Some Aspects of Stabilization Programmes for India: A Macro-Theoretic Analysis

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Abstract

1. Introduction

India gave up the Nehru-Mahlanobis Strategy and adopted the New Economic Policy (NEP) in July 1991. The objective of the NEP is to establish a free market economy by removing all kinds of restrictions of the Nehru-Mahalanobis era on production, pricing, investment, export, import, trade, hiring and firing of workers, work conditions etc. and transferring the ownership of all public sector enterprises set up during the Nehru-Mahalanobis era and natural resources to the private corporations. To minimize government's command over resources, the NEP has drastically reduced direct tax rates and imposed a cap on fiscal deficit, which stands for government borrowing. As a result, the government has to take recourse to indirect taxes to meet its essential expenditures fulfilling the fiscal deficit target so much so that at the present the major part of the government's tax revenue comes from indirect taxes. To meet the fiscal deficit target, it also has to reduce its subsidies or raise its profit by hiking up the prices of the essential intermediate inputs that it still produces. Examples of these inputs are railway services, coal, power, oil etc. Under the NEP, the RBI has made inflation control one of the most important objectives of monetary policy. It has set an inflation target and whenever inflation rate goes above this target, the RBI raises interest rates to bring inflation down to the target level. Under the Nehru-Mahalanobis Strategy the government administered prices of petroleum and petroleum products (henceforth referred to as oil) much below their international prices. The NEP deregulated oil prices so that they become equal to their international prices. The objective of this thesis is to focus on some of the short-run implications of the fiscal deficit target, inflation target, emergence of indirect taxes and profit of the public sector enterprises as the major instrument for financing public expenditure and deregulation of oil prices using macro-theoretic frameworks suitable for India. The thesis consists of three core chapters: Chapter 2, Chapter 3 and Chapter 4. Their contents may be briefly stated as follows. Government expenditure on imported goods has always been important in India. The present government has also devoted a substantial part of its expenditure to imported goods such as imported armaments and imported infrastructure items such as bullet train. The objective of Chapter 2 is to identify the best method of financing public expenditures on imports. It also examines the role of the fiscal deficit target in aggravating or mitigating the adverse effects of different modes of financing considered here. Chapter 3 focuses on inflation in India. It seeks to identify the costs that inflation inflicts on the people of India. It also inquires into how inflation and its costs are affected by the inflation target and the fiscal deficit target when the government uses its own consumption expenditure, public sector enterprises' profit and indirect taxes for meeting the fiscal deficit target. Chapter 4 examines the impact of deregulation of the price of oil. Under the Nehru-Mahalanobis era, price of oil was administered by the government much below its international price. Under the NEP, oil price has been deregulated so that it has become equal to its international price. Chapter 4 compares the macroeconomic effects of the policy of price deregulation and the policy of the administered price when the subsidy that the latter policy involves is financed by taxing the rich and also when it is financed by indirect taxes. The analysis of this chapter applies not only to oil but also to all other imported essential intermediate inputs. In what follows we present the contents of these three chapters in greater detail.

2. Chapter 2: Financing Public Expenditure on Imports under the New Economic Policy

Government of India has been following the New Economic Policy (NEP) since 1991. The NEP has drastically reduced direct tax rates. As a result, indirect taxes have emerged as the major means of financing government expenditure. It has also imposed a fiscal deficit target, which constitutes a cap on government's borrowing. In this chapter, we have sought to make an assessment of these aspects of the fiscal policy of the NEP taking the case government's expenditure on import. The Government of India has always been devoting quite a substantial part of its spending to imported goods. We have tried to identify the best way of financing government's expenditure on imports and, thereby, assess the above mentioned features of the NEP. We have considered the case where the government raises its expenditure on imported goods and finances it by resorting to four different means of financing namely external borrowing, internal borrowing, taxation of capitalists' income and indirect taxation. We have examined the short term macroeconomic impacts of all these four policies both in the presence of the fiscal deficit target and in its absence. We have found that the best way of financing the increase in the government's expenditure on imported goods is by taxing the capitalists' income in the presence of the fiscal deficit target. We have also found that the fiscal deficit target produces strong recessionary effects in the cases of internal and external borrowings. It acts as an automatic destabilizer in the cases of direct and indirect taxation. This chapter, therefore, builds a strong critique of the fiscal policy of the NEP.

