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Budget wishlist for a naked India

By Kunal Kumar Kundu

NEW DELHI - The Central Statistics Office's recently released advance estimate of the lowest GDP growth in India for a decade during the 2012-13 fiscal year is a stark reminder of the malaise afflicting the economy. Although the finance ministry believes that the estimate errs on the downside, there are reasons to believe that this is a true reflection of reality. [1]

For an economy touted as the next best thing for growth after China, the structural shortcomings have exacerbated the problems created by global cyclical downturn. The same structural inefficiencies ensured that the 9%-plus annual growth rate lasted for only three years (unlike in the case of China) when the global growth environment was much more conducive. When the tide finally went out, it became clear who was swimming naked.

Given this backdrop, my wishlist for what should be in the Union budget announcement on February 28 comprises evidence of honest effort (and not mere tinkering) to deal with problems hindering the economy.

The fiscal deficit

First and foremost, we need to see evidence of sticking to the fiscal consolidation target, and of doing so in an appropriate manner. This has two components - reducing wasteful expenditure and generating more revenue.

With regard to expenditure control, I would like to see irrevocable commitment to stick to decisions that are appropriate and not last minute exercise. These include:

Refraining from resorting to accounting jugglery: After the Fiscal Responsibility and Budget Management Act of 2003 came into effect, we saw the introduction of oil bonds, fertilizer bonds etc which were aimed at converting certain above the line items to being below the line and thereby taking those off the calculation of deficit. This resulted in lower official deficit but the burden does not dissipate. Another dubious route adopted since last year was partial non-payment of government's share of oil subsidy. Not only did the government force the oil companies to bear 40% of the subsidy burden it also deferred last quarter's payment for fiscal year 2011-12 to next year. Essentially it resorted to borrowing from the future to pay for past expenditure. That way they managed to keep the fiscal deficit for 2011-2012 at less than 6%, while it actually should have been more.

This year, the government did not pay any subsidy for the first nine months and only in January did it release payment of around 300 billion rupees (US$5.5 billion). Recently, payment of another 250 billion rupees of subsidy has been approved, but given the precarious financial situation it is quite unlikely that it will be made this year. With a likely subsidy of around 1.6 trillion rupees, the government would either borrow once again from the fiscal 2013-2014 budget to pay for the previous year's subsidy or let the oil companies bleed. Either way, it's a very unhealthy situation.

Not axing capital expenditure: History is replete with incidences of desired capital expenditure being sacrificed at the altar of fiscal prudence. Unable to bear expenses of politically imperative social sector spending not matched by revenue, the option of cutting capital expenditure follows the path of least resistance. Unlike benefits of capital expenditure, which does not accrue immediately, social sector expenditure leads to instant gratification and the recency effect has positive impact on electoral outcomes.

Given this, the government should not only ensure strict adherence to subsidy reduction measures (and not give in to political shenanigans), it should not introduce new schemes (the expenditure on which is recurrent in nature) that cannot be backed by recurrent revenue streams. Starting new schemes based on one-time revenue generation efforts like disinvestment, the cellphone spectrum auction and the like is a sure fire route to fiscal destruction.

All effort should be made to ensure the success of cash transfer scheme for subsidies to people living below the poverty line, which has the potential to plug the humungous leakage in the system. In a scenario where investment has been falling and the investment climate has yet to improve, any government pull-back on the capital expenditure front will not only impact overall investment sentiment but also come at the cost of future growth potential. It is important to remember that this is the first year of the 12th Five-Year Plan. Unlike previous plans, we have not seen a spurt in government capital investment and unless this happens, a virtuous investment cycle is unlikely to kick in.

With regard to improving revenue collection, the foremost focus should be on widening that tax base. India's tax to GDP ratio as of the 2011-2012 fiscal year is 16.3% (lower from the peak ratio of 17.6% achieved before the global crisis erupted), of which the tax revenue earned by the central government accounts for 10.4% of GDP. India should aim at improving the ratio to 20%. The best way to achieve that is to bring in more people into the direct tax net. Only 2.86% of Indians (or 33.57 million people) paid personal income tax in the 2011-2012 fiscal year, of which more than nine out of every 10 were salaried individuals. This needs to change. According to India's Finance Ministry, a mere 1.4 million of tax payers disclosed annual income of more than 1 million rupees. Clearly, tax evasion is taking place on a huge scale, mostly from the non-salaried class.

The government needs to put in an honest and concerted effort to make more non-salaried people pay tax rather than focusing only on the salaried, a much less cost-effective exercise. What is even more galling is that agriculture income continues to be untaxed and none of the political parties have mustered courage to bring this income under the tax net. With approximately 50% of India's population engaged in agriculture, that's a loss of revenue that the government can ill-afford. It is also well-known that a fairly large number of rich and well-connected individual escape the tax net by disguising their income as agriculture income. This needs to be change.

Current Account Deficit

Like last year, the high twin deficit (the fiscal shortfall and current account deficit) has afflicted the economy. While the fiscal deficit is likely to be between 5.5% to 6 % of GDP in the current year, the current account deficit (CAD) may well come in between 4.5% to 5% for the full year - a record high. An important reason why the currrent account deficit is rising is that savings have been shrinking faster than the fall in investment. During the current year, it is likely that savings will be below 30% of GDP, down about 7% from the peak rate of 36.8%.

