



The Indian Budget: What Impact Will It Have?

The macroeconomic performance of the Indian economy has slipped over the past two years, as evidenced by slower growth in output and exports, as well as a higher fiscal deficit and inflation. A few sectors - agriculture, information technology (IT), consumer goods, media, and pharmaceuticals - have held up. Heavy manufacturing and capital goods, however, are in a downturn. Investor confidence is still weak, reflecting continuing political uncertainty and spillovers from the Asian crisis.

The government's budget focuses heavily on confidence-building measures for the financial sector and on incentives for India's booming industries. The budget is more realistic than last year's and emphasizes modest reform measures that address micro-level constraints and distortions, rather than a sweeping change in policy direction. Although unlikely to jump start growth, the budget introduces several proposals that will help revive the equity market and facilitate restructuring in industry. It avoids the expansionary fiscal policies and the "swadeshi" proposals of last year, but fails adequately to restrain the fiscal expenditures that contribute to India's large fiscal deficit and to address weak export performance. Although the budget proposals affirm the government's commitment to reform, they reflect the political constraints under which it is operating.

Annual **GDP growth** in India has slowed, from an average of 7 percent in previous years to around 5.5 percent in 1998-1999. The current market consensus forecast for growth in 1999-2000 is 5.2 percent; the government's estimate is considerably higher at 6.5 percent. The two main macroeconomic policy changes following the budget are a tightening in fiscal policy through tax increases and an easing in monetary policy through interest rate cuts. The impact of the budget on output growth will depend on the offsetting impact of higher taxes and lower interest rates on economic activity.

The budget is likely to boost growth in **agriculture** through an increase of 35 percent in the plan allocation for the sector and through an array of proposals aimed at strengthening local irrigation systems and rural credit schemes. Agriculture was a star performer last year, with growth at 5.3 percent due to a rebound in food-grain production, and the government is keen to maintain the sector's advantage. These measures are also politically popular with a wide range of constituencies.

The budget's growth stimulus for **industry** is less clear. Industrial output has sharply decelerated over the past year, from 6 percent in first six months of 1997-1998, to 3.6 percent for the same period in 1998-1999. The budget offers incentives to the so-called "sunshine industries" - IT, consumer goods, media, pharmaceuticals - but also contains some proposals that will benefit the currently depressed capital goods and heavy manufacturing industries. The proposal that income from mergers and acquisitions be exempt from capital gains tax should facilitate the ongoing restructuring in industry. Some sectors in industry, such as the automotive sector, will gain from the higher customs duties; sectors hurt by the higher duties will benefit from the restoration in the Modvat credit at 100 percent, whereby duties on imported inputs are fully offset by tax concessions on the finished product. Proposals aimed at boosting the housing sector may also stimulate growth in sectors such as steel and cement. Above all, the interest rate cuts that were introduced days after the budget may stimulate investment. It is difficult, nevertheless, to predict how strong a recovery will take place or how soon. Several sectors of Indian industry are going through a painful restructuring, and global commodity prices are still depressed. Both factors may keep the slump going for some time. The rise in corporate taxes may also delay recovery.

The budget measures are unlikely to lead to a significant revival in **investment**. Public sector investment is unlikely to pick up, with so much of the budget revenue dedicated to subsidies and other current expenditures. **Foreign investment** will thus be crucial to financing capital expenditures. The budget provides for faster clearance of foreign investment proposals (within 30 days) and for the establishment of a Foreign Investment and Implementation Authority (FIIA) to accelerate the flow of investment into actual projects. After an outflow of U.S.\$350 million last year, foreign portfolio investment is

expected to recover to U.S.\$1.4 billion and foreign direct investment (FDI) to U.S.\$3.2 billion. Foreign investment, however, is likely to remain concentrated in IT, pharmaceuticals and consumer goods. Despite a relatively pro-foreign investment regime, foreign investment in infrastructure will be hard to attract until the issue of tariff rates for infrastructure services is resolved. Foreign investment in public sector enterprises (PSEs) is likely to remain low, due to a diminished appetite for emerging-market equity, limited managerial autonomy on the part of the PSEs, and an overall haphazard privatization process.

The **currency** has been gradually allowed to depreciate over the past year; it is likely to depreciate further following the interest rate cuts. It may go down from the present rate of around Rs43:\$1 to Rs48:\$1 by end 1999. The budget proposals are, on balance, neither inflationary nor deflationary, but underlying inflationary pressures remain strong and could be triggered easily (average consumer price inflation is currently around 9 percent). The outlook for **inflation** will depend, among other factors, on industrial growth; on domestic price changes due to the depreciating currency, customs duty and diesel tax; on the magnitude of government borrowing; on agricultural supply; and on changes in world oil prices.

