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India's Budget: Modest Reform, Modest Populism

The Congress-led government's first major economic policy act, the budget submitted on July 8, combines ambitious but general new initiatives on agriculture and education with incremental reforms that continue opening the economy. Politically, the budget balances the government's desire to accelerate growth against the demands of its leftist coalition partners. The fiscal deficit will constrain economic policy, and a weak monsoon will hold down GDP growth. The gap between the fast- and slow-growing states will continue to grow as India's most dynamic states mobilize private capital to spur their economic development.

Total expenditures are set to increase 8.9 percent over FY 2003, less than the nominal rate of GDP growth. The budget proposes a major rise in capital expenditures, 27.2 percent over last year's budget estimates, compared with a 5.3 percent increase in current (revenue) expenditures. The revenue account, however, is the primary constraint on deficit reduction.

Agriculture and Rural Development: Agriculture and rural development are signature issues for the Congress-led government, which believes that its victory in key areas was enhanced by rural voters' dissatisfaction with the BJP's policies. A good monsoon provided robust growth last year in agriculture, which supports 58 percent of the population. The government hopes for growth of 4 percent next year through a significant increase in agricultural credit and public investment in the farm sector. The budget calls for major investments in rural infrastructure, such as roads, drinking water, sanitation, and rural housing. These initiatives represent what the government has described as "growth with a human face."

The means of implementing the government's proposals ideas are less clear. The government will fund the new agricultural schemes, as well as those in the social sectors, through bloc grants to the Planning Commission, leaving the commission free to reallocate funds based on the effectiveness of different initiatives in practice. This makes it almost impossible to tell how much money will actually be spent, much less how effective the new initiatives are likely to be.

Social Spending: The new government's platform calls for universal access to education and health care, with a focus on underserved rural areas. Its Common Minimum Program promised to raise spending on education from roughly 4 percent to 6 percent of GDP. Spending on primary and secondary education is up 7.5 percent. This increase will fund school construction, teacher hiring, and educational supplies, but it does not set India on the path to meet the 6 percent target. A new tax for education is expected to raise between 40 and 50 billion rupees ($850 million to $1.1 billion).

On the health side, the government plans to recast its health insurance program to focus solely on those below the poverty line. To date this initiative has been troubled by serious administrative problems. Lack of information about the program among both the poor and health care providers has contributed to the fact that only 11,000 people are currently covered.

HIV/AIDS: The government has spoken elsewhere about the importance of scaling up India's response to the HIV/AIDS epidemic. However, the finance minister unveiled his budget with only a cursory mention of AIDS. The budget for the National Aids Control Program has increased by only 3 percent, less than the rest of the health sector, to 2.32 billion rupees ($50 million). India has the world's second largest HIV/AIDS-infected population, 5.1 million. Even when one adds the resources provided by foreign donors, the amount allocated is a fraction of what is needed for a vigorous response.

Private Investment: Figures from the Reserve Bank of India (RBI) show that foreign direct investment (FDI) actually fell from $4.7 billion in FY 2002 to $4.5 billion in FY 2003. The budget proposes to raise the caps on foreign direct investment in three critical sectors: telecommunications (to 74 percent), civil aviation (to 49 percent), and insurance (to 49 percent). The leftist parties in the coalition have bitterly protested these changes. Current thinking is that the first two are likely to pass. Insurance, however, requires separate enabling legislation besides passage of the budget and may be opposed by the opposition. A newly created Investment Commission is intended to ease the interface between investors and the government, and the budget speech promised that all foreign investment could now move along the "automatic" approval route. The key to success here will be the implementation of these measures.

Privatization is expected to slow down significantly compared to the last year of the outgoing government, the result of pressure from the leftist parties in the coalition. Budgeted privatization revenues are down 75 percent from the past year with only a few, limited equity offerings planned. The government appears to be continuing with privatization of the country's two major international airports in Delhi and Mumbai, despite the protests of its coalition partners, but this is likely to remain controversial. Public investment in profitable public sector enterprises is slated to increase, but the government has promised not to sell off profit-making public sector industries.

Infrastructure: The budget also proposes significant increases in public investment in infrastructure, recognizing that weaknesses especially in power and transport are a major barrier to private investment. It has also made 400 billion rupees ($8.6 billion) in loans available for infrastructure projects, initially focusing on airports and seaports.