This trend needs to be reversed since high domestic savings foster high income and growth. It is more so in case of India, since domestic saving finances a major proportion of investment. In India, the household sector has consistently been a net saver, and it makes a predominant contribution to domestic saving. Majority of household investment in financial assets is in fixed income instruments, while equity accounts for a miniscule portion of their portfolio. Persistently high inflation and negative real rate of interest has resulted in a decline in household savings in financial assets. Also, with an erstwhile aversion towards taking on debt dissipating, household savings may not have much upside potential, especially in urban areas. Given this, efforts to increase savings should focus on the following:

Corporate savings: While some tax-breaks to induce household savings may be expected, the overall impact on savings may not be substantial because it may simply lead to realignment of household savings towards tax-favoured assets, without increasing the overall quantum of savings. A better approach is to encourage corporate savings. This will not only help finance corporate investment but also strengthen their collaterals. The budget ought to focus on linking tax benefits or interest subsidies on investment to desired outcome - be it the creation of capital stock, or an increase in expenditure on research and development and other productivity enhancements.

Fiscal consolidation: This is key. A reduction in the fiscal deficit will push government savings and help reduce the CAD. This can be better understood by the following identity:

$C+I+G+(X-M) = C+S+T \Rightarrow (I-S)+(G-T) = M-X$

Where C = Consumption, I = Investment, S = Savings, G = Government expenditure, T = Tax, X = eXports and M = iMports

Unbridled rise in government expenditure leads to a situation of imports exceeding exports, thereby driving up the CAD.

Employment generation

Innumerable studies on India's growth potential have been unanimous on one aspect - ie the potential dividend accruing from India's improving demography. As the younger people mature and enter the work force thereby increasing the working age population of the country, India stands to benefit throughout this transition period. However, it all boils down to the working age population being gainfully employed. [2] Unfortunately for India, the past decade has been one of virtually jobless growth with employment elasticity of growth in the industry being negative during the second half of the decade.

The Indian education system suffers from serious lack of quality and adequate input from industry, leading to a vast majority of Indian graduates being considered unemployable. At the same time, India suffers from high incidence of child malnutrition and stunted growth. While the New Manufacturing Policy envisages creation of 10 million jobs in the manufacturing sector by 2025, these structural flaws need to be addresses.

Not only does India need to spend a larger proportion of GDP on health and education, the focus should equally be on outcome-based spending. Mere spending without an adequate audit only increases leakage without results. The budget should talk about outcome audits for both health and education spending and, subsequently, lay down appropriate guidelines. Unless this is done, and done fast, India will miss the bus and the demographic dividend could well turn into a curse.

Kick-starting investment

India's investment cycle needs to restart, and in earnest. The slowdown in investment has led to a drastic fall in the potential for growth, resulting in bouts of inflationary pressure the moment the economy starts to pick up speed. At present, India's potential growth rate has come down to anywhere between 6.5% and 7%. However, let us not be under the illusion that investment will pick up if interest rates are cut. While nominal interest rates are high, real rates are low enough to have led to a surge in investment. However, various policy announcements since the last budget coupled with political shenanigans has vitiated the investment climate.

While the government needs to stick to its own investment target as envisaged in the 12th Five-Year Plan (mentioned earlier), the budget should ensure the following to enthuse private investors and thereby unleash a virtuous cycle:

Stability of the policy regime: Introduction of the retrospective General Anti-Avoidance Rule and cancellation of 2G licenses are two very good examples of what should never have been done. The last thing that any investor would want to see is change in policy that results in entire business plan going awry. Foreign investors who invested in India's telecom sector on the basis of license granted by the Government of India to an Indian company have every right of being aggrieved as their investment stands to be impaired. India's policy-making history is replete with unstable policy regime.

The time has come to assure investors, in no uncertain terms, that policy once announced would never be tinkered with. What is also important is to issue clear guidelines on any policy matter and not leave it open to interpretation. Case in point is last year's budgetary concession on customs duty allowed for import of steam coal but was meant for coal import for power generation what with the customs department now banking on the semantics to impose higher duty on coal imported during the year.

Fast-tracking of project approvals: There should be time-bound clearance for projects, which calls for speedier regulatory and procedural approvals. In India, laws do not speak with each other and there's a clear problem as far as inter-ministerial coordination is concerned. This trend needs to be reversed.

- **Goods and Service Tax (GST)**: A clear commitment toward a time-bound roadmap for implementation.
- **Disinvestment**: Pursue disinvestment aggressively and utilize the proceeds to bridge fiscal gap and not announce new social sector initiatives depending on these flows.
  Given the backdrop of a slowing economy (hobbled by inappropriate policy choices) and an impending general election (which, many fear, could result in the delivery of a more populist budget), this year's budget assumes tremendous significance as to whether the government is really keen to give the economy a chance or will instead cave into political reality. For far too long the economy has been held hostage to politics. The time to act is now.

Notes:

1. See Indian economy in worsening straits, Asia Times Online, February 13, 2013.
2. See Young, Jobless and Indian, Wall Street Journal, November 23, 2012.

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