly in favour of further opening up of Indian economy and expressed that the government will examine suggestions to hike FDI limits in consultation with all stakeholders. The upper limit for FPI investment in a company can now be increased from 24 per cent to prescribed sectoral limits with an option given to concerned corporates to limit it to a lower threshold.

There is lot in fine print by way of amendments to several statutes including foreign assets, benami transactions and RBI Act.

I reckon this year's Budget was focused on redistribution of wealth with tax administrative reforms keeping in mind the transparency agenda and increased digitisation of transactions. It certainly lays down a blueprint for the next Budgets.

With inputs from Shreyash Shah and Karan Dhanuka

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An incomplete agenda

Many rational changes made to improve effectiveness but basic reforms left out



THE INDIRECT TAX AGENDA

SUKUMAR MUKHOPADHYAY

The changes that have been made in the indirect taxes are mainly in customs since no change can be made in GST in the Budget. But some indications have been given here about the improvements in procedure that obviously have been agreed to by the GST Council. Electronic invoice is being devised in such a way that it will act as the e-way bill and the compliance burden will be substantially reduced. This will be a great improvement in procedure and

will facilitate movement of goods. It will also reduce the chance of evasion. A simplified monthly return is being devised for tax payers of less than ₹5 crore, which again will be a great improvement. A fully automated GST refund module will be another great simplification.

On the customs side, with a view to promote Make in India, higher protection has been given to many items such as cashew kernels, PVC, vinyl flooring, metal fittings, CCTV and many other items. There is always a demand for higher protection for goods that are not made in India but which need to be made. So those who want to make them, ask for imposition of higher duty on them. It is a very difficult exercise to find a mean duty that will not make the importers go out of business of assembling and at the same time, make the new manufacturers viable if they start manufacturing. And for the same reason the nil duty on many electronic items that are now being made in India are being withdrawn which is theoretically a correct move. End use

based exemptions for palm stearine fatty acid and some types of paper are being withdrawn, which is also a very correct move, since these individual exemptions have always been very detrimental both economically as well as from the implementation point of view.

A very grand scheme known as Legacy Resolution Scheme is being introduced for the purpose of quickly disposing of the legacy of cases with regard to excise and service tax that arose before the GST came in two years back. It is estimated that nearly ₹3.75 trillion are held up in these cases. This will greatly relieve the department and the trade and business from litigation. This is a great idea. There is already a Settlement Commission that could be given this job. However, the full name of this scheme is Sabka Vishwas Legacy Dispute Resolution Scheme. Prefixing the expression *Sabka Vishwas* to the scheme is quite funny. That is why possibly the main Budget speech does not mention this expression.

Certain increases in the rate of duty

will attract lot of attention and criticism. Newsprint has been traditionally exempted. Now duty of 10 per cent has been imposed on newsprint, uncoated paper used for printing of newsprint and light weight coated paper used for printing of magazines. This will generate a lot of protest from newspapers. Printed books have always been exempt. Now a duty of 5 per cent has been put on books. The reason that has been given is that it will improve the chance of books being printed in India. This is quite an invalid logic. With 5 per cent duty on imported books, the scale of preference to get books printed abroad will continue as before. Only bad name will come to the government. There will be huge protest against this. Therefore, this is a wrong move.

A very important improvement in the tariff structure has been achieved by advaloremisation of certain duties namely cashew kernels. But this could have been done in a big way for many other items mostly the textiles. It may be remembered that one of the conditionalities given by

the International Monetary Fund during the time of liberalisation from 1991 to convert fixed duty into advalorem. During that time this was achieved in a big way but some items still remain.

However, no general rationalisation of the tariff has been achieved. If we go through all customs tariff, at a glance, we find that there is enormous scope of rationalisation by simplification of rates without losing any duty. Important chapters such as papers, textiles, machinery and instruments are examples where so many different rates of duty are prevalent though one rate of duty is prevalent. Chapter 48 on paper shows that mostly the rate of duty is 10 per cent. But there is one duty of 20 per cent. If this is also made 10 per cent and some exemptions are withdrawn, all papers will come under the same rate of duty of 10 per cent. That will eliminate all problems about drawing samples and test in the laboratory. In Chapter 50 for silk, all rates of duty are 25 per cent but for a few items, it is 30 per cent. The same for Chapter 51 that is also textile items. In Chapter 52 for cotton, the rates are 20 per cent, 25 per cent and 30 per cent and some specific duties. The biggest simplification will be 25 per cent for all the textile chapters.

