Is Inclusive Growth Feasible in Neoliberal India? Some Preliminary Notes on Fiscal and Credit Policy

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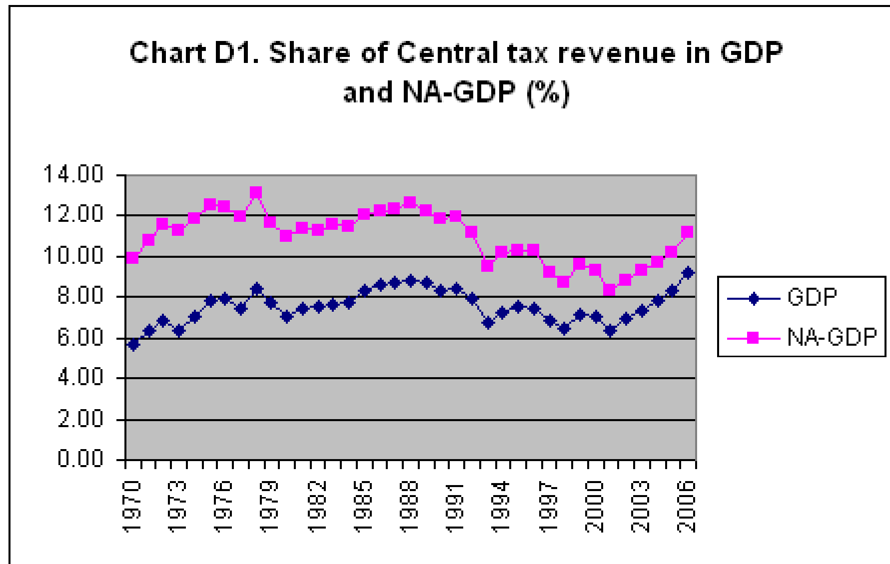
Fiscal Policy

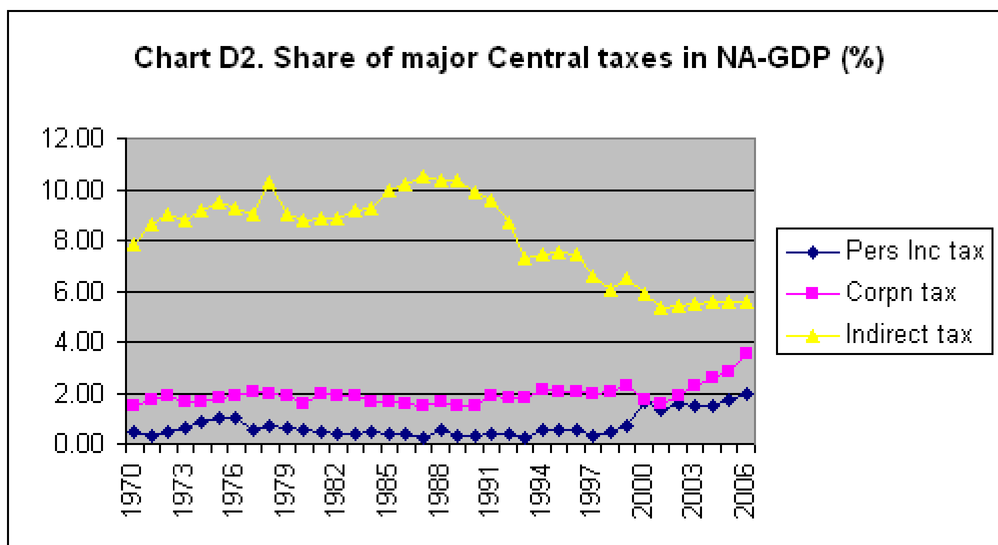
In examining the fiscal issue, let me start with the tax-GDP ratios. In recent official discourse credit is claimed for an improvement in the overall tax-GDP ratio. From Chart D1 one finds that the ratio has recovered from the trough of 1999-2001, and crossed the earlier peaks of the late 1980s in 2005 and 2006. The rise in the last couple of years has a windfall element. Thanks to high oil prices in the global market, the oil PSUs contributed in 2006-07 as much as Rs. 93,800 crore in direct and indirect taxes (BL 5/12/07), amounting to more than 28% of the total tax revenue of Rs. 345,972 crore. Elsewhere, I argued that the off-budget fuel subsidies financed in the last couple of years through bonds issued by the Central government, and should have been more appropriately regarded as part of the Centre's fiscal deficit (or loss of indirect tax); in that case, the overall tax/GDP ratio would be lower by 2%. If one looks at the other line on the ratio of taxes to non-agricultural GDP (NA-GDP), there is no improvement in the long run. Even with the windfall gains of the past two years, the percentage at 11.2 in 2006 was well 12.7 in 1988. There are good reasons to prefer NA-GDP over GDP as the denominator. Most of the taxes, direct or indirect, are collected from non-agricultural households and other economic units. There is no income tax on agricultural income. For direct sale in local or urban markets, a farmer pays no indirect tax. Indirect taxes on agricultural commodities are levied when these enter the regional or national network of distribution and augment the incomes of non-agriculturists. Of course, the farmers do purchase industrial inputs and consumer goods on which indirect taxes are levied. Since the share of agriculture in the GDP has been steadily shrinking from 42.3% in 1970 to 17.5% in 2006, the contribution of agriculturists to indirect taxes should be negligible.

