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Indian budget seeped in optimism
By Kunal Kumar Kundu

The latest edition of India's financial theater that is the Union Budget 2011, was, like the recently released Economic Survey report, full of hope and optimism.

To a larger audience, it was a positive budget simply because there was no negative news on the taxation front. It seems that the market believed that given relatively strong growth during the financial year ending this month there might be an urge to increase certain indirect tax rates, especially the excise duty on the fast-growing automotive sector.

Additionally, the stated intent of the government to borrow less during the coming financial year than the estimated borrowing in the current financial year (approximately 300 billion rupees lower at 4.17 trillion rupees, down from 4.47 trillion rupees) also went down well with the market, which cheered the reduced fiscal deficit target for the next year (at 4.60% of gross domestic product, or GDP, compared with an estimated 5.1% of GDP during FY2011.

Sure the budget had some positive announcements to make.

- The Direct Tax Code or DTC will come into force from April 2012
- Preparations for a Goods and Service Tax or GST rollout are in the final stages and a bill will be introduced during the current session
- Foreign direct investment regulations will be consolidated into one comprehensive document
- Foreign institutional investors will be allowed to invest in mutual fund schemes. However, this has the potential to further skew the flow of foreign funds in favor of hot money, which has been a bane for India
- Short-term interest to farmers will continue to be at 7%, while farmers who repay loans on time will get loans at 4%, 3% less than normal. The agricultural credit limit has also been raised to 4.75 trillion rupees, an increase of 1 trillion rupees
- The government is to move towards direct transfer of cash subsidy to people living below the poverty line in a phased manner for better delivery of kerosene, liquefied petroleum gas and fertilizers. If (and only if) this works well, this can reduce some leakage from the system
- 400 billion rupees are planned to be raised through disinvestment during FY12
- Finance Minister Pranab Mukherjee has provided nearly half of the proposed plan expenditure for 2011-12 to the infrastructure sector - at 2.14 trillion rupees, this represents a significant 23% growth over the current year
- To take the process of financial sector reforms further, a variety of legislation is proposed in 2011-12
- Amendments to the Banking Regulation Act in the context of additional banking licenses to be given to private sector players
- Creation of an "India Microfinance Equity Fund" of 1 billion rupees. The government is considering putting in place an appropriate regulatory framework to protect the interests of small borrowers.

While not earth-shattering in themselves, these were the stand-out announcements during the budget. It is also important to note that the finance minister managed to steer clear of the populist course, which is indeed positive.

Agreed, the budget exercise has ceased to become a platform for important policy decision announcements. Rather, the expectation is that, since parliament functions during the rest of the year, its sessions could be used effectively for policymaking. In reality, quite often this does not happen and during the current year, when the government stumbled from one scam to another, parliament was as good as non-functional. In essence, there was hardly any big-ticket reform announcement during the year. For a developing economy like India, policy paralysis has a huge opportunity cost.

In effect, the basic problems continue to be unaddressed.

- While black money is supposedly one of our biggest concerns, the agriculture sector continues to be untaxed. As a result it has become an avenue for the high and mighty to evade tax. With these people being well connected and a large number of politician themselves being beneficiaries of such largesse (directly or indirectly), this is not an issue that is even thought fit for discussion

- Both the Economic Survey and the budget have been very explicit about the threat that inflation poses. However, during the entire budget speech, there were only nine references to inflation, mostly in passing, and the only explicit measure (if I may call so) was dependence on hope - hope that inflation will come off due to the lag effect on tight monetary policy and the base effect. There has been some mention of improving the supply response of agriculture to the expanding domestic demand and expectations that the states to do something along the lines of agricultural marketing policy but no definitive announcement was made to underline real intent. In fact, with certain increase in duties, the budget may end up making additional holes in the pockets of the domestic consumers

- The budget also talked about implementation gaps, leakages from various public program and the fact that quality of outcomes poses serious challenges. But, as has been the case with all the earlier budgets, no serious intent has come forth which shows that the government is serious about administrative and bureaucratic reforms that can help plug the loopholes. Way too much hope, it seems, is pinned on the UID (personal identification) programme (which is not supposed to be mandatory in any case) while precious little is being done to plug the corruption driven leakages in the delivery mechanism

- To me, however, the biggest disappointment is the way deficits are being treated. Time and again we hear of roadmap toward fiscal consolidation but available indications make one very worried. This, however, requires a more in depth understanding of how events have unfolded this year, which I plan to do in the following paragraphs

As I have mentioned previously, various Indian governments have exhibited an uncanny ability to find expenditures to match rising revenue. In this connection, it is important to note here that during the previous budget, the government expected to garner about 350 billion rupees from auction of telecommunications spectrum. In effect, they garnered close to 1 trillion rupees, nearly triple the amount.

