

India's Leadership Stumbles: The Economic Dimension—Budget 2002–2003

The months of February and March 2002 were hard ones for Prime Minister Vajpayee and his Bharatiya Janata Party (BJP), and ultimately for the country. The BJP did poorly in elections in several Indian states, including the largest. The country was rocked by communal violence and continuing controversy over the contentious and illegal plans to build a temple by the Vishwa Hindu Parishad (VHP), a Hindu religious and cultural organization normally considered part of the BJP power base. All levels of government were bitterly criticized for their handling of this issue. At the same time, the budget for the coming fiscal year, presented on February 28, seemed to provide little basis for the jump start the economy needs, and the government displayed little real commitment to its modest reform measures. This month, two separate issues of the South Asia Monitor will assess where these different events leave Prime Minister Vajpayee and India. This report covers the budget and the economic prospects; a second will address political developments.

Finance Minister Yashwant Sinha's Indian budget for 2002–2003, with total expenditures estimated at Rs. 4,103 billion (\$84.59 billion), received a lukewarm response from Indian politicians, business leaders, academics, and the general public. Its projected deficit, 5.4 percent of GDP as comparable to last year's, continues the high deficits that have plagued the Indian fiscal scene. It extends some of last year's reform efforts, but its proposed subsidy cuts are criticized as politically harsh, and the government has already withdrawn some of the more controversial ones. Critics also charged that the budget did little to jump-start a sagging economy. Fiscal constraints in practice make it difficult for the government to use the budget as a stimulus mechanism, so the real culprit here is the government's inability to bring the deficit under control in a decade of high economic growth. The two key tests in the future will be the government's willingness to follow through with key reforms, especially in the management of electric power and the closely related need for a major push to improve governance.

Economic Liberalization: Although the first generation of economic reforms significantly liberalized the economy, India is still one of the most highly protected markets in the world. The government launched a second generation of reforms in the 2001 budget, continuing the liberalization of the Indian market. While the 2002 budget does not add any new dramatic measures, it does follow through on last year's reform policies. It continues the reduction of customs duties, with the maximum now set at 30 percent, down from 35 percent, and a commitment

to bring India's maximum tariff down to 20 percent by 2004–2005.

The budget also continues a process of gradual partial liberalization of capital flows. Indian companies that wish to invest abroad may now invest up to \$100 million on an annual basis without special permission, up from the prior limit of \$50 million. Furthermore, Indian companies that are interested in making overseas investment in joint ventures are now allowed to invest without prior approval, provided that they invest no more than 50 percent of their net worth (up from the previous 25 percent limit). Also, the budget calls for the full convertibility of deposit schemes for nonresident Indians (NRIs). Finally, the budget calls for foreign companies operating in India to pay an income tax rate of 40 percent, rather than the standard 48 percent (a small but relevant reduction).

Less noticed but potentially significant is the budget's proposal to permit financial institutions to deduct up to 7.5 percent of their income from their taxable income in order to make provision for nonperforming loans. Business observers believe that this is a very useful step toward reducing the burden of bad loans on Indian banks, and they hope that the percentage will be expanded in future years.

Fiscal Health: The combined central and state government deficits stand at above 10 percent of GDP and have become one of the contributing causes of India's faltering economic growth. This year's budget does little to bring it under control. The fiscal impact of the tax measures associated with continued economic reforms depends critically on whether the economy picks up. In a static economy, the reduction in rates is likely to reduce revenues, especially given India's still-heavy dependence on customs and excise taxes. One revenue enhancement measure was a 5 percent income tax surcharge to help meet the military costs associated with the current high-profile deployment on the Pakistan border. On the expenditure side, Sinha pledged to cut nearly 12,200 central government jobs out of nearly 42,200 identified as "surplus" by the Expenditure Reforms Commission (ERC). This will be difficult to do; such measures have often been promised but rarely implemented in the past.

The biggest factor in the budget deficit is India's bloated subsidy bill. The budget took some modest steps to slow its rise, including calls for the reduction of subsidies for several kinds of fertilizer. These changes reduce the central government's projected fiscal deficit to 5.3 percent in 2002–2003 from the current 5.7 percent, but leave it nearly half a percentage point

above the level originally projected for the current year. However, the government's decision in early March to withdraw the subsidy cut for urea and several other products casts doubts on its ability to implement the rest of the package.

