The Opposite of what was Needed*

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The reduction in the corporate tax rate by the BJP government, which would entail a transfer of Rs.1.45 lakh crores from the public exchequer to the corporate sector, has been generally seen to be insufficient for overcoming the slowdown in the Indian economy. This is not just an understatement; it is actually erroneous. This measure is the very opposite of what was needed for overcoming the slowdown. It would aggravate the slowdown while imposing an increased burden on the working people, and making the income and wealth distribution in the country even more skewed that it would have been. The fact that the government can adopt such a measure in the name of combating the crisis is indicative as much of its ignorance in economic matters as its brazen class bias in enriching monopoly capital at the expense of the working people.

The cause of the crisis, quite obviously, is a deficiency of aggregate demand. State intervention by fiscal means to overcome this deficiency of aggregate demand must take the form, if the fiscal deficit is not to increase, of taxing those sections of the population that spend a smaller proportion of their income for consumption, and using the tax proceeds either directly for State expenditure, or for transfers by the State to those sections that spend a larger proportion of their income on consumption.

Now, it is well-known that companies spend, directly or indirectly (via dividend pay-outs) a smaller proportion of their income on consumption than the working people. This is because companies keep undistributed profits which do not get spent on consumption at all; besides the propensity to consume out of dividends paid out is invariably much lower than out of wage incomes. Hence the way to overcome a deficiency of aggregate demand is to increase taxes on companies and use the proceeds either for raising State expenditure, or for providing budgetary transfers to the working people. Providing tax concessions to the corporate sector and balancing it, if the fiscal deficit is not to increase, through a reduction either in State expenditure or in State transfers to the working people, or through greater taxes on the working people, is the very opposite of what needs to be done; it will have precisely the very opposite effect of reducing aggregate demand and hence aggravating the crisis.

To be sure, if the tax concessions to the corporate sector are financed by a fiscal deficit, then such aggravation of the crisis will not occur, because nobody is being taxed to raise the resource-equivalent of what is being handed over to the big capitalists. But at least five issues need to be noted in the case where the tax concessions are being financed through a fiscal deficit.

First, even here if the tax concessions are financed partly by a fiscal deficit and partly by a reduction in State expenditure or by a reduction in transfers to the working people or by larger taxes on the working people, they may still cause a reduction in aggregate demand if the fiscal deficit-financed part is small enough.

Second, even if the entire amount of tax concession is financed by a fiscal deficit so that there is no reduction in aggregate demand at all, even then the same amount made available to the working people or spent directly by the State would have caused a much larger increase in aggregate demand than it would in the hands of the big capitalists. In other words if Rs.1.45 lakh crores are to be handed over by the exchequer then handing over the amount to the big capitalists, is the least effective means of boosting aggregate demand, quite part from distributional considerations.

Third, not only is handing over money to the big capitalists less effective in boosting aggregate demand than other ways of using it, but it would hardly boost aggregate demand at all. This is because the propensity to consume out of profits is not just lower than out of wages, but it is actually close to zero within a given time period. True, after some time the fact of corporations having larger post-tax profits than otherwise might make them give out larger dividends which might stimulate larger consumption by the big capitalists; but by then the crisis itself would have worsened anyway under its own weight. In other words, tax concessions to corporates will have zero effect on aggregate demand within a certain given time period, which is what matters when we are discussing anti-crisis measures.

Fourth, no matter what effect it has on aggregate demand, i.e. even when it has no effect on aggregate demand, tax concessions to big capitalists financed by a fiscal deficit invariably and necessarily worsen income and wealth distribution in society. A fiscal deficit means borrowing by the government; the counterpart of this borrowing is larger wealth in the hands of somebody else who is lending to the government; assuming realistically that the fiscal deficit does not get financed by foreign borrowing, this somebody else whose wealth goes up must be the domestic capitalists. So a fiscal deficit necessarily worsens wealth inequality by putting in the hands of the capitalists an equivalent amount of claims against the government.

And finally, an increase in the fiscal deficit is likely to reduce the inflow of finance into the Indian economy. This, because the government is not contemplating any capital or trade controls, would make the financing of the current account deficit that much more difficult. True, some concessions have been announced for foreign finance capital as well, along with the reduction in corporate tax rate; but these only say that the enhanced surcharge announced in the budget will not apply on capital gains on the sale of securities by foreign portfolio investors. In other words only the pre-budget situation has been restored; and this would not prevent a drop in the inflow of finance in the event of a larger fiscal deficit. This in turn will force the government to keep the fiscal deficit in check, which means that the effect of corporate tax concessions will be to reduce the level of aggregate demand and thereby worsen the crisis, as argued above.

All this time we have been talking of movements in aggregate demand via the consumption route; it will be argued that tax concessions will boost aggregate demand via stimulating larger investment. But this is completely erroneous. Investment depends upon the expected rate of profit that would be earned on an addition to capital stock, and this depends upon the expected growth of demand, no matter what the actual rate of profit on the existing capital stock happens to be.

Suppose for instance that the demand for automobiles is expected to remain stagnant. Since the existing capacity is already meeting this demand, firms will not add to the capital stock, for doing so would fetch them zero expected rate of profit upon what they add to the capital stock. Now, whether the actual rate of profit is ten percent or twenty percent or fifty percent on the existing capital stock makes no difference to this situation; the expected rate of profit on the addition to capital stock will still be zero. Hence corporate tax concessions which raise the actual rate of profit on the existing capital stock, will have no effect upon investment.

What is more, to the extent that such tax concessions are financed by reduced government expenditure elsewhere or reduced incomes of the working people, so that there is a net reduction in aggregate demand, investment will fall even as greater tax concessions raise the post-tax profits on the existing capital stock.

Had the tax concessions been given to the small scale sector, which is often finance-constrained rather than demand-constrained, they could conceivably have led to larger investment; but when these concessions are given to the corporate sector which is typically demand-constrained rather than finance-constrained, they will, other things remaining the same, have zero effect on investment; and when we factor in the reduction in aggregate demand owing to the overall macroeconomic consequences of such tax concessions, the net effect will be a lowering of investment.

The Modi government's "stimulus" measure therefore will have ironically a deleterious effect upon output and employment, even while worsening income and wealth distribution in the economy. This measure however is hardly surprising from a government whose knowledge of economics is proverbially paltry.

*** This article was originally published in the [Peoples Democracy] on September 29, 2019.**