The revenue implication can be worked out and necessary reform can be

done. For Chapter 84, which is for mechanical machinery, the general rate is 7.5 per cent and for a few items, it is 10 per cent. For Chapter 85 for electrical machinery, the rates are 7.5 per cent, 10 per cent and 15 per cent. For Chapter 90, for instruments, the rates are 7.5 per cent and 10 per cent. The largest majority of items attract 7.5 per cent. If all the chapters are made to attract 7.5 per cent, the rigmarole of defining and distinguishing between mechanical, electrical and distinguishing between different instruments, calling the view of experts will vanish. In general, at the lower level there are four rates of duty, namely, 5 per cent, 7.5 per cent, 10 per cent and 15 per cent. If 7.5 per cent is abolished and only 5 per cent, 10 per cent and 15 per cent are retained, there will be enormous simplification provided that at the same time "one chapter one rate" principle is followed. There has to be exception for a few items like refrigerator, air conditioner and ball bearing.

The conclusion is that while the changes in the Budget in the rates of duty of customs have been for good reasons, except for duties on newsprint and books, general reform of the tariff has not been done.

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Repair and reform

Nirmala Sitharaman has done a good repair job on the fiscal front while announcing some potentially far-reaching financial innovations as well as changes in the definition of the public sector. She has also, unfortunately, reverted to hoary Indian tradition in her tax effort: Soak the rich, raise import tariff walls, and hit petroleum. On the expenditure side, there is little of note in terms of changes from what was presented in the Interim Budget five months ago. While the determination to remain fiscally responsible is welcome, the more important changes may lie outside of the Budget numbers.

But first, the fiscal effort. On the whole, the finance minister has done remarkably well to trim the fiscal deficit to 3.3 per cent of GDP, starting from a much lower tax base than had been assumed when the Interim Budget was presented. Unusually, and perhaps without precedent, the “revised” estimates for the year ended up being hopelessly optimistic. The “provisional actuals” subsequently reported by the Controller General of Accounts revealed revenue slippage of as much as ₹1.6 trillion. Ms Sitharaman does not acknowledge this anywhere in her long speech or Budget numbers (whereas the Economic Survey did take them into account!). Still, it is last year’s tax shortfall that has forced her to lower the tax revenue target for the year by ₹91,000 crore, compared to February, after taking credit for the benefit of the higher income tax surcharges and tariff hikes that she has announced. The rest of the gap has been filled by assuming higher numbers from disinvestment and a hefty additional dividend from the Reserve Bank of India.

This is heroic, but there may be a snag in the new numbers too. The assumption is that tax revenue will grow by over 18 per cent, whereas nominal GDP may grow by no more than 12 per cent. Such assumptions of revenue buoyancy do not always work out. The first quarter’s revenue from the Goods and Services Tax is not encouraging. On the expenditure side there are unpaid bills from last year, which will have to be paid now. Finally, it is not clear how the ₹90,000 crore borrowed outside the Budget to pay for the food subsidy will be squared up, if at all. It is not enough to just meet the headline number on the deficit; that number should also be credible, and not seen as a fudge.

As for the tax effort, the insidious trend of raising tariffs continues on one pretext or other and speaks of a protectionist impulse that must be curbed. Equally insidious is the steady hike in tax rates at the top of the income ladder. The peak tax rate has remained nominally unchanged at 30 per cent since P.Chidambaram introduced it two decades ago, but surcharges and cesses have been added on progressively since. With the latest hikes, the effective peak rate goes up to 42 per cent. That is high by any current reckoning, and counter-productive. No voices may be raised in protest, since there may be fewer than 50,000 in that tax bracket, out of some 70 million who file tax returns. But damage will be done in the long term, and hard to undo. Perhaps a higher tax slab was seen as a superior alternative to the re-introduction of the estate duty, which had been speculated on. On the corporate side, it is hard to understand the incrementalism involved in taking the turnover limit from ₹250 crore to ₹400 crore for a company to qualify for a tax rate of 25 per cent. Why not do the logical thing and remove some of the tax exemptions, and lower the nominal rate for all companies?

