

SOUTH ASIA MONITOR

Number 131
August 3, 2009

"A Calculated Risk": India's New Budget

Uttara Dukkupati

On Monday, July 6, India's finance minister Pranab Mukherjee unveiled a \$210 billion budget that emphasized rural spending, took a cautious approach to reform, and included some useful changes in tax policy. The rise in government spending should stimulate domestic demand, but it will also widen the fiscal deficit to its largest gap in 18 years. Despite the critical reception that followed Mukherjee's speech, the case for short-term stimulus is strong, and if growth does pick up and the government maintains spending discipline, it will be able to manage the fiscal deficit.

Introducing the New Budget: In India, the budget speech, much like the U.S. State of the Union address, is a chance for the government to announce strategic initiatives and clarify its long-term vision for the nation. The importance of the budget speech partly explains investors' high hopes. Investors expected the newly elected coalition to use its decisive victory to quickly push through long-stalled reforms, increasing foreign investment. They also anticipated a cap on government borrowing.

Considering that the Congress Party and its coalition partners were elected on a platform of inclusive growth and cautious reform, these expectations were unrealistic. Nonetheless, the dashed hopes were reflected in India's best-known stock market index, the Sensex, which fell 869 points after Pranab Mukherjee's budget speech. The new budget was characterized by its emphasis on the "aam aadmi," or the common man. This shift in focus took the form of social spending as well as commitments to anti-poverty schemes and infrastructure development. The specific measures included changes in the structure of the fertilizer subsidy, petroleum pricing, and tax reforms. Missing from the budget were specific outlines of institutional and economic reforms.

Rural Poor: Compared to recent years, India's rural economy received more attention and resource commitment in this budget. More funds have been allocated to programs that involve rural job guarantees, food subsidies and agricultural investments. These programs were widely credited with helping Mahmoan Singh's government get reelected with a stronger parliamentary position.

Among many social programs expanded in the new budget, the National Rural Employment Guarantee Act received a 144 percent boost over last year's estimates. This funding increase was coupled with an increase in the guaranteed minimum wage from Rs. 60 (US\$1.25) to Rs. 100 (US\$2.09).

Under the auspices of the National Food Security Act, the budget also promised that every poor family will receive 25 kg of rice each month at a fixed price of Rs. 3 (US\$0.06) per kg. The Pradhan Mantri Gram Sadak Yojana, a high-profile rural road-building program, received a 59 percent increase over last year's funding. A rural housing program, Indira Awaas Yojana, is 6 percent richer than last year. The budget also included a 75 percent increase in funding for the Accelerated Irrigation Benefit. Accelerated irrigation is supposed to help realize India's 4 percent agricultural growth objective. The budget includes tax incentives for investing in "cold chains" and storage warehouse facilities for agricultural produce.

Fertilizer Subsidy: Restructuring the fertilizer subsidy was another government initiative to create more inclusive growth. In India, agriculture makes up 17 percent of GDP. However, the industry supports more than 50 percent of the country's households and 65 percent of its poor. Considering these statistics,

raising the productivity and prosperity of the rural poor is essential to the nation's success. Supporters of the increased agricultural spending argue that the rural economy has been neglected for roughly 15 years, resulting in farmer suicides and increased rural insurgencies in parts of the country (referred to as Naxalite movements).

Last year, India spent 1.5 percent of its GDP on the fertilizer subsidy, and the government spent more than double the initially budgeted amount. This year's budget was Rs. 49,980 crore (US\$10.4 billion), or one-third less than the amount spent last year. The mechanism for the subsidy will also shift from supporting fertilizer factories to direct support to farmers. The intention is to link subsidized fertilizer to better information about the balance of nutrients needed for healthy crop production, though how this will work is not yet clear.