3. Chapter 3: Inflation and Stabilization Policies in India

This chapter focuses on inflation. It seeks to identify the major costs that inflation inflicts on the people in India and show how fiscal and monetary policies enshrined in the NEP aggravate these costs manifold. We pointed out in Chapter 2 that fiscal deficit target is an integral part of the NEP. It imposes a ceiling on the fiscal deficit (government's borrowing) as a proportion of GDP. Here we will point to an aspect that the existing literature on fiscal deficit target has largely overlooked. We will show here that the fiscal deficit target magnifies manifold the adverse effects of inflation. The kind of monetary policy being pursued these days all across the capitalist world including India is also a matter of grave concern for the poor toiling masses who are net lenders to the capitalists. This monetary policy consists in reducing drastically interest rates as soon as a recession strikes an economy and raising it in times of inflation to weaken inflationary forces. All the major capitalist countries have been in the grip of recession for a long period of time. Japan, US and most of the countries in Europe have been in recession since 1992, 2001 and 2008 respectively. Interest rates in all these countries were reduced to the minimum possible level immediately following the onset of recession much to the detriment of the interest of the workers who are net lenders to the capitalists. However, this policy failed to make any impact on recession, which continued unabated. It should be noted here that, even though risk-free interest rates dropped to the minimum possible levels in these countries, loans were available at these low interest rates only to the giant corporations or giant capitalists. In fact, with the onset of the 'Great Recession' in the US and the cut in the Fed rate to zero in 2007, interest rates for the giant corporation dropped to the minimum possible level but interest rates rose steeply for the small and medium enterprises eroding substantially their competitive strength vis-a-vis the giant corporations. We seek to show in this chapter that if interest rates are raised in times of inflation to tackle it, it will significantly strengthen inflationary forces and magnify manifold the adverse effects of inflation causing grievous harm to the toiling masses.

Inflation is a matter of grave concern to the people and the government. It inflicts enormous costs on the society. The objective of this chapter is to develop a suitable macro model for India to study how inflation harms the economy. It does so to examine how the costs of inflation are affected in the presence of the fiscal deficit target and inflation target. Even though Patnaik (2006) and Kaldor (1976) warn of the costs of inflation getting aggravated by fiscal deficit target and inflation target respectively, they have not used any model to rigorously establish their claims. We consider it worthwhile to go into the issues in greater detail and capture the destabilizing effects of fiscal deficit target and inflation target rigorously within the framework of a macro-theoretic model suitable for India. We consider our endeavour necessary in view of the Government of India's fiscal and monetary policy stance. In pursuance of the FRBM Act 2003, the Government of India (GoI) adheres to a strict fiscal deficit target. Following the recommendation of the Urjit Patel Committee Report, the GoI seeks to restrict fiscal deficit to around 3 percent of GDP. The same committee recommended that inflation should be the nominal anchor for monetary policy framework. Following this recommendation, the RBI has set 4 percent as the inflation rate target. If inflation rate exceeds 4 percent, the RBI raises its policy rates to bring down the inflation rate to its target level. If the inflation rate is less than 4 percent, the RBI lowers its policy rates to give a boost to growth, if it is below the desired or potential level. It is important to know whether these policies, contrary to the policy makers' beliefs, act as automatic destabilizers and aggravate the costs of inflation as suggested by the writers mentioned above.

The chapter shows that the fiscal deficit target substantially reinforces adverse effects of inflation, if the government seeks to keep fiscal deficit under control by adjusting government consumption or administered prices of essential inputs such as services of railways, electricity, coal etc. or by raising indirect tax rates. We have not considered direct taxes here since direct tax rates have been reduced drastically since the adoption of the NEP and the government does not hike direct tax rates to meet its fiscal deficit target. It also shows that the inflation target also reinforces inflationary forces and magnifies manifold the costs that an exogenous increase in the inflation rate inflicts on a society.

4. Chapter 4: The Appropriate Oil Price Policy for India – A Macro-Theoretic Study

Since rationing of a scarce good through price rise is the cruellest and most unjust form of rationing, this chapter suggests that the price of oil in India should be administered by the government at appropriately low levels so that the poor can secure the basic necessities of life in adequate quantities and the subsidy should be financed by taxing the rich, who have the ability to pay and make all the non-essential uses of oil. The paper shows that, when the government follows the rationing scheme mentioned above, an increase in the world price of oil will leave the real wage rate and the levels of aggregate output and employment unaffected insulating the workers from the ill effects of a rise in the world price of oil. In contrast, an increase in the world price of oil under free market conditions will lower the real wage rate and very much likely to bring about a substantial contraction in aggregate output and employment much to the misery of the poor.

Similar result will obtain even in the administered price regime if the subsidy is financed by means of indirect taxation.

5. Conclusion

The thesis shows that the best mode of financing public expenditure on imported goods is by taxing the capitalists' income in the presence of a fiscal deficit target. It may benefit the workers. Even if it harms them, the harm done to the workers will be the least compared to what happens under the other modes of financing, namely, external borrowing, internal borrowing and indirect taxation. It also shows that the best policy regarding the pricing of oil or other essential imported intermediate inputs is to administer their prices below their international prices so that the poor have adequate access to the basic necessities of life in adequate quantities and finance the subsidy by taxing the capitalists. It also shows that the fiscal deficit target and inflation target produce strong destabilizing effects following an increase in the inflation rate for exogenous reasons. Hence, the rationale of the fiscal deficit target should be subjected to close scrutiny. Efforts should be made to identify the best methods of controlling inflation. We would take up these issues in our future research programme.