Infrastructure Investments: The budget's major contribution to future growth is a substantial increase in public investment in infrastructure. Specifically, spending on roads will rise by 39 percent, on railways by 23 percent, and on power by 22 percent. Although these "extravagant" allocations came in for some sharp criticism, Sinha argued that the government had to make up a substantial gap in public infrastructure investment, especially since private investment was lacking. Although India's stewardship of such high-profile investments as the Enron power plant contributed to the lack of private capital, at least for electric power, this judgment reflects a realistic assessment of India's short-term options, and increasing public investment in these areas is constructive. The decision to set up an Infrastructure Equity Fund is an interesting initiative, but given its small size—approximately \$2 million—it is unlikely to have a major impact.

In the electric power sector, the key problem remains the sector's chronic financial weakness. With the State Electricity Boards (SEBs) averaging a rate of return close to minus 40 percent, the budget continues last year's effort to work toward a series of understandings between the central and state governments on how to put the SEBs on a sound financial footing through securitization and the issuing of tax-free bonds by the state governments. The settlement scheme between the SEBs and the central government, as well as the general restoration of the power sector, is considered crucial if the Indian economy has any hope of becoming an "Asian tiger" in the next decade or two.

The budget also called for an upgrade of the airports at Delhi, Mumbai, Chennai, and Kolkata to "the standards of world-class airports," the continuation of the prime minister's National Highway Development Program (NHDP), and the general privatization of the Port Trust structure.

Defense Spending: The budget raised defense spending by 14 percent over the levels proposed last year, increasing total defense spending to 650 billion rupees (\$13.3 billion). This continued a two-year trend of sharp increases in defense spending. It is not clear how realistic these figures are, however. The defense services underspent both their procurement budget and their regular budget in the current fiscal year by close to 10 percent, in part owing to disruption of procurement after a procurement scam in March 2001. This year's increase in defense spending is intended for purchases of fighter planes, submarines, advanced surveillance systems, and a second aircraft carrier.

Development: Aside from defense spending, Sinha devoted much of his budget speech to development, especially agriculture. Proposals here focused on reducing burdensome regulation, expanded funding for irrigation, and introducing a new entity for agricultural insurance. By allowing farmers to

receive higher prices for their products, the government hopes to stimulate rural demand for industrial products. It also proposes to continue a program, begun last year, to facilitate the construction of cold storage, which has substantially exceeded its initial target.

The budget proposed large percentage increases for a number of social sectors, including primary education (\$1,021 million, up by 22.5 percent) and the Department of Women and Child Development (\$458 million, up 33 percent). Although the increases in funding for the social sector were small in absolute terms and in relation to the size of the budget, the increase in social sector funding highlights the government's commitment to supporting economic growth from below. In fact, expenditure on the social sector projected at \$6.2 billion, is up by 40 percent in dollar terms since 1997.

Difficult Road Ahead: This is an incremental budget, not a visionary one. The investments it proposes are worthwhile. They will not provide much stimulus to the sagging economy, however, nor will they make dramatic changes in the investment climate. Fiscal constraints may make this inevitable. But the deficit reduction measures fall well short of what would be needed to ease those constraints in the next few years.

India's economic survey—the annual analysis produced by its top economic officials—did not provide its usual projection of economic growth in the coming year. Private economists' projections cluster around 5.5 percent, little changed from this year's disappointing 5.4 percent, and well below the 8 percent its planners have written about. The key to increasing growth lays not so much in the budget as in investment, and this in turn depends critically on the government's ability to improve the atmosphere. This means a big push for improved governance.

Looking at the next year, another key question is how the government will manage or expand its political margin for maneuver. Right now, the measures India's leaders consider politically realistic have little economic impact. Recent events—the military standoff with Pakistan, the communal violence in Gujarat, and the BJP's falling prestige domestically—will make the government's economic goals both more important and harder to reach. A prolonged military standoff would divert resources away from the government's economic agenda to defense. The communal violence in Gujarat and the continuing threat of provocative action by Vajpayee's political constituents in the VHP will constrain the government's options and could also hurt an already sluggish economy.

Nimit Dhir and Teresita C. Schaffer

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 public policy positions. Accordingly, all views, positions, and conclusions expressed

in this publication should be understood to be solely those of the author(s).

© 2002 by the Center for Strategic and International Studies.