



INDIA: CAUTIOUS BUDGET 2000

India's budget for Fiscal Year 2000 was carefully crafted to minimize the political complications of cautious steps toward reform. The business community greeted it with disappointment. Political parties-including government coalition members found it too harsh. It featured measures to benefit information technology, modest steps toward streamlining taxes and reducing subsidies, and a massive hike in defense spending. The aggregate deficit, is still dangerously high, projected at over 10 percent of GDP. The current revival of industrial growth may ease next year's budget management, but fiscal overload is bound to depress the new investment needed to reach the government's hoped for 7-8 percent growth rate. While the government wants to move the reform agenda forward, there is little consensus on the short list of key moves and their sequence.

Investment and the IT boom: Finance Minister Yashwant Sinha billed the \$77.6 billion national budget for 2000-2001 as a move towards more open markets and more vigorous investment, with some poverty alleviation measures to reduce the price paid by India's poor. The incentives for investors were aimed heavily at the information technology sector. Estimates of that sector's growth go as high as \$50 billion in export revenues by 2008, compared with \$4 billion today. The budget slashed duties on telecommunications and technology imports, both essential to the sector's further growth. The decision to phase in corporate taxes on previously untaxed income from exports including software was more controversial, but could be a fiscal boon if the sector's explosive growth continues.

A group of "Silicon Valley Indians" had pressed the government to simplify the rules on venture capital, including tax treatment of venture capital funds. The results were somewhat contradictory. The budget speech announced that venture capital funds could now be set up without prior approval by the tax authorities. However, the budget left unclear whether the principle of "pass through" will be applied to their taxation, and venture capital funds must still be organized as trusts rather than as limited partnerships. Some of these elements may be clarified when the finance bill is formally presented for government approval in May. Expanded venture capital access could benefit other sectors as well, notably energy and pharmaceuticals.

Opening the markets: The budget preserved, but did not significantly advance, India's move to a more open trade regime. As expected, tariff cuts were announced on a range of products, along with the decision to cut India's maximum tariff rate from 400 percent in 1990-1991 to 35-40 percent in 1999-2000. India continues, however, to have one of the most restrictive trade regimes in the world, and not surprisingly, domestic producers are resisting liberalization of their own sectors.

Bank reform: Indian authorities regard bank reform as a necessary precursor to the significant opening of capital markets. They are moving cautiously, mindful of the major political and labor problems that would accompany privatization of the nationalized banks. The budget's decision to allow the government share of bank capital to fall from the present statutory minimum of 51 percent to 33 percent through new capital acquisition is looked on as a possible first step in that direction. The banks, however, will not be "corporatized." They will have larger private sector representation on their boards of directors and are supposed to enjoy greater autonomy, but will remain, as they are now, statutory bodies in which the government can still call the shots. In other aspects of bank reform, the government is establishing a Financial Restructuring Authority (FRA), which will deal with the problem of nonperforming assets.

Privatization: Senior government officials are optimistic that privatization in other areas of the economy will speed up. They point out that the freeze on privatizations during the six-month caretaker government has created a pipeline of cases waiting to be implemented. Most involve partial sales of the government's shares in a particular enterprise, so they are significant primarily for the revenue they may generate. More important for future policy is the development of independent regulatory mechanisms in telecommunications, insurance, and other areas where the private sector is a recent entrant. This has been a bumpy process so far.

Defense spending... Defense spending is set to rise a massive 28 percent to \$13.4 billion. This comes on top of a defense budget overrun of over \$600 million, largely due to the fighting in Kargil, and two years of 10 percent budget increases. About half of the increase is expected to pay for capital expenses, up over 40 percent over last year. Programming a major procurement increase in such a short time may be difficult.

...and subsidies: No politician likes to eliminate subsidies. They currently total over 10 percent of GDP. The budget proposes some reduction in food subsidies while minimizing the impact on the poorest people. The loudest protests came from the chief minister of Andhra Pradesh, one of the government's coalition partners, who had just defeated an avowedly populist candidate in a state election. The government is holding the line, but this controversy illustrates the difficulties it would face with a more ambitious reform program.

Caught in a budgetary squeeze between politically needed subsidies and an oversized deficit, public investment has dropped from an average of 10.5 percent of GDP in the 1980s to only 6-7 percent today. This adds to the need for private investment in infrastructure, effectively the only way to bridge this gap.

Tax measures: The budget featured some welcome innovations designed to simplify the tax collection system and clear the backlog of tax disputes. The major tax measure is the introduction of the single 16 percent value added tax (VAT) in place of the three current rates. This is intended to provide long-term stability and eliminate disputes of classification. The budget also raised the corporate tax on undistributed dividends from 10 percent to 20 percent.

The fiscal bottom line: The combined deficit of the central and state governments, projected at over 10 percent of the GDP, could undermine the economic progress the country has made in the last decade. The central government deficit, reduced after the 1991 financial crisis, is again creeping up, and is estimated at 6.5 percent of GDP. Of this, over half comes from the "revenue budget", the excess of non-capital expenditures over revenues. In the mid-1990s, the revenue deficit was only one-third of the total. The central government's interest payments now total about half of revenue, up from about a third in early 1990s. Deficits at the state level now account for more than 4.2 percent of GDP.

Decentralization: The increasing prominence and success of private industry, coupled with the rise of a few strong leaders as chief ministers of economically successful states, has put the issue of center-state relations on the national agenda. But the ability of states to move ahead economically depends largely on their control of revenue. Even some of the fast-growing states are currently running very substantial deficits. The central government is experimenting with incentives for bringing down state deficits, including technical assistance linked to more costly central government bailout financing.

Growth prospects: Between mid-1996 and 1999 India had four different governments and three parliamentary elections. The resulting political uncertainty contributed to slow GDP growth, which fell from an average annual rate of 7.0 percent during 1992-1997 to an average of 5.5 percent during 1997-1999. This is still higher than the pre-1990 norm, but not enough to make a real dent in poverty. However, there was no reversal of economic reforms, and there remains a strong consensus in favor of the market-opening measures now in place, and broad agreement that the government needs to tackle a long list of fiscal and regulatory issues. But there is no consensus on the short list of the most critical measures, and the outlook is for a policy agenda that is to a large extent improvised to minimize political controversies.

This year should bring an increase in growth, reflecting a more stable political environment, reviving industrial growth, and strong export performance. Threatening that prospect are two key vulnerabilities. The first is the fiscal deficit, which can only be brought under control with a politically unpopular effort to restrain unproductive spending. Partly as a result, real interest rates are now close to 9 percent. The government has announced a drop in several key administered interest rates, hoping to avoid discouraging new investment.

The second problem is the political fallout from uneven growth. Neither the Hindi heartland nor most of rural India has shared in the current prosperity. Agricultural growth is barely keeping pace with population growth. The challenge for the government will be to keep moving toward market-based policies while ensuring that some of its benefits reach the countryside. Agricultural pricing policies, investments in education, and improved infrastructure are all part of this effort. These policies go beyond the scope of the budget, but they will determine whether India in the next decade is the next "Asian tiger" or the more familiar "elephant."

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