The budget contains several measures designed to restore confidence in India's **financial sector** and to encourage banks to resume lending. Although India has emerged relatively unscathed from the turmoil in global financial markets, the crisis in Asia has underscored problems in its heavily regulated financial sector. A few months ago India's largest state-owned mutual-fund scheme, the US-64, suffered heavy losses following a fall in domestic share prices, which led to a wave of redemptions. There is also widespread concern about the exposure of public banks and development banks to heavy industry, particularly steel. With a slump in these industries, banks' nonperforming loans have been mounting, with the result that many of them have tightened their lending policies, further exacerbating the current industrial slowdown. Mounting bad loans have also led to a fall in bank share prices; at the same time, new domestic entrants and the slump are squeezing banks' profit margins. Policies aimed at restoring financial sector health are important for two reasons. First, recapitalizing financial institutions is not really a viable option because it would place an unsustainable burden on the precariously large fiscal deficit. Second, mobilizing household savings into the equity market could be a means of reviving industrial growth.

Against this background, the budget proposes several confidence-building incentives, especially for the mutual funds. All income from the Unit Trust of India (UTI) and other mutual funds will be tax exempt; dividends from mutual funds with more than 50 percent investment in equity will be tax exempt for a period of three years; and the government will restructure the US-64 by establishing a new fund that will buy the stocks of the US-64 by issuing five-year bonds backed by government bonds. The long-term capital gains tax will be reduced from 20 percent to 10 percent. On the banking side, public banks' main problems relate to the recovery of defaulters' assets and non-performing loans. Five debt-recovery tribunals are to be established and banks are to receive tax concessions in return for writing off bad assets.

While the above proposals are to be welcomed, the budget is lacking in measures to strengthen India's macroeconomic and external position. The **fiscal deficit**, at 6.5 percent of GDP in 1998-1999, up from 6.1 percent in 1997-1998, lies at the heart of the country's macroeconomic vulnerability. The government forecasts a fiscal deficit of 5.8 percent of GDP for 1999-2000. This figure is based on optimistic growth, tax, and disinvestment revenue targets which the government failed to meet last year. The budget measures are unlikely to raise revenues significantly or to curtail expenditures.

The fiscal deficit reflects generous government subsidies and low tax revenues. The burden of subsidies (which account for over 14 percent of GDP) is bankrupting both the center and the states, crowding out much needed public expenditure on infrastructure, and contributing to sectoral distortions. Industry is subsidizing power and water consumption for the tax-exempt agricultural sector through high tariff rates. The budget contains no proposals for subsidy cuts; the main belt-tightening scheme is the elimination of four top-level posts in the bureaucracy. The core of the structural reforms on expenditure has been postponed for review by a future "Expenditure Commission."

Given the lack of proposals to contain fiscal expenditures, the core of the budget's deficit reduction proposals focuses on tax increases and indirect tax rationalization. The budget imposes a 10 percent surcharge on corporate tax and on personal tax for individuals with income above Rs. 60,000 (U.S.\$ 1,400); a 10 percent surcharge on customs duties for most commodities; and a Rs. 1 tax per liter on diesel fuel. At the same time, the customs rate bands are cut from 7 to 5, and excise duty rate bands from 11 to 3. The rationalization in the tax structure will contribute to a more transparent business environment. The tax increases, on the other hand, may not increase tax revenues if, as in the past, they encourage greater tax evasion and possibly dampen growth. Broadening the tax base through a reduction in the widespread tax exemptions granted to several sectors in the economy and improving the tax administration system might have been a more effective, equitable, and less distorting means of achieving higher tax revenues. Tackling the fiscal deficit will also require a fundamental reappraisal of **center-state tax relations**. Under present arrangements, the central government is primarily responsible for raising tax revenue, and the states for expenditure. As a result, states have had limited incentives to contain expenditure, which has particularly been focused on subsidies, and to raise their own revenue. Modifying the present revenue-sharing arrangements will require a constitutional amendment.

India's trade balance has worsened this past year. Export growth has sharply slowed - exports fell by 3 percent and imports grew by 10 percent during the first six months of 1998-1999 over the same period the year before. The main proposal in the budget to encourage exports is a scheme aimed at providing cheaper pre- and post-shipment export credit. On the import side, the government hopes to reduce gold imports - a major source of the rise in non-oil imports - through the introduction of a "gold deposit scheme." Overall, the budget is lacking in a coherent vision for the export sector. It fails to introduce proposals that would aggressively address the structural constraints facing small- and medium-scale exporters. Additionally, the slight rise in average protection resulting from the various changes in customs duties is further likely to hurt exports, by increasing import costs. The deterioration in India's export performance could lead to a precarious external position, especially in view of weaknesses in the capital account and possible future oil price rises. The trade deficit is expected to widen, from approximately U.S.\$13.5 billion in 1998-1999 to U.S.\$16.5 billion in 1999-2000.

PROGRAM NOTES: A discussion with Kuldip Nayar, noted writer and diplomat, on Indo-Pakistani relations will be held on Wednesday April 7, at 5:00 p.m. at CSIS.