Disinvestment and Economic Reforms: Mukherjee's presentation of the budget reinforced the impression that the government is a reluctant and low-key reformer. Private-sector sources were hoping for indications that the private sector's role in the economy was going to be boosted. The Finance Ministry is working on a bill to raise the ceiling on foreign direct investment in insurance from 26 percent to 49 percent. Otherwise, the budget offered little encouragement. It said little about privatization, or disinvestment in the Indian term, aside from an estimate in the Economic Survey that privatization could yield revenues of Rs. 25,000 crore (US\$5.2 billion). In recent years, however, the projected revenues have rarely been reached.

Mukherjee's reaffirmation that the banking and insurance sectors will remain in the public domain added to the disappointment. Lowering public-sector stakes in banking and insurance sectors has been a thorny issue in the best of times. After witnessing massive private bank failures in the west, it was unrealistic to expect the Indian public sector to dismantle state financial institutions, which have been regarded as reasons for India's relative stability through the global economic downturn.

At the policy level, the government missed an opportunity to announce initiatives that would facilitate public-private partnership in infrastructure, as well as ways to attract more foreign capital to sustain growth rates. The finance minister could have also discussed deregulation of restricted sectors. Instead, he vaguely alluded to these topics while deferring any significant policy announcements.

Infrastructure: Unlike previous budgets, the new budget emphasized spending on infrastructure. Mukherjee said the government would make it a priority to spend 9 percent of the country's GDP on infrastructure development by 2014. There was a 160 percent increase in the funds allocated to Accelerated Power Development and a 23 percent increase in the funds for the National Highways Development Programme. The budget also mentioned increased funding for housing initiatives for the urban poor. The commitment to each of these programs was heartening in a country plagued with inadequate infrastructure. The government also stated that it will work to remove policy, regulatory, and institutional bottlenecks to speed implementation. Analysts welcomed the increased focus on infrastructure but complained that the government failed to explain how it will rectify a patchy implementation record.

The government did make one announcement to allay fears about implementation. In a bold move, the government selected Nandan Nilekani, cofounder of the information technology giant Infosys, to head the Unique Identification Authority of India (UIDAI). UIDAI will work to create a nationwide identification system to ensure that government funds reach the intended recipients. If properly implemented, this system could improve the lives of millions of Indians. This is a small step toward improving expenditure efficiency. Although the budget did not mention similar plans for infrastructure, it is hoped that infrastructure implementation will receive comparable improvements.

Petroleum Pricing: In 2002, the Indian government deregulated gasoline and diesel pricing. However, due to threats of increased inflation and political pressures, it reintroduced price controls soon after.

India imports almost three-quarters of the oil and gas it consumes. For the economy to flourish, domestic prices of petrol and diesel have to be broadly in sync with global prices. To this end, Mukherjee has proposed setting up a panel of experts to advise the government on retail pricing of petroleum products.

This is a modest proposal, but its announcement reflects a commitment to continue moving toward a deregulated petroleum and diesel market. The ease with which the government pushed through a 10 percent rise in fuel prices earlier this month also bolsters the view that India is on its way to market-based petroleum pricing. If oil prices were to increase dramatically, the path to price deregulation would become much more difficult.

Defense: Defense spending is slated to rise 24 percent over actual expenditures in 2008/2009, and capital expenses for defense are planned to rise by 34 percent. Capital expenditures have sometimes fallen short of the budget because of the complexity of India's procurement process. This budget, however, is in line with the trend toward substantial capital improvements in India's military and makes clear that the economic crisis has not squeezed defense spending. Overall, defense spending, as a percentage of GDP, does not depart significantly from past spending.

Tax Reforms: If the new budget's spending reforms elicited criticism, most of the proposed tax reforms garnered a more favorable response.

The most important, the goods and service tax (GST), aims to abolish barriers between states by fiscally unifying the nation under one set of tax policies and rates. Defying expectations, Mukherjee remained committed to implementing the GST by April 2010. The tax would replace India's service tax as well as the value-added taxes levied by the central and state governments. Implementation of the GST requires the agreement of all of India's states. That will be difficult to achieve, however, as India's state governments guard their revenue-raising power jealously. In the proposed budget, Mukherjee has moved away from a single GST toward a dual, or two-tiered GST, with one level for the central government and another for state governments.