The finance minister has been more forthcoming, and imaginative, in her other reform measures. If she is able to carry through on the promise of reducing government shareholding in public sector companies to less than 51 per cent, she will take them outside the purview of the three “C”s that these companies’ managers complain about (the Central Vigilance Commission, the Central Bureau of Investigation and the Comptroller and Auditor General). Greater operational freedom could result, though whether that will automatically improve performance remains to be seen, given the many other limitations under which these companies function. Important meanwhile is the promise, repeated, of four labour codes to replace 44 labour laws, the opening of more windows for foreign investment, and the promise of monetising unused land. More could have been done, say, by selling completed infrastructure projects and using the money thus raised to finance further infrastructure investment.

The more interesting changes are the financial innovations, of which one is the proposal that the government should borrow overseas and not just in the domestic market. This is a good idea, if done within safe limits, because global interest rates are at historical lows (much of the market operates at less than 1 per cent interest), compared to about 6.7 per cent domestically. If India can borrow at about 2.5 per cent, and pay 3 per cent for a currency hedge, it works out noticeably cheaper than borrowing locally. There is the additional benefit that government borrowing will not drive up domestic interest rates, and could prompt private investment. Meanwhile, quite a lot has been promised for promoting the bond market, providing a backstop to banks buying highly-rated assets from non-banking financial companies, making life easier for foreign portfolio investors, introducing credit default swaps (of global financial crisis fame!), and other such.

The closing question is whether the Budget does enough to promote economic growth. The 7 per cent growth projected for the current year in the Economic Survey is tinged with some optimism. Within the tight fiscal corsets imposed on her, the finance minister has tried to address specific issues like keeping down interest rates, helping the financial sector get out of its troubles, and so on. Whether this will be enough to do the trick is what remains to be seen.

Continuity and follow-through

The main emphasis of the speech is on the expansion of existing programmes and the initiation of new programmes



THE BIG PICTURE

AJAY SHAH

The first Budget speech after the general elections gives us a window into the strategy for economic policy for five years. The prime focus in the July 2019 Budget speech seems to be on schemes, and on enlarging the government. There are concerns about the extent to which this is compatible with the evidence of an economic slowdown in the last year. Conceptually, we need to fuel buoyancy of the market economy, which will yield the tax revenues for welfare programmes.

The first Budget speech of a new government is a particularly important one. Sometimes, immediately after the elections, there is a new team that has yet to find its feet. This year, there was continuity in the team, so the Budget speech reflects a thought out strategy statement by an established team.

Some observers have criticised the Budget speech as being low on specifics, on promising to evaluate something instead of actually announcing it, on announcing expenditure plans and not backing them up with precise or adequate magnitudes of resourcing. However, once we see the Budget speech as a strategy statement for five years, these approximate statements are perfectly admissible and in fact rather useful. We should read the Budget speech as giving us insights into the worldview of economic policy-makers, of the policy pipeline for five years.

The Bharatiya Janata Party has pushed many welfare programmes in its previous period, and has argued that successful delivery of welfare was key to its electoral success. Reflecting this, the main empha-



ILLUSTRATION BY BINAY SINHA

sis of the speech is on the expansion of existing programmes and the initiation of new programmes.

This raises the question of resourcing. In the international experience, welfarist governments have worked when the engine of the market economy works well. Ample GDP growth yields ample tax revenues, which are then spent on welfare programmes. Welfarism has worked poorly when the foundation — a rapidly growing private economy — is not in fact present.

The key lever to obtain higher tax revenues is not a few per cent here and there of higher tax rates. The key lever to obtain higher tax revenues is to obtain a doubling of GDP which will yield a doubling of tax revenues. In order to make welfarism work, we have to nurture the foundations. Economic freedom and the institutional apparatus of a modern economy generates private sector optimism, investment, job creation and growth.

In the recent year, we have seen some concerning economic data. The engine of the market economy is not faring so well. This has adversely affected tax revenues. When GDP is lower, metrics such as the deficit/GDP ratio and the debt/GDP ratio become higher, which impacts upon the cost of government borrowing.