Indirect taxes fell steeply from well over 10% of NA-GDP during late 1980s to an average of about 5.5% since 2000. As part of the reform agenda, import duties that made a large contribution to the overall tax revenue were slashed after 1991. Even if one grants that many earlier tariffs were too high, there are questions about the new rates; those on industrial inputs were often higher than on finished goods, including capital goods, and this led to excessive imports at the cost of domestic production. At the same time, to encourage the domestic consumption of durables and other consumer goods (barely purchased by the masses), excise and sales taxes on these items were also drastically lowered, while the tax burden on food and other items of 'basic necessity' remains unchanged.

By contrast, direct taxes appear to be a success story. As a percentage of the NA-GDP, personal income tax collection more than tripled in recent years as against the last two decades of the previous century, but was still quite low at a mere 1.7%. On the positive side, the number of individual taxpayers has increased at a fast pace thanks to a new scheme that allowed traders and others to pay a fixed sum with an unwritten assurance that no probes would be conducted; the

number of individual assesses was quite low at 3.5 million in 1990, and it picked up from 1994 to reach 14.2 million in 1999. On the other hand, tax rates were reduced in tune with neoliberal philosophy; as a result, 'tax payable' as a percentage of total income of all assessees fell precipitately from 18.2 in 1990 to just 8.3 in 1999; the corresponding percentages for the top group with a taxable income above Rs 1.0 million were 45.3 and 21.4 over the same years. [*Indian Public Finance Statistics 2004-05*, Ministry of Finance, Delhi, table 7.1.]





Corporate income tax, according to Chart D2, rose at a more modest rate from 1.9 percent of NA-GDP in 1990-94 to 2.7 percent in 2002-06. Even the small increases need not signify an improvement in tax efficiency. Although I have not come across a reliable recent estimation, the share of the corporate sector value-added in the GDP has probably gone up in recent years. The Union Budget 2007-08 estimated that owing to various exemptions, the effective tax rate in 2005-06 was only 19.3% of profits against the statutory 33.7%. The revised budget figures for 2006-07 on 'revenue foregone' (RF) under the main heads of Central taxes and gross tax collection (GTC) as follows.

	GTC	RF
Corporate income tax	146,497	50,075
Personal income tax	82,510	15,512
Customs duties	81,800	123,682
Excise duties	117,266	99,690
Sub-total*	467,950	288,959
Less export-related credit		-53,768
Total	**467,950**	**235,191**

Aggregate RF, without adjusting for export-related credit, was as high as 62% of GTC; after adjustment; it was still over one-half. Despite the precarious fiscal position, new tax sops are being offered by both the Centre and the states to investors. The most controversial of these is the SEZ (special economic zone) scheme. The Ministry of Finance estimated in 2005 the loss of Central taxes owing to the SEZs at Rs 1,02,600 crore in the next 4-5 years against the projected investment of Rs 1,00,000 crore. (RBI, *Annual Report 2005-06*, Box 1.2.) In the wake of the appreciation of the rupee since mid-2007, Indian exporters of labour-intensive manufactures found their competitiveness eroded; the Centre has not only announced a slew of new subsidies but also requested the states to offer more.