The budget contained modest increases in the personal tax exemption for individual taxpayers. It also abolished the fringe benefits tax. Lauded among corporations, this measure will exempt employers from being taxed on any benefits beyond salaries that they give to their employees.

In an effort to counteract the negative impact the global financial crisis has had on Indian software exports, the government also extended the Software Technology Park of India (STPI) tax holiday. The budget also included other tax incentives for research and development, hopefully making the Indian IT industry (and other sectors) more competitive in a global economy.

Finally, the new budget raised the Minimum Alternate Tax (MAT) on corporate profits from 10 percent to 15 percent. Analysts criticized the increase in the MAT because of its impact on gas exploration. Even though the budget included a seven-year tax holiday on natural gas exploration, essential for India considering its critical energy needs, raising the MAT effectively negates the gains oil and gas firms expected from the tax holiday.

Overall, the finance minister and his team should be commended for their tax reforms. In a recession, planners of a federal budget are under pressure to resort to protectionism. For the most part, Mukherjee resisted that temptation, lowering tariffs rather than raising them. Furthermore, despite the burgeoning fiscal deficit and shortfall in advance tax collections, Mukherjee did not raise taxes. Instead, he opted to stimulate domestic demand by scrapping unpopular and inefficient tax policies.

Fiscal Deficit: Mukherjee took a calculated risk in presenting a budget with a fiscal deficit of 6.8 percent of GDP. Taken together with the deficits of the states, the total fiscal deficit will be closer to 10.8 percent of GDP. The basic argument here is that the stimulus provided by the deficit is necessary to sustain the momentum toward economic growth, especially in a global economy tainted by recession.

As Indian economist and former finance secretary Shankar Acharya points out, India's government can borrow from only three sources: the domestic market, the Reserve Bank of India (RBI, India's central bank), and foreign sources. Too much borrowing from the market crowds out private investment, directly or via higher interest rates. Too much borrowing from the RBI runs the risk of inflation. Too much foreign borrowing can lead to a payments crisis caused by external debt.

This explains the concerns about the high deficit: over the long term, it becomes untenable. Mukherjee acknowledged this problem in his Medium Term Fiscal Policy Statement (MTFPS), which envisaged a reduction of the fiscal deficit to 5.5 percent of GDP in the 2010/2011 fiscal year and a further reduction to 4 percent in 2011/12. Critics argue that a fiscal correction of 1.5 percent of GDP in two successive years has never been achieved in India. Whether this government can exercise the fiscal discipline needed to carry out this reduction will ultimately determine the budget's success. It is too early to discount the budget based on its expanded social spending.

Reform by Stealth: Like its architect Pranab Mukherjee, the new budget is both pragmatic and cautious. It leaves space for economic and institutional reform without the possibility of incurring wrathful criticisms because of broken promises. If Mukherjee can bring about lasting reforms, he will almost certainly do so quietly, almost stealthily, without loud pronouncements during budget speeches.

The success of the budget and of the government's economic policy will be judged in the coming months and years. The budget's success depends heavily not only on fiscal discipline and domestic demand but also on how quickly international consumption will rebound. The Indian government has outlined a respectable roadmap, but as always, the success or failure will be measured by its implementation.

Uttara Dukkupati is a research assistant with the South Asia Program at the Center for Strategic and International Studies in Washington, D.C

South Asia Monitor is published by the Center for Strategic and International Studies (CSIS), a private, tax-exempt institution focusing on international public policy issues. Its research is nonpartisan and nonproprietary. CSIS does not take specific policy positions; accordingly, all views, positions, and conclusions expressed in this publication should be understood to be solely those of the author(s).

© 2008 by the Center for Strategic and International Studies. All rights reserved.