



SOUTH ASIA MONITOR

APRIL 1, 2001
No. 32

INDIA BUDGET 2001: CAN THE GOVERNMENT DELIVER?

On February 28, 2001, Indian finance minister Yashwant Sinha presented a \$80.5 billion budget widely hailed as the budget that will help start the second wave of reforms. It promised government “downsizing”, cut government-administered interest rates, eliminated tax and tariff surcharges, raised the target for disinvestment from government-owned industry, and even proposed new labor legislation. It also pledged a major push to reform the struggling electric-power sector. Three weeks later, however, a defense procurement scandal provoked the departure of one small party and four ministers from the government. Although the budget itself will eventually pass, the government will now have to devote considerable time to rebuilding a national consensus before it can hope to pass the companion legislation on which many of the “second-generation” reforms depend. At best, the schedule for reform will be considerably stretched out.

Fiscal Deficit and Government Downsizing: The budget speech was preceded by an unusually hard-hitting Government Economic Survey, which bluntly highlighted the fiscal deficit and infrastructure weaknesses as critical vulnerabilities. The speech itself caught the same spirit, beginning with an impassioned plea to control the fiscal deficit, that now stands at 10 percent of GDP (including the state budgets). Sinha announced that the fiscal year 2000 central government deficit was 5.1 percent, in line with his estimates last year (a boost for his credibility, because the usual pattern has been for the deficit to increase in the course of the year) and promised to cut it to 4.7 percent in FY 2001.

Sinha also promised to reduce the size of the government by 10 percent in five years through staff attrition, starting with his own ministry. The Indian government spends \$16.1 billion a year on the salaries of 3.72 million state and central government employees; the central government’s payroll comes to 21.1 percent of revenues. There is stiff resistance to downsizing from both the civil service and the cabinet. Senior ministers have been reluctant to respect previous recommendations for reductions in staffing.

User Charges: Sinha also made a strong case for imposing reasonable user fees on a variety of government services. This was addressed most emphatically to the ailing electric power sector, widely regarded as the most important obstacle to higher growth. The state electricity boards are all in financial trouble, with levels of uncollected bills and system losses averaging 19

percent. Losses in some states are much higher, reflecting political commitments to subsidies, promises of free electricity to farmers, and overall mismanagement. The renewed controversy over Enron, which has been in a showdown over nonpayment by the Maharashtra electricity board, is only the best-publicized example of the problem.

Because state governments are responsible for electricity, the prime minister convened a meeting with state chief ministers three days later. Participants said that the meeting was serious and that the chief ministers, many of them from opposition parties, had largely avoided taking political potshots at the reform effort. The central government did not attempt to dictate the details of each state’s reform package, but the basic deal it proposed was a firm path to financial solvency in exchange for one-time central government help in meeting the electricity boards’ current unfounded obligations. Inevitably, there are questions about whether such a bailout can be held to being “one time,” but this is a good first step.

Financial Sector: Sinha astonished political observers by cutting government-administered interest rates on small savings by 1.5 percent. India has some of the highest interest rates in the world (11.5–12.5 percent, compared with inflation of about 8 percent). This boost to financial institutions and business investors was expected to outrage millions of small savers, but the reaction has been quite muted. India’s central bank, the Reserve Bank of India, also slashed the rate at which it lends to banks to 7 percent.

Taxes and Trade: The government hopes to collect \$48.5 million this year from taxes, up from \$42.5 million in 2000–2001. The surprise here was the decision to drop income tax surcharges of 15 percent for individuals and 11 percent for companies imposed in previous years, retaining only the 2 percent tax surcharge to offset last January’s earthquake damage in the state of Gujarat. Similarly, surcharges on customs duties were abolished. The budget promised a further reduction in India’s tariff rates—currently up to 35 percent, among the world’s highest—and reaffirmed the abolition of quantitative restrictions on imports as of April 1. Here too, Sinha gained points for credibility; many observers noted that in past years “temporary” surcharges had proved very durable. Other tax measures included reduction of the dividend tax and extension of the tax holiday for infrastructure projects and special economic zones.