Last but not the least, India's tax/GDP ratio is one of the lowest among the major developing countries. In trying to prevent, following the neoliberal prescription, the public sector from 'crowding out' the private sector, the Central and state governments have for all practical purposes become a toy in the hands of big capital, foreign and domestic. The official claim of an overall gain in tax efficiency after 1991 sounds hollow from a macroeconomic perspective, but is quite apposite if one looks at the world through the prism of the so-called 'wealth creators'—the rich and the super-rich across the borders.

The tax cuts and tax sops for individuals and corporations across the world, including India, follow from two inter-related neoliberal premises. One, the lower the tax rate, it is argued, the greater is the incentive for tax compliance, and hence the tax yield goes up. The Indian data presented above flatly contradicts this assertion. Moreover, with de-regulation in various sectors and *de facto* transition towards free capital flows, there is evidence that in recent years millionaires everywhere, including India, have been seeking offshore tax shelters to avoid paying any tax at all. Two, all neoclassical theories posit that a firm's investment depends on its post-tax income. Generally, this has not been true, as loan capital and equity capital raised in the market place across countries and historical periods contributed far more to firms' investments. It is all too evident in the current phase of M&A frenzy across the world, and especially the big-stick acquisition by Indian companies. It follows that tax cuts and tax sops have no justification from a social perspective and are tantamount to a straightforward gift from the national exchequers to the private investors.

One startling consequence is the phenomenal rise in the concentration of income and wealth in all major countries and at the global level. One may cite among many others the studies by Milanovich (2002), and by Davies *et al.* (2006) from WIDER. Of direct relevance in the present context are the annual *World Wealth Report* on high net worth individuals (HNWI) across the globe, each with assets of at least $1 million, since 1996

of Capegimini, an associate of Merrill Lynch. In 2005 the number of HNWI in India was disclosed for the first time; it was 83,000 and rose to 100,000 in 2006. However, the data on aggregate wealth are given for regions and not for individual countries. The average wealth per HNWI for the Asia-Pacific region came to $1.31 million in 2005 and $1.45 million in 2006. It follows that the aggregate wealth of the Indians stood at $109 billion and $145 billion respectively in the two years.

These estimates may be on the low side. According to the rich list pf *Forbes Magazine*, there 28 Indian billionaires, excluding those residing abroad, with a combined wealth of $97.3 billion in 2005. If the number of HNWI estimated by Capegimini is correct, 82,972 (83,000 – 28) of non-billionaires had each $1 million in assets, the whole group should have owned at least $180 billion. Similarlrly, in 2006 *Forbes* listed 32 Indian billionaires with a total of $153.7 billion in assets; if one Capegimini's number of millionaires, the wealth of HNWI would be a minimum of $250 billion, or an increase of 39% over the previous year.

Now, the last figure is about 25% of the country's GDP in that year. If the HNWIs earned a modest 10% rate of return on their wealth, they had their disposal 2.5% of national income; the annual income of the average HNWI was 275 times the per capita income of the country. Combining Capegimini's global data on HNWI (9.5 million persons holding $37.2 trillion in wealth), the IMF figure on world GDP ($48.25 trillion), the figure of 6.5 billion for world population, and the same 10% return on wealth, I have estimated that at the global level the income of average HNWI is 53 times the world's per capita income. The latter is barely 40% of the multiple for India. There is no doubt that the fiscal regime after 1991 played a major role in creating the extreme disparity.

