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Chidambaram shows dangerous budget skills

By Kunal Kumar Kundu

NEW DELHI - The duo who guided India to the path of economic reform in 1991 in response to a crisis then - Manmohan Singh, at the time finance minister, and then minister of state for commerce P Chidambaram - were at helm again this year in more elevated roles, when India presented its union budget last week for the financial year 2013-14 against a backdrop of an economy in a crisis.

Gross domestic product (GDP) is at a mere 5%, inflation is high, savings and investment are high and there is an inordinately high twin deficit (the fiscal deficit, or FD, and current account deficit, or CAD.

India's twin deficit during 1990-91 was at 10.6% of GDP (FD at 7.6% and CAD at 3.5%), the same as where India is likely to be headed this year (an FD of around 5.6% and CAD likely to be about 5%).

Further below, I will discuss why I believe that India's FD will be higher at 5.6% and not the 5.2% that Finance Minister P Chidambaram wants us to believe. The additional constraint during this budget is that India is heading into an election next year, which means that politics are unlikely yield too much space to economic reality.

Yet, if one goes by the face value of recent budget announcements, economics are not yielding much space to politics. Despite the forthcoming general election, the finance minister resisted the temptation to give in to populist demands or announce tax breaks and/or freebies to entice voters. While his budget did not go of the way to cater to the needs of the ruling political parties heading for an election, it has not done any harm to their election prospects either. This was critical and he should be lauded for that.

That is where probably all the good news ends. If one was eagerly looking forward to some signals of how the government plans to guide the economy out of its present rut, there seems to be no determined effort to tackle the problems at hand. Like the annual Economic Survey released at the end of February, the budget also acknowledges the problems faced by the economy. But the pertinent question is, where's the solution?

In my piece last month on budget expectations, I reiterated the need to focus on arresting the trend of declining savings, increasing tax base, reinvigorating investment cycle and focusing on twin deficit.

Sadly, none could be found except for some bits and pieces that may not count for much. While the provision of additional depreciation incentive for investments of one billion rupees (US$18 million) and above is welcome, the government has reversed that sentiment by mercilessly cutting its capital expenditure just to show the world that it is able to meet his deficit target.

Not much innovative thought could be found regarding a desire to increase the tax base. The imposition of a 10% surcharge on those with taxable income of 10 million rupees and above while sparing the super rich in the agriculture sector exposed the fallacy in the finance minister's thought process.

More importantly, if one digs deep into the data and the underlying assumptions, the numbers made public fail to stand up to scrutiny.

Growth: To begin with, the GDP growth expected next year is clearly over optimistic. The budget document states that the nominal GDP growth is assumed at 13.4%. As per the economic survey, growth (in real terms) is expected to be between 6.1% and 6.7%. This means that the government expects growth to be nothing less than 6.7%. Without any specific growth driver, both the economic survey and the budget documents are silent on how growth will perk up from 5% in 2012-13 to 6.7% in 2013-14. In fact, India would be lucky to grow at even 6% during 2013-14. This will throw the entire budget arithmetic out of gear.

The other worrying part of the assumption is that the government expects average inflation for 2013-14 to be 6.7%. Given that India's January 2013 inflation was 6.62%, no improvement in inflation is expected going forward. Rather, a mild deterioration is expected.

Fiscal deficit: The finance minister seemingly considers the publicly announced 5.2% fiscal deficit target as the be all and end all of his existence. While that is what both the rating agencies and Reserve Bank of India want to hear, nobody seems to be bothered about how it is going to be achieved.

True to his skills of masterfully using the budget arithmetic (accounting jugglery if you will), Chidambaram was at his crafty best, something that I expressed my fear about on this site last week.

For the current year to March 2014, he assumed he will be able to close the period with a fiscal deficit of 5.2% of GDP, lower than the revised estimate of 5.3%. First, his revised estimate of petroleum subsidy stands at 969 billion rupees. But the catch is, this includes 385 billion rupees of unpaid oil subsidy from the previous year that has been paid out this year. Essentially, for the current year, he is accounting for only 584 billion rupees.

However, the total under-recovery during the first nine months of 2013-14 (ie April-December) was 1.25 trillion rupees and this is expected to be about 1.64 trillion rupees for the full year. This puts the government's share of subsidy at around 980 billion rupees (assuming they force the oil companies to bear 40% of the subsidy burden).

