A Self-made Fiscal Trap*

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In the revised estimates for 2018-19 reported in Budget 2019, the NDA government had hugely inflated figures on central revenues and expenditures in 2018-19. This was one of many signals that it was faced with a fiscal crisis it did not want to reveal. Matters have only worsened since then. Numbers released by the Controller General of Accounts (CGA) show that, over the months April to October, net tax revenue accruing to the Centre had risen by just 1.1 per cent relative to the corresponding period of the previous year, way short of the inflation rate and the rate of growth of nominal GDP. If we go by the figures quoted in the papers tabled by Finance Minister Nirmala Sitharaman, the government had projected net tax revenue to rise by 11 per cent in 2019-20 relative to the revised estimates it provided for 2018-19. But since those revised estimates were inflated as the provisional CGA figures for 2018-19 suggest, the net tax revenue for 2019-20 needed to grow by more than 25 per cent for projections to be realised. It is with that high figure that we need to compare the abysmally low 1.1 per cent growth rate in the first 7 months of this fiscal year.

The crisis that this differential between the 7-month actual and annual projected growth rates points to is the result of many acts of commission and omission by this government and some that preceded it. First, since a central objective of neoliberal reform is to incentivise the private sector into leading investment and driving growth, tax reform has emphasised rate reduction and leniency, resulting in a situation where tax buoyancy has eroded and the tax-to-GDP ratio has on average been low and falling over a number of years. During the 1990s, the adverse effect that this tendency could have had on public expenditure was countered by resort to borrowing to finance additional spending, with the centre reneging on its promise to global finance and the international financial institutions to rein in the fiscal deficit. But that changed in 2003, when the government chose to succumb to demands from those sources and passed the Fiscal Responsibility and Budget Management Act, which forced it to opt for fiscal conservatism and reduce the fiscal deficit ratio to 3 per cent over time. Since taxes were not buoyant, reducing the fiscal deficit ratio required limiting expenditures, even allowing for receipts from disinvestment and various forms of off-budget manoeuvres.

This should have slowed growth considerably, because of a fall in government investment and consumption. It did not, because this was the period when, as a result of a surge in commercial bank lending triggered by large inflows of capital from abroad, debt-financed private spending on investment and consumption more than substituted for the now constrained tax- and debt-financed public spending. This helped raise India’s growth rate considerably, lifting with it the revenues and expenditures of the government. However, in time it became clear that this growth riding on a credit bubble could not be sustained, with large non-performing assets (NPAs) and closure of some banks and non-bank finance companies heralding the end of the debt-financed private sector boom. As a result, growth has been decelerating sharply in recent quarters and signs are that India is likely to be overwhelmed by a recession. Falling growth, by curtailing in turn tax revenue increases, only limits government expenditure even more, assuming that it sticks close to its deficit reduction “glide path”. That worsens the recession.
But, it turned out that this was the least of the government’s problems. While these fiscal developments were unfolding, the previous NDA government not only directly damaged the economy through its demonetisation blunder, but also decided to implement in haste a Goods and Services Tax (GST) regime that has proved to be a major mistake, rather than the ‘game-changer’ it was claimed it would be. It has not delivered the revenues the government expected, and even those revenues have shrunk with the recession. Having been implemented since July 2017, the GST regime has had enough time to overcome any teething troubles it may have been faced with. Yet, 2019-20 is proving to be a dismal year for collections from the GST.