From the viewpoint of fiscal soundness, the most important metric is the pri-

mary deficit. The simple rule which yields fiscal soundness is — a country that achieves a small primary surplus in most years (for instance, eight to nine years out of each 10) is in good shape on fiscal soundness.

The Budget data released on Friday show that we are running at a primary deficit of about a half trillion rupees a year. While this is not as good as running a small primary surplus every year, it is not a big shortfall. It is not hard to achieve a fiscal correction of a half trillion rupees. By this reasoning, we are not far from a sound fiscal position. This sanguine assessment must be adjusted by fiscal data experts, who would need to carefully bring in adjustments to the reported Indian fiscal data.

Another effective way to watch for incipient fiscal stress is rising interest payments. The two numbers that we see today are 11.1 per cent growth for 2018-19 and 12.4 per cent growth for 2019-20. At 4 per cent inflation, this corresponds to real growth of 7.1 per cent and 8.4 per cent. These are high growth rates, potentially higher than GDP growth, in which case the interest/GDP ratio would rise. These facts would also need to be adjusted to reflect interest payments on off-balance-sheet debt.

A key feature that emerges from the

Budget data is the size of the government. A dynamic and successful market economy is one in which government is small. The most important metric of the size of the Union government is non-interest government expenditure. This has growth rates of 15.9 per cent for 2018-19 and 13.7 per cent for 2019-20. If we subtract out 4 per cent inflation, then this involves real growth rates of about 12 per cent and 10 per cent.

These are fairly high growth rates. If such growth rates were carried forward, at 10 per cent real, the size of the government would double every seven years, and at 12 per cent real, the size of the government would double every 5.8 years. This will interfere with the engine of a buoyant market economy. A buoyant market economy is one which is led by the innovation and imagination of private persons.

Is it the strategy of the government to achieve a large expansion of the Union government, relative to the economy, over the coming five years? There may be another explanation. The nominal growth rates embedded in the Budget exercise often remind me of the nominal growth rates used in the last decade. From 2015 onwards, however, inflation has dropped substantially. We used to have a thumb rule of 8 per cent inflation in India, but the RBI Act now embeds a 4 per cent inflation target for RBI. The full power of the central bank, as an institution, is now devoted to achieving 4 per cent CPI inflation. Once we get used to 4 per cent inflation, our thumb rules about nominal changes need to shift in favour of lower values.

As an example, 12 per cent nominal growth was once quite normal and acceptable in fiscal planning. With the traditional 8 per cent inflation, this corresponded to about 4 per cent real growth. But with inflation down to 4 per cent, a 12 per cent nominal growth implies an 8 per cent real growth, or a doubling every nine years in real terms. Fiscal planning needs to shift down to more modest growth rate assumptions.

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Unrealistic revenue projections

The macroeconomic impact of a Budget has to be judged primarily by the demands that the government makes on the household and corporate sector through its taxation and borrowing proposals. The impact of how much it spends also matters for macroeconomic health.

The Budget has presented its numbers comparing Budget estimates with revised estimates for last year. However, because the Budget is being presented in July we have the Controller General of Accounts estimates of provisional actuals which are substantially different from the revised estimates presented in the Interim Budget in February 2019. Using these provisional actuals as the base, the implied growth rate in the Budget forecasts is 25 per cent for total receipts (25.6 per cent for net revenue receipts) and 20.5 per cent for total expenditure.

The revenue projections are unrealistic. With an expected real growth of 7 per cent and inflation being contained within a 3-5 per cent band, nominal GDP growth would be 10-12 per cent. The revenue projections imply an elasticity of more than two which is not likely to be realised. Clearly the ₹1.67 trillion shortfall in the provisional actuals of revenue in 2018-19 has not been taken into account. In all probability, the end of the year will see the same jugglery with the subsidy payments that we saw this year to keep the deficit figure on target. The real deficit is more likely to be closer to 4 per cent than the 3.3 per cent indicated in the Budget.