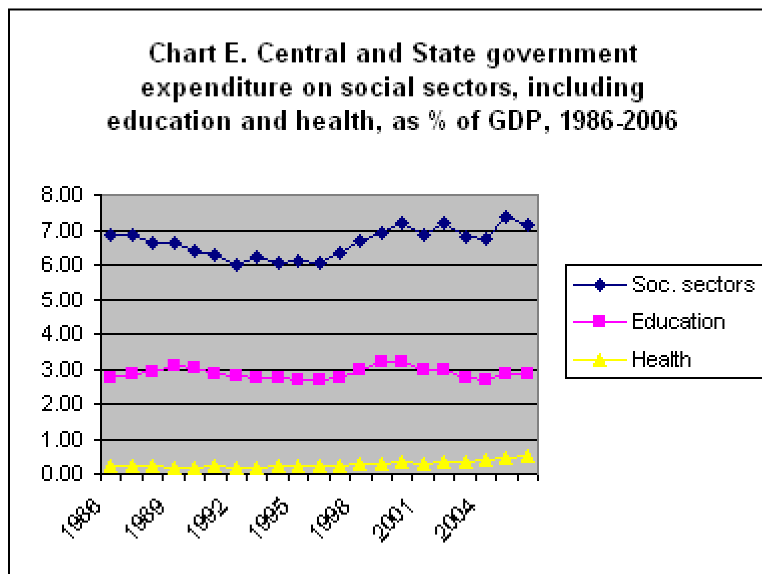
*   *   *

One may also ask if the new order in India with neoliberals, domestic as well as international, clamouring for 'flexible labour market' with no floor on real wages, is compatible with a major expansion in budgetary outlays on social sectors. If health and education improves significantly, and the social safety net for all workers becomes effective, the labour costs must increase for all employers. Leaders of 'socialist' China have given a call for 'harmonious' and 'scientific' development, as the country faces widespread discontent at least as acute as in India. The Chinese leaders' concern (like that of our UPA government) finds hardly any reflection in the budgetary outlays, although they have at their disposal foreign exchange assets of $1.5 trillion, or almost one-half of the country's GDP.

Quite apart from radicals like our Left parties and individuals like Patnaik and Bhaduri who are fierce critics of the present regime, bleeding-heart neoliberals like The Economist and Nobel Laureate Sen have forcefully argued for a much higher allocation of state funds for the social sectors. The UPA government is also committed. Why has it not happened? *Other things remaining the same*, such outlays would add to the fiscal deficit that may not find favour with the 'international financial community', leading to a downgrading of the credit raking of India and all our domestic firms. My contention is that it is not the ignorance or cussedness of the political elite, but the 'systemic' constraints that keep the social sector outlays at a bare minimum. China, too, despite the lofty talk over the past few years of 'harmonious development', and much greater autonomy in view of her negligible GFD, surplus in the CAB, and a mountain of dollar reserves, has not been able to allocate more public funds into the social sectors. For, fostering the growth

of private enterprise, though under the hegemony of the state and the Party, has taken the centre stage in China's policy.

Ever since the economic reforms started in 1991, the opposition, comprising of the Left parties, and also, alternatively, of the BJP or the Congress party, harshly criticised the neglect of outlays on these sectors in successive budgets. The currently ruling coalition fought the 2004 elections with a common minimum programme that envisaged 'public spending' on health, as a proportion of the GDP, to rise over the next 5 years to 2-3%, and that on education to increase in a 'phased manner' to 6%. Chart D shows that very little has changed since the end of the BJP rule. [**Footnote**. Not being able to obtain time series data from the *Annual Reports* of the RBI, I relied upon the CMIE. The data in Chart D pertain to expenditure on revenue and capital account of the Centre and the States on 'all social services', covering (i) education, including sports, art and culture; (ii) medical, including medical and public health, family welfare, water supply and sanitation; (iii) housing; (iv) urban development; (v) information, publicity and broadcasting; (vi) welfare of SC, ST and OBC; (vii) labour and employment; (viii) social security and welfare; (ix) nutrition; (x) relief against natural calamities; (xi) 'other' social services; and (xii) secretariat – social services. My coverage is somewhat less than that of the 'social sectors' in the *Annual Reports* of the RBI; the GDP percentage for FY 2006 is 8.5 in the latter, but is lower at 7.2 for 'social services' in Chart D. However, the trends are quite similar.]



This niggardliness in contrast with the alacrity with which the government has been lavishing fiscal incentives to rich individuals and big companies [Note big companies paid 19% in tax as against 24% by small cos.] is not accidental. The interest payout from the exchequer on account of the RBI's sterilisation policy (see below) is currently 4% of the GDP. The FRBM Act limiting the fiscal deficit, does not apply to such patently unproductive expenditure. A government struggling to bring the fiscal deficit down to the level prescribed in the Act can hardly raise expenditure levels beyond a token amount for socially beneficial schemes on education and health.