The budget presented by Finance Minister Nirmala Sitharaman had scaled down earlier estimates of GST collection and projected an average collection of central GST at Rs. 5.26 lakh crore in 2019-20, as compared with the Rs. 6.04 lakh crore budgeted for in 2018-19. This was because the actual GST collection in 2018-19 was at Rs. 4.58 lakh crore around three-fourths of what had been projected. The Rs. 5.26 lakh crore figure for 2019-20 implied average monthly collections of CGST of around Rs. 43,830 crore. As compared with that, over the 8 months April to November 2019, the average monthly CGST collection stood at around Rs. 41,000 crore, implying that even the massively scaled down projection is unlikely to be realised. The situation is so bad that the government is holding back payments of the compensation due to the states because of shortfalls in the GST revenues due to them relative to a promised 14 per cent annual increase. Besides delays in the payment of overdue compensation on the grounds that collections from the compensation cess were inadequate, the Centre is pushing for a reduction in the 14 per cent guaranteed increase in revenues of the states. This effort to punish the states for the failure of a regime designed and pushed by the Centre, threatens to trigger a new round of centre-state conflict. The Centre would have liked to raise GST rates in a meeting held in December. But that was opposed by the states on the grounds that it would further squeeze demand. In their view, what was required was delivery of legitimate revenue and compensation transfers due to the states, and greater freedom for the states to borrow and spend.

This made sense, since what is needed in a context when debt-financed private spending is winding down, is an increase in government expenditure financed, if necessary, with increased borrowing. With the Centre not acceding to the demands of the states the responsibility for adopting an expansionary fiscal stance falls on the Centre. Such an increase in central expenditure can only be financed with some combination of (i) enhanced revenue generation by raising tax rates and widening the tax base; and (ii) additional borrowing by relaxing ceilings set on the fiscal deficit. If the tax and/or debt financed increase in spending raises growth, it would also improve tax collection in future and facilitate the recovery. Unable to raise tax revenues and unwilling to raise the fiscal deficit to GDP ratio, the government has in the past resorted to temporary measures like increasing receipts from disinvestment and privatisation or pushing public enterprises to borrow and spend off-budget. But the government has already exploited such options to the full. For example, receipts from disinvestment have already touched an unprecedented high of around Rs. 100,000 crore in 2018-19.

Thus, the real options are increased taxation and enhanced deficit-financed spending. The government is clearly not pursuing the first. To the contrary, despite being cash-strapped, in a shocking development in September this year, Finance Minister Nirmala Sitharaman announced a ‘stimulus’ in the form of a huge reduction in the
corporate tax rate from 30 (or an effective rate of 34.61 per cent after surcharge and cess) to 22 per cent (or an effective rate of 25.17 per cent) for domestic companies that do not avail of tax incentives or exemptions. New domestic manufacturing companies incorporated on or after October 1, 2019 will pay corporation tax at the reduced rate of 15 per cent (which is an effective rate of 17.01 per cent) so long as they do not avail of incentives and exemptions. And the minimum alternative tax (MAT) applicable to companies that do avail of incentives and exemptions has been reduced from 18.5 per cent to 15 per cent. This is a huge bonanza, which is expected to result in revenue foregone of anywhere up Rs. 1.45 lakh crore in a full year or around 0.8 per cent of GDP. Wiping out revenues of that magnitude when faced with a fiscal crisis would only intensify that crisis by forcing further austerity. The presumption that the bonanza offered to the corporate sector would stir animal spirits and unleash an investment boom is naïve to say the least. Faced with dwindling demand and rising inventories, firms would absorb as extra profit the subsidy implicit in the tax cut and invest if at all in speculative areas that do not run up against the barrier of deficient demand.

Along with the tax cut, the government has declared that, other than for small deviations, it would zealously stick to its fiscal deficit target, and has in practice done so. Moreover, it has refused to accede to demands from the states that they be allowed to increase their deficit spending to 4 per cent of state GDP from the current 3 per cent. The result has been that public spending and demand have shrunk and have aggravated rather than compensated for the fall in private demand resulting from the developments discussed earlier. This is now proving to be a recipe for disaster because slowing growth has worsened the fiscal position of the centre, as tax revenue growth turns even more sluggish. The Centre may try to reduce its own burden by penalising the states, but overall the economy as a whole will suffer as decelerating public and private investment and consumption drive it to recession. The NDA government is clearly caught in a fiscal trap which it has set for itself.

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