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A pre-Budget reform map

Cut subsidy, move to a customer-centric model for government

THE sovereign debt crisis has forced governments to come to terms with the fact that maintaining growth through increasing debt financing (deficit) is not sustainable. So we must accept sustainable growth which is prudently funded. The fiscal deficit at 5.5 per cent approximately (expected) is high and must be brought down to acceptable levels.

We also cannot have two Indias, the haves and the have-nots. Financial inclusion is an economic, political and social necessity. So we need the perfect budget which strikes the optimum balance between growth, equity and fiscal deficit. A bit like the holy grail, much desired — but perpetually elusive.

The way around the problem of diverse pulls and pressures in budget-making is to build a non-partisan, nationwide consensus on the urgent need for fiscal rectitude within a paradigm of democratic capitalism with a conscience. What are some of the specific measures that we need?

Deficit reduction based on history works best when it is achieved through a combination of spending cuts and higher taxes. The biggest bang comes through sharp reduction in what economists call "non merit subsidies" (middle class). However politically sensitive it may be, it is critical to move to a regime where the middle classes pay market rates for a vast range of goods/ services such as oil, gas, electricity, water, education, travel, food, etc. Better to pay as you go than suffer later.

The popular argument that trying to prune subsidies for the middle class could hurt the really poor and deserving does not hold as most subsidies do not reach intended beneficiaries. The key contributor to fiscal deterioration is subsidy — the Central government subsidies in 2008-09 were 2.4 per cent of GDP. To put it in perspective, this is higher than defence expenditure, capital expenditure and pay/ allowances/ pensions of government employees put together.

The food subsidy bill is Rs 56,000 crore. Do these reach the intended beneficiaries? Minimum support prices are raised because of pressure from the politically powerful and the government then has two options: raise issue prices in public distribution or let the subsidy bill go up. Since the former is so clearly regressive, the government settles for the latter. The small farmer does not benefit.

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The benefits of oil subsidies flow disproportionately to the middle classes and go directly against the goal of conservation. Unless prices are aligned with the market, this will be the biggest drag on the fisc in the long term and will also encourage wasteful consumption while discouraging exploration and investment.

How do we increase tax collections? It is possible to de-link tax rates from the government's tax take. The existence of a large parallel economy estimated at anywhere between 30 and 50 per cent of GDP means that tax collections can be increased by bringing this vast pool of transactions and income in the tax net. The computerisation of indirect taxes like excise has paid off in increasing their buoyancy. Again, the combination of technology and data can increase revenues significantly without even touching tax rates or possibly even lowering them.

Structures like the Goods and Services Tax (GST) combine the use of technology and automatic monitoring of transactions so that all the stages, between the factory gate and the ultimate point of purchase by the consumer, are caught in the tax net. The Direct Tax Code (DTC) does away with the myriad exemptions and rebates in direct taxes and thus dilutes the influence of diverse lobbies that currently influence policy-setting for direct taxes and result in gross inefficiencies in the tax structure. Both these have to be ushered in with a sense of urgency.

In fact, raising income tax rates for the top income might yield political brownie points but it makes for bad economics. It would affect income tax collections only at the margin. Income taxes are itself a relatively small, 18 per cent of total tax collections going by budget estimates for 2011-12. Thus the impact of raising tax rates for the upper income brackets is likely to be small.

Income tax rates in the Scandinavian economies are high. Yet diverse surveys have shown that Scandinavians do not resent paying high taxes because they see their governments as a customer-centric service provider. This customer-centric approach revolutionised Indian business and the economy moved from a supply-constrained model to a consumer demand-driven model. This model must now extend to government. We must fix standards of customer service for functions performed by the state for the benefit of citizens. These standards should be monitored and there should be a complaint redress mechanism and punishment for wrong behaviour. The use of technology can ensure proper time-bound, result-oriented implementation.

Studies have shown that a combination of cost reduction and tax efficiency can easily add a percentage point to GDP. Thus fiscal consolidation by itself could put us back on the path to high growth in the future.

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