A Counter-productive Measure*

Prabhat Patnaik

The Modi government has an unerring instinct for bungling in economic matters. It has come out with a "fiscal stimulus" for tackling the current economic slowdown that will actually make matters worse. After successive interest rate cuts which were predictably futile, it finally turned to fiscal means; but the measure it chose was a cut in the corporate tax rate. This has produced an absurd anomaly in the tax-structure, between personal and corporate income tax rates; but let us ignore this and look only at its macroeconomic impact.

This slowdown is a consequence of inadequate aggregate demand whose roots lie deep within neo-liberalism. Income inequalities have worsened tremendously under neo-liberalism, both in the world as a whole and within each country, including India. This is because the mobility of capital across the world, which has led to relocation of plants from the advanced capitalist countries to the low-wage third world countries, has restrained workers' wages in the former; but it has not raised working people's incomes in the latter either, because of two other features of neo-liberalism.

One is the withdrawal of State support to peasant agriculture and petty production generally which has undermined these sectors' viability. This has caused a spate of peasant suicides, and also increased emigration from the countryside to towns in search of jobs. The other is the removal of restrictions on technological-cum-structural change in the economy which raises greatly the rate of labour productivity growth. The rate of employment growth correspondingly is lower than before, despite higher growth in Gross Domestic Product. Both these factors cause an increase in the relative size of the labour reserves, which keeps wages down.

Both in the world as a whole and in individual countries therefore while labour productivity has increased significantly, real wages have not, raising in the share of surplus (roughly, of property incomes) in output, which appears in a refracted form as an increase in income inequality.

Such an increase in income inequality reduces aggregate demand, since the propensity to consume out of income is higher for the working people than for the rich. A rupee transferred from the former to the latter therefore reduces consumption demand; and, since investment responds only to the growth of the market, and hence has no reason to rise in any given period to counteract the reduction in consumption demand, the tendency under neo-liberalism is towards an atrophy of the level of activity.

Such a tendency was kept in check globally by contingent factors, mainly asset price bubbles in the U.S.; in India too there were contingent factors like a pent-up demand for goods that had been inaccessible before liberalization, and local asset price bubbles. The cessation of these factors, which had to end anyway, has precipitated a crisis the world over, and also in India, where it has been compounded by the follies of the Modi government like "demonetization" and the GST. These have hit small and petty producers hard, with an adverse impact on the rest of the economy.

What the Modi government has now done for alleviating the crisis is precisely what had produced the crisis in the first place, namely a further increase in the share of surplus. Income redistribution from the working people to the big capitalists had reduced aggregate demand and produced the crisis, while the Modi government is trying to resolve the crisis by a further income redistribution from the working people towards the big capitalists! That is precisely what the corporate tax concession, amounting to Rs. 1.45 lakh crores, entails: since it cannot be financed by an increase in the fiscal deficit (for a larger fiscal deficit is anathema for globalized finance capital which would then shun India and precipitate a balance of payments crisis), its financing requires a rise in taxes upon the working people, or a restraint on government expenditure on welfare schemes for them and transfers towards them.

Such a redistribution, for reasons already discussed, would necessarily mean a further reduction in consumption demand in the economy. It may be thought, however, that with a rise in the post-tax rate of profit, investment expenditure would increase, offsetting the reduction in consumption demand.

This however is erroneous. Suppose the automobile industry sells 100 cars this year and expects to sell the same number of cars next year. In such a case, since these 100 cars are being produced from existing capacity, the industry will make zero investment; it will not add any further to capacity at all. And this would be the case even if the post-tax rate of profit on the sale of these 100 cars increases because of tax concessions.

Addition to capacity in the corporate sector, or what we call corporate investment, depends upon the expected growth in market-size, and not on the rate of post-tax profit that is being earned. Even if the latter increases because of tax concessions, this makes not an iota of difference to the expected growth of the market-size, which is why investment will remain unchanged despite these tax concessions.

Since consumption demand will be adversely affected because of these tax concessions, while investment will not increase immediately, output will be adversely affected. This will make capitalists expect lower output in the next period than otherwise, which would make them curtail investment. These tax concessions therefore would aggravate the crisis.

But can such tax concessions lure into India foreign investment, that would have otherwise gone elsewhere, for meeting global demand? The problem here is that given the stagnation in the world economy very little investment is occurring anyway; and Trump's protectionism aims to ensure that investment catering to the U.S market at least remains within the U.S. Besides, if at all such tax concessions succeed in luring noticeable investment from other countries, they will immediately attract retaliation from those countries.

In this setting, to expect any significant increase in investment within the economy from this source, because of these corporate tax concessions, is futile. And it certainly would not offset the contractionary effects of these tax concessions on the level of activity.

So far I have argued assuming that the tax concessions will not be financed by an increase in the fiscal deficit. The government however can increase the fiscal deficit by camouflaging it as a transfer from public sector enterprises, as it did while appropriating reserves of the Reserve Bank of India. Since corporate tax concessions would then not be getting financed through any reduction of government expenditure or increase in other taxes, there would be no contractionary effect.

The scope for this however is limited. The public sector oil companies, the most productive milch cows for the government, will be seeing a reduction in their resources because the recent attack on Saudi Arabia's oil facility has raised world oil prices. If this rise is passed on to consumers to maintain company resources, then that will again have a contractionary effect on the economy.

Hence the Modi government's measure will be contractionary for the economy. What was needed was the very opposite of what it has done, namely to increase government welfare expenditure by taxing the rich, especially through wealth taxation. But that, besides being beyond the government's ken, would threaten the currently hegemonic corporate-Hindutva alliance.

*** This article was originally published in The Telegraph on October 9, 2019.**