Defense Expenditures: The budget increases defense spending by 17 percent to 770 billion rupees ($16.6 billion). This marks the fifth consecutive year of increases above 12 percent. In past years actual expenditures have fallen short of estimates, as the government has had difficulty in fully implementing its procurement plans. Much of this year's funding increase is intended to pay for recently signed multibillion dollar contracts, including the purchase of a Russian aircraft carrier and an advanced airborne radar system. Although the government has said this is a one-time increase, we can expect future increases as part of India's bid to modernize its military and increase its strategic capabilities.

Tax Reform: India's tax system is plagued by cascading taxes that distort basic price relationships, by official corruption, and by widespread evasion. As a result, India has an extremely small tax base and collects only 9.3 percent of GDP in tax revenues. The most notable reform proposal is the elimination of the long-term capital gains tax and the reduction in short-term rates to 10 percent. Instead, the government proposes a tax of 0.15 percent on transactions in traded securities, excluding bonds and mutual funds. Foreign institutional investors (FIIs) and large fund managers advocated the proposal as a way to create parity between themselves and domestic investors, and as a way to bring unreported funds within the tax collection system. The local securities industry has strenuously objected.

The government proposes to implement two major tax reforms in the near future. First, the finance minister's budget speech promised to introduce by next April a uniform value-added tax (VAT), which would significantly boost tax revenues and create a national market while rationalizing the tax structure. The implementation of a national VAT has been delayed five times since 2001, and further delays are possible.

Second, the budget reduces customs duties on many metals and minerals, including steel and copper. Future rate cuts can be expected as the government tries to bring tariffs in line with the levels of its neighbors in Southeast Asia. However, domestic interest groups will object and progress on trade liberalization will be slow. Both the Congress's rural constituents and the drive to show that India is able to play a leadership role in the battles currently roiling the World Trade Organization (WTO) will reinforce India's reluctance to cut farm subsidies.

A Stubborn Deficit: India's combined central and state government deficits have climbed inexorably since 1998, from 6.5 percent of GDP to 9.4 percent, with the central government accounting for nearly half the total. The recently passed Fiscal Responsibility and Budget Management Act mandates yearly cuts in the central government deficit, leading to its elimination by 2009. The government has publicly committed itself to the task. This is a tall order.

The government aims to reduce the central government's deficit for the upcoming year from 4.8 percent to 4.4 percent of GDP. This estimate assumes (1) an 8 percent real growth in GDP will boost revenues and (2) a 25 percent increase in tax revenues, including a massive drive to collect tax arrears. Both assumptions are probably unrealistic.

On the expenditure side, three items—interest payments, defense, and subsidies—account for over half of all spending. Little can be done to reduce interest payments, and defense budget increases enjoy broad support. Subsidies are ripe for reform. Estimates of the amount that do not reach their intended targets run as high as 85 percent. No Indian politician likes to cut subsidies however, and the new government and its coalition partners are strongly attached both to farm subsidies and to the schemes for food distribution to the poor.

Macroeconomic Outlook: India had a banner year in 2003 - 2004. Strong agricultural growth, with a good monsoon following a very poor crop year, as well as robust expansion in industry and services, led to 8.1 percent real GDP growth. India's current account surplus, net capital inflows, and exports all rose during this period.

The government aims at growth of 7 to 8 percent in the coming year. Most economists feel growth of 8 percent is necessary to significantly reduce poverty. This will be hard to sustain. Even with strong growth in industry and services, the poor monsoon is likely to be a significant drag. The Reserve Bank of India, the country's central bank, projects real growth of 6.5 percent.

Meanwhile, both global and domestic inflationary pressure is increasing. Last year there was simultaneous growth in money demand, by both consumers and businesses, and the money supply. The government has been selling short-term Market Stabilization bonds to siphon off excess liquidity (foreign exchange reserves now stand at nearly $120 billion). Indian wholesale prices rose 6.5 percent in June compared to the previous year.

India's fiscal situation will be a policy straitjacket for the government. In addition, India's size, federal structure, and the complexity of moving major resources into rural programs make it difficult to implement new programs. This reinforces the importance of mobilizing nongovernment resources for India's economic growth and development.

Watch the States: The real story of India's economic development will be told at the state level. Many issues dear to the heart of the Congress government, notably agriculture, health, education and electric power, are primarily state subjects. Fiscal constraints make it doubly important for India to mobilize private investment and the substantial household savings available within India. The past decade shows that state governments can have a major impact on where foreign investors choose to locate. The quality of state governance and the ability of states to deal with these issues will be key, and the inequality of states will continue to grow.

--- *Santosh Sagar & Teresita C. Schaffer*