Moreover, there is a conflict of objectives on two related issues. (a) The buzz word in various government circles, including Left-ruled Kerala and Bengal, is public-private partnership, covering health, education, infrastructure, and so on. The Indian corporate sector has for the past decade been wallowing in high profit rates. A joint venture, say, for the X-Ray department of a

public hospital, would attract a private investor only if the returns were higher than from an X-Ray unit fully owned by the investor. Since the government fixes the charges, usually lower than in a private outfit, the hospital must provide various facilities at costs much lower than in a private X-Ray clinic. Government expenditure for these facilities may not increase, as there is a great deal of underutilised resources in most public hospitals. The joint venture would appear to be 'Pareto optimal' in the sense that none would suffer and some would gain. If, on the other hand, the government allocated more funds to the hospital for the latest X-Ray equipment, and ensured professional management of the unit, the charges could be lower than under the joint venture scheme and reach a much wider clientele. Now, it is widely known that countries with a more or less universal health care system have a somewhat better record in terms of WHO's heath indicators, while total health expenditure (public and private) as a proportion of the GDP is much lower than in countries where the private sector provides the bulk of health services. It is as true for rich countries like Canada, West Europe and Japan, belonging to the first group, as against the USA, as for developing countries Cuba, Sri Lanka and Venezuela in contrast to China, India etc. where the state plays a minor role. If the overriding objective of state policy is *to create space for private enterprise in as many sectors as possible*, clearly budgetary outlays on health, education or infrastructure must be kept to the minimum.

(b) Following the Common Minimum Programme of the UPA government, certain welfare programmes have been launched, the most prominent being the Rural Employment Guarantee Act that proposes to offer 100 days of paid work for one member in every rural family. So far the amount of government outlays has been quite modest. Another project of the CMP was to ensure a minimum level of social insurance for persons in the 'unorganised sectors' of the economy comprising of xxx million workers or xx% of the country's workforce. The NCEUS has submitted its report, and a law may be passed. However, there are strong reservations in the upper echelons of the government. For, a constant refrain in neoliberal writings on India or any other country is the need for a 'flexible labour market' with no floor on wages as a means of promoting the growth of labour-intensive firms in different sectors. From that standpoint, employment guarantee or social insurance would enhance the bargaining power of labour and impede rapid growth of employment at 'market wage'.

Credit Policy: Agriculture, SSI and Sterilisation

While committed neoliberals routinely decry the inefficiency of Indian public sector banks dominating our banking scene, and the first India Survey of the OECD (2007, Box 5.1, p.160) called for their privatisation to carry the reform agenda forward, there is no doubt that a sea change has taken place since 1991. By examining the data from *Trends and Progress of Banking in India* (RBI 2007), Mathur (2007) has conclusively shown that the public sector banks are faring quite well in comparison with the domestic private sector banks. He used such yardsticks as profitability, the share in total assets of the non-performing ones, capital-adequacy ratio, etc. Using the same criteria, Mathur contests, however, the RBI view that our banks have reached global standards of efficiency; among the foreign countries he includes five developing countries and five from the OECD.

Are the goal posts set up by Western bankers suitable from an Indian perspective? Public opinion here (also in many other countries), cutting across the political spectrum, has expressed strong disapproval of 'financial exclusion' of the weaker sections of the population from bank credit in the wake of neoliberal reforms.

After nationalisation in 1969, the banks extended credits to many sections of the population that were previously considered ‘unbankable’ and obtained loans, if any, from moneylenders etc. Two groups deserve special attention, namely agriculturists and persons engaged in agriculture and small-scale industries (SSI).   and other private sources. A Task Force of the National Commission for Enterprises in the Unorganised Sector (NCEUS 2006) estimated that out of the national workforce of 397 million in 2006, only 35 million are in the ‘organised’ sector in medium and large businesses, administration, etc., while the rest of 362 million are in the ‘unorganised’ sectors, including 235 million in agricultural and 127 million in non-agricultural activities; within the latter are 29 million persons engaged in SSI. In June 1969, just before nationalisation, the percentage shares of these two sectors in total bank credit were 1.3 and 8.5 respectively; for other ‘unorganised’ sectors employing 98 million workers, no comparable data exist on bank credit.

