India Budget 2007 – If Chidambaram\(^1\) won, then India lost.

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A Goldman Sachs report\(^2\) on the BRIC countries based on the Solow’s growth model places the Indian economy ahead of the US in the next 50 years. The Solow’s growth model assumes that capital, labor and total factor productivity\(^3\) (TFP) are the key drivers to economic growth. Although this assumption is not very accurate, these three drivers capture lots of crucial economic factors into account. For example, inflationary factors that play a major role in deciding the dimensions of the capital and labor markets are built into this model through the capital and labor inputs. In this article, we will try to link this budget with the above mentioned drivers of growth.

Instead of simplifying the tax code, this budget has worked to add on more complications. In India, there is a 30% tax on personal income and then a 10% surcharge on that income. Additionally, there is a 1% “education cess” surcharge. This budget bought another education surcharge of 1% on secondary education. We feel that people are not as troubled by the effective taxes as they are with the number of different surcharges. Accounting for the different number of surcharges is cumbersome. This example was for personal income tax. For company income taxes, this surcharge list runs longer. There are more than 10 different surcharges that one has to pay in importing materials. People waste a lot of time just to figure out these categories. We believe that people will be much more productive with a flat tax rate. They will spend more time working and less time accounting for these surcharges. This will increase TFP.

The effective tax rates for medium businesses in India work out to be around 34% - 38% depending on the type of business. Then there is the unofficial tax that is paid to the government official as bribes\(^4\). Approximating this tax as 2% would bring the effective tax rate to around 40%. Very large businesses get special tax exemptions because they are placed in the so called Special Economic Zones (SEZ). Although theoretically, it is not only the large businesses that are allowed to enter the SEZ’s but that is what ends up happening. The government has forgotten that it is the medium and small businesses that will define India’s future. It is the medium and small industries that need government help and not the large industries. The large industries will reach limits in terms of their marginal product of labor and capital. We believe that the Indian government is working towards destroying the medium and small sector rather than helping it to come up. This is a great worrying factor for the long term growth picture of India.

\(^1\) P. Chidambaram is the Finance Minister of India
\(^2\) Goldman Sachs, Global Economics Paper No: 99, Dreaming with BRIC’s: The Path to 2050.
\(^3\) Total Factor Productivity can be seen as the degree of efficiency and the related technological innovations in the economy.
\(^4\) It doesn’t matter whether one pays the government tax or not. This unofficial tax is present in both the cases. It will be roughly 20% in case you decide not to pay anything to the government. That is also the reason why a lot of people in India don’t pay taxes to the government. They prefer to pay this unofficial tax and save the actual taxes. We also fear that complicating the tax structure further will decrease the taxing base as people would prefer to pay the unofficial tax (which ironically has a flat structure)
The implementation of the fringe taxes will be detrimental to the incentive structure. Let us talk about staff welfare and see how that will be affected by this new tax. There will be a 6% tax levied on all staff expenses and welfare initiatives. So now all the staff outings, trainings and even the food expenses during the staff meetings will be taxed. What effect will this have on the company policies? Will the company now spend on staff outings? Will they promote staff get–together’s that are so important in the overall welfare of the working atmosphere? We need to think about these questions and much more. This can have a very deleterious effect on labor productivity.

In this budget, the finance minister outlined the initiatives that he would be taking to control inflation. We also believe that these measures will work but with one caveat. These measures will only work when people will believe them. “Credibility” is the buzzword over here. We do not have to go far to see that the finance minister has lost all his credibility. Hours after his differential excise policy on the cement manufacturers was announced, that the cement cartel increased the prices. The move backfired. The finance minister had included this as measures of decreasing inflation but now this will increase the inflationary pressures. Even in the past, the finance minister has not allowed the Reserve bank of India to function independently. Every time the Reserve bank raised rates, the finance minister comes out with a statement about cutting rates in the future. This is definitely not the best scenario for a developing capital market.

The Goldman Sachs report says, “The key assumption underlying our projections is that the BRICs maintain policies and develop institutions that are supportive of growth”. We believe that this assumption might not be true if the Indian government does not work to improve her economic and tax policies. Though the above analysis is by no means complete, they give a flavor of the present system. India will have to bring a steady change in her policies in order to sustain growth and productivity. This budget has been a total failure in this regard. Instead of addressing the above issues, this budget has further worked to exacerbate the deteriorating situation.

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5 A Differential excise duty is to be levied on cement. A retail price of less than INR 190 per bag will attract an excise duty of INR 350 per tonne while the same will be jacked up to INR 600, if the retail price exceeds INR 190 per bag.

6 Cement prices in western and northern India have been raised by INR 12 per 50 kilogram bag from March 1, a trade body official said on Thursday, Reuters