Thus the government is not accounting for oil subsidy of 396 billion rupees in this fiscal year. Had that been done, the actual fiscal deficit would be 5.6% of GDP and not the forecast 5.2%. Assuming, like last year, the shortfall will be paid out during 2013-14, this will mean that the government will be left with only 254 billion rupees as subsidy (given the budgeted oil subsidy for 2013-14 is 650 billion rupees) pertinent to 2013-14.

Either way, success in fiscal consolidation is a chimera.

The allocation for food subsidy for 2013-14 saw an increase of a mere 50 billion rupees to 900 billion rupees. Given that food security is one of the most important planks for the government heading to the polls, this seems to be grossly under-provided.

As election nears, there is a possibility of higher expenditure on this account. The government will also likely reverse its decision for a graded increase in diesel price. Each of these can lead to a spurt in subsidy expenses.

Thus, with the economy unlikely to grow at the rate expected while expenses most likely will perk up, the fiscal deficit could very well be a casualty. But, with the finance minister staking his reputation on his stated roadmap, we will likely see further increased pressure on oil companies, and/or a severe cutting down of capital expenditure, and/or more innovative accounting practices.

Fiscal austerity: The government has been making noises about fiscal austerity for some time now to adhere to its fiscal consolidation roadmap. The question is at what cost?

According to the budget data, the government will likely reduce its total expenditure for 2012-13 (as compared to what has actually been budgeted for) by 4%. But what is dangerous for the economy is that the expenditure compression comes at the cost of capital expenditure (which was lower by as much as 18%), which will impact India's future growth potential.

In fact, revenue expenditure (which includes plenty of wasteful expenditure) was lower by a mere 2%.

If one excludes the component "grants for creation of capital assets" from revenue expenditure, then net revenue expenditure actually increases by 1% as compared to what was budgeted, rather than shrinking, as austerity should have required.

Thus the quality of economic growth will suffer. What it also reveals is the government is clearly in election mode (and hence continued spending on leaky social projects), the economy be damned. So much for the much avowed fiscal austerity.

Revenue expectation: Apart from highly optimistic growth assumptions that will put to severe test the government's tax revenue buoyancy expectations, the government has more than doubled its expectation of generating disinvestment revenue from the sale of state-owned interests.

Save for a few years, the government's performance in matching the disinvestment revenue target has been abysmal, to say the least. During 2011-12, the government expected disinvestment revenue to be about 400 billion rupees but managed less than 155 billion rupees. For 2012-14, the expectation was 300 billion rupees; it is likely to end up with 240 billion rupees, and that by forcing state-owned enterprises such as State Bank of India and Life Insurance Corporation of India to bail them out when there was hardly any taker for their offerings.

For 2013-14, the government expects disinvestment revenue to more than double to 550 billion rupees, of which it expects to get 400 billion rupees from direct disinvestment and the remainder by selling its existing minority stakes.

This again seems to be highly optimistic, unless it again forces state-owned enterprises to bail them out. Investors (mostly institutional investors, be they foreign or domestic) will be wary of picking up stakes in state-owned companies given the extent of financial repression by the government.

Not only are the oil companies forced to share subsidy burdens but also inordinate delays in reimbursement of subsidies, pushing up borrowing requirements of the oil companies and often pushing them in to red. At the same time, forcing state-owned companies to buy shares of one another is another red flag for the investors.

Foreign investment: This year's budget has been less adversarial in regard to foreign investors than last year's, which had provisions such as the General Anti-Avoidance Rules on tax matters, and retrospective tax laws were introduced.

With foreign direct investment slowing to a trickle in 2012, it was expected that the government would spare no effort to woo back foreign investors. Yet, on the contrary, this budget saw a proposal to increase the rate of tax on payments by way of royalty and fees for technical services to non-residents from 10% to 25% subject to the maximum tax rate applicable under various double taxation avoidance agreements (DTAA).

However, a close look at the various DTAAs reveals that the maximum taxation is 15%. Additionally, the budget also says that a tax residency certificate "shall be necessary but not a sufficient condition" to take advantage of double taxation avoidance agreements.

This introduces an additional headache for investors as the scope for litigation can increase.

In an effort to maximize revenues, the tax authorities might seek to find loopholes so as to be able to tax foreign entities at a higher rate than prescribed in the DTAA. Thus, rather than taking steps to encourage increased foreign investment inflows, the budget has introduced a sense of uncertainty in the minds of potential investors. This measure will also encourage treaty shopping, as investors from non-treaty countries would seek to route their investment through countries with which India has treaty.

To conclude, while the budget appears pragmatic, it exposes a government in election mode and hence a selection of choices that will do virtually nothing to reverse declining economic trends unless the global situation improves. Not the type of policy making one expects.

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