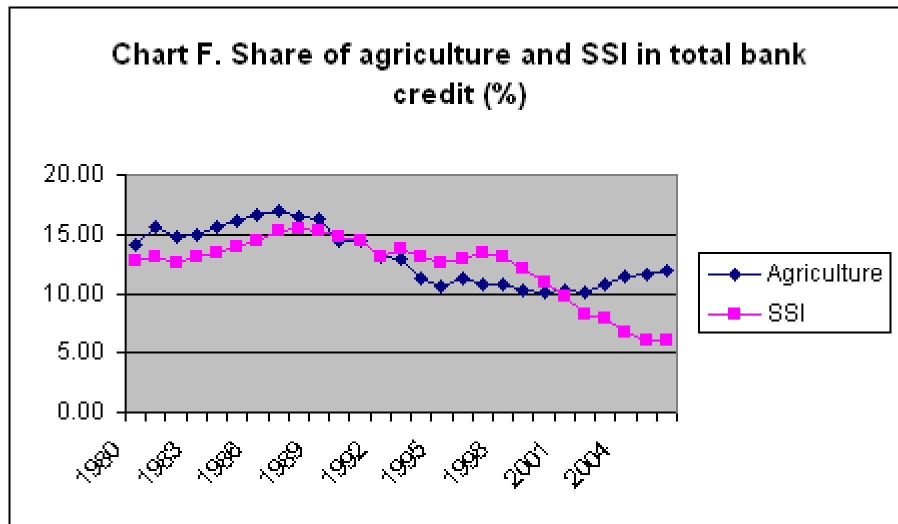


Chart F. Share of agriculture and SSI in total bank credit (%)

The trends in ‘direct credit’ to agriculture and loans to SSI as percentages of total bank credit from FY1980 to 2006 are shown in Chart F. [**Footnote**. While the credits to the two sectors represent the amounts outstanding at the end of the period, I preferred (owing to non-availability of comparable data for the last couple of years) the data on the flow or disbursement during the year for total bank credit. This small anomaly should not vitiate the long-term trend.] Since my focus is on financial ‘inclusion’, I have left out ‘indirect credit’ to agriculture as the recipients are mainly institutions and agents that serve agriculture. Ramakumar and Chavan (2007, table 5) noted that in FY2005 more than 84% of indirect credit went to big accounts (Rs 1 crore and above), while the share of small loans (<Rs 25,000) was a mere 0.9%. ‘Indirect credit’ to agriculture constitutes around 4% total bank credit.

Farmers have never obtained from banks their ‘due’ share of credit, if one goes by the sector’s contribution to the GDP. However, there was a perceptible improvement in the 1980s when the credit share rose from 12.9 to 17.0 percent. A marked fall was first

witnessed in 1991 and the slide continued till 2003. Then followed a mild upturn, but even in 2007 the share of agriculture was still one percent below that of 1980.

The present Governor of RBI, Reddy (2006) has broadly supported the neoliberal reforms, but in tune with the UPA government, lamented the neglect of farmers by commercial banks in their lending. In the National Common Minimum Programme (2004) the government promised a three-fold rise in credit to farmers. An unprecedented spate of suicides by farmers had aroused the conscience of the nation. A study by K. Nagaraj (www.rediff.com, 27 November 2007) put the number of such suicides, mostly from Maharashtra, Andhra Pradesh, Karnataka, Madhya Pradesh and Chhattisgarh, at 150,000 between 1997 and 2005.

On the same issue, the very title of the paper by Satish (2007), 'Agricultural credit in the post-reform era: A target of systematic coarctation', is most apt. The Concise Oxford Dictionary defines coarctation as the congenital narrowing of the aorta, i.e. the main artery of the body, supplying oxygenated blood to the circulatory system of a human being. Satish showed how drying up of bank credit from the early 1990s contributed to the protracted crisis in Indian agriculture, affecting in particular small and marginal farms.

The study by Ramakumar and Chavan (2007, table 7) underscores the highly skewed distribution of direct credit to agriculture. The percentage share in the total of small loans (<Rs 25,000) improved from 58.2 in 1985 to 66.1 in 1990, but fell steeply after 1995 to 18.1 in 2006, while that of big loans (Rs 1 crore and above) jumped 1.5 in 1990 to 8.9 in 2006. Besides, only a tiny fraction of agriculturists obtain any bank credit. As against 235 million agricultural workers, as noted above, RBI (Trends banking, Appendix Table III.4) indicates the number of accounts under direct credit at 23.5 million. Or, 90 percent of farmers remained outside the bank network.

Coming to the SSI, Chart F depicts a trend that is even more dismal than that for agriculture. By 1980, the SSI share of bank credit at 12.2% had improved considerably from 8.5% in 1969, and there was a further rise to a peak of 15.5% in 1989. Then followed an unbroken stretch of years of decline, and it was more precipitate since 2001. Actually, the years of UPA rule have been the worst so far, with the share falling from 7.8% in 2004 to 6.1% in 2007.

