Is India on the cusp of a fiscal revolution?

Arun Jaitley will present the fifth budget of the Narendra Modi government this week. The budget will be announced against the backdrop of a strong economic revival combined with greater macro risks. This column had noted a fortnight ago that the Indian economy in 2018 would look very different from the one in 2017 because of these two factors, and would thus test the new macroeconomic policy framework.

Various monthly indicators suggest that economic recovery will gather pace over the next few quarters, and investment bank Nomura says in a recent report that a V-shaped recovery will be driven by a strong pickup in investment activity as well as export growth. The flip side is that the current account deficit is expected to widen, interest rates in the bond market have begun to move up and the significant steepening of the yield curve suggests growing worries on the inflation front.

This combination of stronger growth with greater macro risks suggests that the finance minister should avoid fiscal adventurism. The economic recovery has enough internal strength to move ahead without fiscal support while it makes sense to preserve fiscal firepower in case there is a global shock over the rest of the year. It will be a tough political decision in the months leading to the next general election.

There is a broader issue that needs to be introduced into the Indian fiscal debate at this point in time. Is India ready for a fiscal revolution? Thomas Piketty has shown in his empirical work that most Western countries underwent fiscal modernization between 1914 and 1950. For example, income tax moved from being an elite tax levied on a thin slice of the population to a mass tax that a growing proportion of citizens paid.

The Indian nation state sits on a weak fiscal foundation. There are two consequences of this. First, low tax revenue means that essential tasks such as national security, the provision of public goods and offering social security cannot be done without running what would be among the highest fiscal deficits in the world.

Second, the low proportion of direct taxpayers leads to weak political incentives for good governance. Almost all Indians pay regressive indirect taxes but it could be argued that people are more alert about how their money is being spent when it is a question of progressive direct taxes. The Indian fiscal contract is very different from the one in developed countries.

The most reasonable criticism of the view that Indians pay far too little tax as a proportion of gross domestic product (GDP) is that we are a poor country. Tadit Kundu and Pramit Bhattacharya have shown in a data story published recently in this newspaper that India is not an outlier in terms of the tax-GDP ratio once the numbers are adjusted for per capita income. Indians pay enough tax given their average incomes.

Is that about to change? Here are two optimistic guesses about why the fiscal foundations of the Indian state could be strengthened in the next decade.

Global economic history suggests that income tax collections as a per cent of GDP tend to rise sharply once average incomes cross the $2,000 threshold—from 1% of GDP to around 5% of GDP. These four extra percentage points can make a world of difference. India is on the cusp of that threshold. What has happened in China is instructive. Its income tax revenue as a per cent of GDP began to climb in the early years of this century.

Many alert readers will notice that China had a lower level of per capita income at the turn of the century than India has today. Then why was there an inflexion point in its income tax collections? Piketty has argued that one reason why India has had less success in making the income tax a mass tax could be because “the proportion of formal wage earners in the labour force is ridiculously low”.

This is a very useful backdrop to examine the ongoing debate about whether India is creating adequate jobs in formal enterprises—as well as welcome the data in the Economic Survey released earlier this week on the formalization of the Indian economy. The very possibility that India is creating more formal sector jobs than most people assume, plus the fact that average incomes are close to $2,000, provides the initial conditions for a fiscal revolution.

Higher collections of direct taxes—on income, corporate profits, capital gains and property—could create fiscal space for the government to reduce rates on regressive indirect taxes such as the goods and services tax (GST). One of the central aims of the 1991 tax reforms was to move away from a heavy dependence on regressive indirect taxes. That job is still half done.

The even more powerful possibility— and it is only a possibility right now—is that higher direct tax collections could provide the next few Indian governments with the financial resources to maintain national security, provide public goods, build infrastructure and fund a meaningful social security system without being forced to run up huge fiscal deficits.

Is such a fiscal revolution just around the corner? It is impossible to say for sure—but some of the answers are blowing in the wind.

Note: The complete data on income tax collections in India and China can be accessed here: *Income Inequality And Progressive Income Taxation In China And India, 1986–2015*, by Thomas Piketty and Nancy Qian, *American Economic Journal*: *Applied Economics*, 2009.

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