The budget for 2019-20 has assumed an inflow of ₹1.05 trillion from asset sales, higher than the ₹80,000 crore realised in 2018-19. Asset sale by the government is



THE MACROECONOMIC REVIEW

NITIN DESAI

not very different from a debt-strapped promoter selling some of his assets to meet liabilities. The main economic gain would be if the asset sale comes with the transfer of management to a private buyer who is able to utilise the assets better. A mere sale of minority of shares directly or through ETFs may help the finance ministry to stay within targeted deficit limits. But if the proceeds of asset sales are used to finance current consumption then the beneficial effects of deficit containment are more or less lost. If on the other hand, they are used for sound asset creation through new investments then it would amount to a reshuffling of the government's asset portfolio and may be of economic benefit in the medium- or long-term. The central government's direct capital expenditure in this year's Budget is up by 11.8 per cent relative to the provisional actuals for the previous year. The revenue expenditure is up by 21.9 per cent on the same basis. One cannot escape the conclusion that asset sale proceeds are going towards current consumption.

The government's borrowing require-

ment, which is the gap between current receipts and expenditures, is met mainly by market borrowing with about a third being financed from inflows into small savings and provident funds and draw down of cash balances. This year, the central government's market borrowing will be about 2.2 per cent of GDP. In FY19, the RBI absorbed nearly 75 per cent of the fresh issuance of government securities, partly to infuse liquidity into the market hit by the NBFC crisis. Large redemptions of government debt will begin starting 2019-20 and gross borrowings in the new fiscal will be high. The N K Singh panel to review India's existing Fiscal Responsibility and Budget Management (FRBM) rules recommended a debt-to-GDP ratio of 40 per cent for the Central government by financial year 2022-23. At present it is around 48 per cent and is not expected to decline much in this financial year. Looking at the medium term projections in the Budget papers, the Singh Committee goal does not look attainable.

Adding the demands of state governments and public enterprises, the public sector borrowing requirement is about 9 per cent of GDP and that pre-empted virtually all of financial savings of the household sector. This year's Budget has announced the government's intention to raise some of its borrowing requirements from external sources. Hopefully, somebody in the government has worked out what it would cost given our borderline investment grade sovereign credit rating.

The state of the credit market is a major source of macroeconomic concern. Though the NPA problem of banks seems to be coming under control, the crisis in the NBFC sector is still not resolved. The

core of the problem is the asset liability mismatch as the NBFCs funded these with short-term loans from banks and mutual funds, each of these accounting for roughly one-half. With the large defaults by a couple of major players, even the more solvent NBFCs are suffering because of greater caution by banks and a closer scrutiny of ratings by liquid and debt mutual funds. The bulk of the holdings in liquid and debt funds are held by corporates whose treasury departments are also becoming more cautious and looking for safer havens for parking their surplus funds.

The NBFC were an important lending source for cash-strapped promoters, property developers, small industries, purchasers of housing and durables. And the drying up of credit flow from them will constrain the goal of boosting private investment. The Budget proposal to guarantee bank borrowings by NBFCs who have a sound credit record will certainly help. And the commitment to provide ₹70,000 crore as capital infusion into public sector banks will improve liquidity. Hopefully this will improve the transmission of rate cuts and reduce the credit risk spreads that widened when the NBFC crisis broke.

This Budget has taken some risks in fiscal management and the deficit (and the government's borrowing requirement) may be larger than the forecast. The measures to boost investment by and in the start-ups and SMEs, and the measures taken to boost liquidity and credit flow will give some boost to growth. But one would have liked to see some moves to stimulate exports and reduce the real cost of capital, both of which were flagged as areas for action in the Economic Survey.

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Robbing the middle class to pay the poor

One key headline-point from the Narendra Modi government's latest Budget is the raising of top tax rates for the rich earning more than ₹2 crore a year. The increase is steeper for the super rich above ₹5 crore per year. The top tax rate now goes to 42.3 per cent.

It seems like such an awful example of Indira Gandhi-style “soak-the-rich” politics, people like us might say. Many others in deeply pink polity would hail it as an uplifting evidence that Modi too has fully embraced the principles of socialism as mandated in the Constitution's post-Emergency preamble. Never mind that he leads India's most unabashed government of the Right into its second term.