An NCEUS Task Force has made a comprehensive report on the economics of the unorganised sector. Some of its findings on the credit scene may be highlighted. (NCEUS 2007, chapter III.)

(1) Not more than 5 per cent of such enterprises had access to bank finance and about 96 percent of these borrowed money from friends, relatives and moneylenders.

(2) The Household Indebtedness and Investment Survey, conducted by the National Sample Survey Organisation in 2003, brings out the important role of moneylenders in the credit system. The share of the non- institutional category, mainly moneylenders,

has actually risen in the rural areas between 1981 and 2002, when moneylenders' share in total loans was nearly 45 percent in the rural, and 25 percent in the urban, areas.

(3) Since 1969 the RBI has set targets for 'priority sector' lending by banks, but these have not been followed.

a. Agriculture was to receive 18% of net bank credit (NBC), and farmers were due to obtain directly at least 13.5%. The actual percentages have been falling short by a wide margin after 1991.

b. The SSI sector contributed to 39% of industrial production and 35% of export at end-March 2006. There was no specific target for this sector, but it obtained 58% of all priority sector credit in 1969. By 1992 the share came down to 39%, and continued to slide thereafter to 24% in 2004, and further to 18% in 2006.

c. Within the SSI sector, 60% of the credit is earmarked for 'tiny' or 'micro' enterprises. From 2001 to 2006 the percentage declined from 54.0 to 40.5. Moreover, artisans and village industries are the smaller enterprises; the number of such accounts with the banks fell from 2.4 million in 1995 to 1.3 million ten years later, while their share of NBC declined from 0.9 to 0.5 percent

d. The banks currently charge around 15% as interest from the SSI, as against 7-8% from large-scale industries owing to their high creditworthiness. It is true that that the ratio of non-performing assets (NPA) to the total loans is somewhat higher for the SSI, but the absolute size of their NPA is also much smaller than for bigger borrowers.

The Task Force concluded that 'the flow of credit to unorganised enterprises has been abysmally low.' Some of the stark findings of the NCEUS Task Force suggest that the ground reality for credit to the SSI is bleaker than what Table xxx conveys. Besides, there has been a sustained campaign against the SSI in the reform era. On the one hand, the reservation (under industrial policy) of many industrial product lines for the SSI sector over many years was blamed for the inability of large units to realise the benefits of scale economies. Consequently, several hundred products (out of an earlier list of 869 at the peak) have been 'deserved'. The neoliberal critics also alleged that the potential loss of special benefits as an SSI unit discouraged many owners from expanding their operations. As a result, the official definition of SSI became more elastic over the years, with the threshold of an SSI in terms of capital employed or fixed investment increasing much faster than the rate of inflation in the economy; however, the upper limit for investment in plant and machinery was reduced in 2001 from Rs 3 crore to Rs 1 crore.

Sarma and Nikaido (2007) have explored another factor behind the declining share of SSI in bank credit. The Bank for International Settlement (BIS), regarded as the Central Bankers' Bank, evolved the 'Basel norm' on capital adequacy for a commercial bank and India has adopted it. It is measured by the ratio of capital to risk-weighted assets held by a bank. While Treasury bills carry a zero risk, loans to private sector borrowers carry varying risk-weights from 20 to 100 percent or more. 'Independent' credit rating agencies

(CRA) assess the risk weights. [**Footnote**. The reliability of the agencies has been questioned both in India and elsewhere for a variety of reasons. This is an issue that needs a deeper probe. But there is no doubt that they add to the costs of borrowing.] If a borrower does not approach a CRA, and few SSI units can afford their fees (even after government subsidy of 75% of the fees), the banks assign 100% risk to the loan. *Ceteris paribus* the bank would prefer lending to a solvent client with a risk factor of 50%. Given the stress on capital adequacy, profitability and low NPA for banks, it is no wonder that banks minimise their exposure to the SSI and the weaker sections. This in turn led to an increase in the stranglehold of private moneylenders – a scourge that was contained to a certain extent during the period, 1970-90 thanks to the nationalisation of private (non-foreign) banks.

Thus the advent of the UPA government with its agenda of putting an end to the 'financial exclusion' of the weaker has not made much of a difference. Is it case of sheer hypocrisy or a straightforward corollary of the ruling ideology of financial liberalisation?