Labor Laws: The budget speech addressed the long overdue issue of rigidities in the labor market, widely regarded as a “third rail” of Indian politics. Sinha proposed that Chapter V-B of the Industrial Disputes Act, which stipulates that employers in specified industrial establishments must obtain prior government permission for layoffs or plant closures, will now apply to industries employing up to 1,000 workers instead of 100. In exchange, the severance package would be increased from 15 day’s salary to 45 day’s salary for every year of service. For the nationalized banking sector, Sinha has floated a scheme to restore control over personnel to bank management by abolishing the Banking Services Recruitment Board (BSRB). These measures, although announced in the budget speech, require passage of separate legislation in addition to the budget itself. Even before the political scandal broke, this would have been a tough sell. Labor unions and opposition parties labeled the proposals “anti-working class” and promised to fight them.

Small Scale Industries: Indian industrialists have been worried about the influx of cheaper, high quality consumer goods from China, and have been demanding protection from the government. Part of the reason Indian industry is uncompetitive in comparison to its eastern neighbor is the Gandhian legacy of reserving production of some 800 products for small-scale industry. The first assault on this policy was the decision some months ago to “de-reserve” garment exports. Leather and toys are now to be “de-reserved.” The end of quantitative restrictions will make all these products freely importable, subject only to tariffs. These moves will undoubtedly shake up the small-scale industry sector, but may ultimately be a welcome boost for Indian exports.

Privatization: Ailing public sector industries contribute greatly to India’s fiscal deficit. For several years now, the government has budgeted \$2.1 billion in receipts from privatization, but has brought in only a tiny fraction of that amount. This year’s budget increases the target to \$2.5 billion, and the finance minister has declared that 27 entities are ready for privatization.

As the budget was being presented, the sale of the Bharat Aluminum Company was going through, bitterly protested by labor and the opposition. The chief minister of the state in which the plant was located joined the protesters. The privatization minister was unbending in his defense of the overall policy and of this particular sale. The episode showed the government’s determination, but also illustrated the problems it will face, especially when the first few deals are consummated. In light of the subsequent political fallout is likely to keep to a fairly cautious pace.

Defense: The defense budget increase of 13 percent, to \$14.9 billion was less of an eye-catcher than last year’s 28-percent increase, but still well ahead of inflation and the overall increase in budget expenditures. Last year’s expenditures were about 2 percent below budget; this year’s increase is more realistic.

The Political Bombshell: As a statement of government intentions, the budget is most welcome. It has been hailed by the business community, is looked on as a victory by the government’s reform constituency, and, except for the labor law revisions, has provoked less opposition than expected. However,

three weeks later, the “Tehelka tapes,” produced by some enterprising journalists, released pictures of senior government officials accepting bribes for influencing defense procurement. The ensuing political storm unleashed pandemonium in parliament, which adjourned its Budget Session after passing only a “vote on account,” equivalent to a Continuing Resolution, rather than the budget itself. Formal passage of the budget, a do-or-die requirement for the government, has been deferred until the next session. The accompanying legislation, on which the budget’s reform measures depend, has not even been introduced, and both the government coalition partners and the opposition will be looking for a way out of the political pain it involves. The norm in recent years has been to legislate budget-related policy reforms that lag a year or two behind the budget. Many of the measures in the 1997 “Dream Budget” were never enacted.

The defense scandal illustrates how easy it is to distract a coalition government from its policy agenda. It has cost the BJP government its moral high ground on corruption issues. It has placed in plain public view the issues of corruption and governmental effectiveness, which may be an even more fundamental obstacle to India’s ambitions than its strictly economic problems.

Defense Minister George Fernandes had to resign from the government, because the defense sector was involved and because senior members of his party, including the party president who is particularly close to him, were directly implicated. Mamata Banerjee, the colorful railways minister, who had presented a blatantly irresponsible railway budget in late February, pulled her three ministers out of the government, claiming to be shocked by this scandalous behavior. But chiefly she acted because her party faces a critical state election in West Bengal and a pullout suited her state agenda.

Neither departure represents a body blow to the government or a threat to its parliamentary majority, and both parties may well be back in the next six months. However, the scandal eats up valuable time and makes the leadership vulnerable to new demands from coalition members looking for goodies for their constituencies. Effective government as well as economic reform depends on the government’s policy focus, and it will need to work hard to recapture that.

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