Both are wrong. Because the Modi government isn't really soaking the rich, but the middle classes, who also happen to be its most loyal vote bank. Question: Is their unquestioning loyalty the reason the government can afford to treat them like this?

Over the past five years, the Modi government has carried out probably the

most spectacular and efficient transfer, or redistribution of national wealth to the poor. It is tough to estimate it to the last decimal point, but between housing, toilets, cooking gas and Mudra loans, anything between ₹9 trillion and ₹11 trillion was distributed to the poor. That it was done with minimal leakage and with no discrimination of caste or religion has been acknowledged. It helped Modi win a bigger second majority. And where did this money come from?

Our immediate instinct would be to imagine it came from the rich. But not quite so. The government kept raising taxes on fuel as crude prices fell and folding the bonanza into its pocket. Most of this came from the vehicle-owning middle classes.

You can conclude, therefore, that a spectacular transfer of wealth did indeed take place to the poor. But it came from the middle classes of all strata and not particularly the rich. It also bought enough votes from the grateful poor for Modi to sweep the election.

All exit poll data, from the big cities to



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urbanising states, tells you that the middle classes too voted overwhelmingly for the BJP. The rapidly urbanising state of Haryana, the richest in India with very few extreme poor, is a good example. The BJP was marginal here until 2014. Now it collected 58 per cent of the vote.

This is the most important political takeaway from the way Modi has run his economy. He has taken from those in the middle to give to those at the bottom, and both are voting for him with equal enthusiasm. The middle classes have emerged

as his most rock-solid vote bank. And they happily pay for it.

Now come to the latest Budget. Once again, there is that mere pretence of taking from the rich. But should it bother the rich?

CBDT data shows that in the last financial year only 6,351 individuals returned incomes above ₹5 crore with average income of ₹13 crore. How much additional revenue will it bring? Just about ₹5,000 crore. Not much more than a year's turnover of the IPL, the Indian Premier League. The poor will be thrilled the rich are being socked. And the really rich will complain in whispers but keep buying anonymous electoral bonds and dropping them off in one letter box — you can guess which one. Because if they don't, the taxman might call.

The poor are easily fooled purely for their cheap thrills and entertainment, but the real joke is on the middle classes. Because, as in 2014-19, they're the ones who will contribute the wealth to be transferred to the poor. To begin with, the finance minister gifted them additional taxes on petrol

and diesel in the Budget to “make up”, hold your breath, for the drop in crude prices.

This has followed a string of policies that can only be described as “soak the middle class” and not the rich. During the Modi years, long-term capital gains tax on equities was introduced, dividend distribution tax was increased, additional tax was levied on dividend income above ₹10 lakh per year, surcharge on incomes between ₹50 lakh and ₹1 crore was raised (unless you call them super rich today), subsidies were reduced and taken away from the middle class including on cooking gas. We'd welcome the removal of these non-merit subsidies. But remember, who is paying.

That Modi and the BJP can continue to treat the rising and expanding middle class this way shows that they have gamed its mind perfectly. Its loyalty to them is fired not so much by economic impulse as by something more visceral: The resurgent, muscular Hindu definition of Indian nationalism that they have bought into. Add to this, the dislike of the Muslim. Many of them may still find lynchings abhorrent, but they are quite happy to see Muslims completely out of the power structure: Cabinet, top government posi-

tions, and greatly reduced in Parliament.

My colleague and political editor DK Singh points out a remarkable set of figures on the number of times the BJP finance ministers have mentioned the middle class in their budget speeches. Generally, it's averaged five. In Piyush Goyal's Interim Budget speech, it suddenly shot up to 13 times. It was election eve, after all. In Nirmala Sitharaman's now, it fell to three. Of course, she also completely forgot the promises Goyal had made to them in his speech in February: Increase in standard deduction, TDS threshold, relaxation of tax slabs. Why should we bother when you will vote for us out of your love for us while the poor vote with gratitude?

For decades, India's Muslim minority was similarly gamed by our “secular” parties. They knew Muslims will vote for them out of their fear of the RSS/BJP. That's the reason they saw no need to do anything for the Muslims. Their vote came as ransom for protection. The BJP has now realised the majority middle class sees a similar fundamental compulsion to vote for it. That's the reason we call them Modi's “Muslims”.

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