With such a cushion, it was widely expected that the actual deficit numbers for FY11 would be much lower than budgeted. While the budget estimate for FY11 was for a fiscal deficit of 5.5% of the GDP, in actuality, it was lower at 5.1%. The positive story, however, ends there.

Despite the one-time windfall gain through spectrum auction and some positive tax buoyancy, the fiscal deficit was as high was 5.1% of GDP. In fact, the extra revenue from the auction (than what was budgeted) was about 0.8% of GDP. In effect, the government clearly slipped on the fiscal deficit front.

In fact, the actual deficit at 4.01 trillion rupees was higher than previously budgeted at 3.81 trillion rupees. On the other hand, the revenue deficit turned out to be lower than budgeted (at 2.7 trillion rupees as against 2.77 trillion rupees).

This was because, the government, rather than using the windfall revenue generated in a productive fashion, used it to foot the increasing subsidy bill. There is thus a dichotomy between the intent of the government and the action.

Another way of looking at quality of the deficit is to take the ratio of Revenue Deficit (RD) over Fiscal Deficit (FD). The higher the ratio, the poorer the quality of deficit, since this means that the government uses up most of its borrowings for housekeeping expenses, leaving a lower proportion of borrowed money for productive expense.

During FY09, the ratio was 75.24%. Next year, it went up to 79.48%. During FY11, the government managed to bring down the ratio less than 70%, but that was mainly because of a reduced revenue deficit. For FY12, the ratio is back to about 75%.

This means that the government can use only about 25% of the borrowed money to invest in asset creation, from the return of which it intends to service the debt. This being the case, interest expense continues to be a big chunk of expenditure of the government. During FY12, out of total revenue receipt of 7.9 trillion rupees, 3.42 trillion will be used only for interest payment and to repay debt that would fall due for repayment.

Even at first glance some of the assumptions of the budget number seem to be questionable. The subsidy budget, for example. During FY12, the subsidy burden is pegged at 1.44 trillion rupees as compared to 1.64 trillion rupees during FY11, lower by about 12.5%. This, at a time when oil prices are expected to remain on the boil.

The government's best bet is the so-called move toward market-related pricing. And there is a big if. When diesel is not market related and continues to be subsidized as inflation fear holds grip, how can mere adherence to market-related petrol prices serve the purpose?

Even petrol prices, though being market related, do not rise immediately, thereby adding to the subsidy burden. The greater fear, of course, is the international price level itself. The uprising that started in Tunisia has spread to Libya with a much more destructive connotation. As the turmoil spreads from North Africa to the Middle East, oil prices are expected to remain at elevated levels going forward.

This can and will add further fuel to the subsidy fire. Add to that the subsidy implication of the food security bill, and there is very little chance of the subsidy bill remaining under check. With subsidy being the holy grail of Indian politics and with five states scheduled to go to the polls during FY12, not much hope can be pinned on the government being able to control subsidies, let alone reduce them.

Even the expected growth in nominal GDP is a bit suspect. The budget document assumes a 14% growth in nominal GDP during FY12. Given that the government expects inflation to be at around 5%, the targeted real GDP growth rate is a pretty optimistic 9%.

This will be a real tall order, especially given that rising interest rates are expected to slow down domestic demand, Europe expects to just muddle through or even experience contraction in some economies reeling under steep budget cuts, and the US is unlikely to hold on to the stimulus-driven rebound in growth for long.

The worrying part of this is that it seems that our policymakers are taking a 9% growth for granted, with major reforms being put on hold. And through this expectation of higher growth, every finance minister tends to give a roadmap for a reduction in deficit, without any intent, whatsoever, to control wasteful expenditures.

In essence, I am not convinced about the deficit numbers, nor am I convinced about the real intention to reduce the deficit. If history is anything to go by, the government's profligacy is unlikely to restrained, especially during a period when five Indian states will head for elections and when no further windfall gains are expected. Add to this the uncertain global scenario and it is clear that the budget is more a statement of optimism and not much anchored to ground reality.

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