CSIS

SOUTH ASIA MONITOR

NUMBER 57 APRIL 1, 2003

Opportunity Lost? Indian Budget 2003–2004

India's budget for fiscal year 2003–2004 will make some contribution to short-term growth but continues the piecemeal approach to economic policy apparent in the last two budgets. With four key state elections during the first half of 2003 and national elections due in 2004, we can expect India's economic policy to muddle through rather than taking bold initiatives. India's growth, under these circumstances, will depend largely on the weather and on a few major investment decisions, and it is not likely to surge ahead in the immediate future.

India's cricket victory over archrival Pakistan provided an upbeat backdrop for Finance Minister Jaswant Singh to present his first Indian budget on February 28. The business community, with the exception of a few voices of dissent, received the budget with guarded optimism; opposition criticism was both predictable and manageable. The budget's big numbers were largely in line with recent trends. Projected expenditures are up 8 percent over the previous year. The government's economic survey, released at about the same time, forecast the coming year's economic growth at 4.4 percent, down from the current year's estimated 5.6 percent.

Continuing deficits threaten investment capital

Fiscal Discipline: The budget forecast a national government budget deficit of 5.6 percent of GDP, up from the current year's target of 5.3 percent but below the actual level of 5.9 percent. If past experience is any guide, the actual deficit at the end of the year will again exceed the target. More worrisome is the consolidated deficit of the central and state government, still between 9 and 10 percent of GDP, one of the highest in the world for a major economy. Concern over "crowding out" investment and upward pressure on interest rates is mounting. Deutsche Bank estimates that interest payments already absorb 50 percent of the government's revenues. Taken together with a stubbornly high subsidy level, now reaching 16 percent of net revenue of the central government, this suggests that India's fiscal problems will only get worse until the government feels able to take more forceful measures to address them.

Taxation: India's budget has continued its promised reduction in peak customs duties, which were cut from 30 to 25 percent. A decision to shift the burden of corporate dividend taxation from the recipients to the companies will be popular with higher-income groups, as will the decision to exempt capital gains taxation of equities held for a year or more. The government envisages covering part of the resulting shortfall by introducing a value-added tax (VAT) at the state level and eventually at the federal level. In an economy where the services sector accounts for over 50 percent of GDP, this will eventually bring substantial new revenue into the tax net. However, implementation of the VAT will be gradual. In the medium term, India's tax structure remains income inelastic and highly dependent on the customs and excise taxes that India has promised its trading partners to continue to reduce.

The budget did not adopt the recommendations of a commission headed by former finance secretary Vijay Kelkar for simplifying and restricting the number of exemptions and loopholes in the tax code. Like earlier budgets, this one contains a list of fiscal changes aimed at specific sectors. Decreases in direct and indirect taxes on products such as cars, imported liquor, and information technology products target the middle classes, a key political constituency. Various tax benefits for the information technology sector were extended.

The government is already facing pressures to withdraw even these moderate increases in taxes and fees. The proposed reduction in the subsidy on fertilizer, designed to improve the fiscal picture, was withdrawn a few days after it was introduced in response to intense political pressure. There are calls for a two-year delay in introducing the VAT. These adjustments to the budget are normal, especially in a political year, but they make the budget process a highly visible test of the government's will and power.

Privatization and Infrastructure Investments: A key component of the budget and future growth is investment in infrastructure. The government envisions spending approximately $12.5 billion on a series of infrastructure projects that include 48 new roads, two international convention centers, the renovation and modernization of two airports, and expansion of the National Railways. Encouraging investment in energy is a recurrent theme. The budget broadens the list of power projects eligible for special tax benefits; it also reduces from 25 to 5 percent the customs duties on regassification plants for liquid natural gas (LNG).

The other side of the government's investment plan is privatization. Estimated revenues from privatization have been increased to $2.75 billion. In past years, privatization receipts have always fallen well short of their targets. The current year's receipts were $700 million, compared to the budget target of $2.5 billion. However, the decision late in the last fiscal year to go ahead with privatization of the two major public sector energy corporations suggests that the momentum is toward faster and more efficient action, so performance in the coming year is likely to come closer to the budgeted figures.

Banking Reforms: Some of India's key economic analysts believe that reform of the financial sector is the key strategic move the government needs to make. This budget does not tackle the thorny issue of bank privatization, but its banking changes are likely to increase the independence and market orientation of India's banks. The budget raises the cap on foreign direct investment in private banks from 49 to 74 percent and proposes to remove the 10 percent restriction on voting rights for foreign investors on bank boards. This move will facilitate mergers and acquisitions by international financial groups while also responding to the complaints of foreign investors who wanted more autonomy and freedom from regulatory hurdles as a prerequisite to increasing their investment. The government has also proposed allowing domestic banks to carry forward accumulated losses after they merge, thereby creating a potential tax benefit for future merger activity.

Bank reforms and debt consolidation may strengthen bank portfolios

Debt Consolidation: The government intends to take advantage of its strong reserves and low international interest rates to restructure its financial obligations. It will retire a pool of high-cost World Bank (WB) and Asian Development Bank (ADB) loans totaling approximately $3 billion. Domestically, it plans to institute a debt swap scheme to enable state governments to prepay high-cost debt and a pilot cash-management program that allocates discretionary funds on a staggered timeline basis.

The mechanism for implementing this debt consolidation is a buyback of central government domestic debt from Indian banks. In a significant addition to its push for strengthening the banking system, the government has also offered a tax exemption on gains from the sale of these securities if the proceeds are applied towards reducing banks' nonperforming loans (NPLs). The burden of NPLs has fallen steadily over the past several years, but official Indian figures cited by the IMF still estimated gross NPLs at 12.4 percent of public sector banks' loan portfolios in 2000/01, and Fitch Ratings Service estimates their aggregate value at $7.4 billion. A tax gain/ NPL swap could cut the aggregate value of nonperforming loans by up to one-third.

The government also hopes that these measures will help bring Indian interest rates in line with world rates, thereby further integrating India into world financial markets. With the same end in mind, the budget announced a variety of other measures designed to put downward pressure on interest rates, including a reduction of the Reserve Bank of India's (RBI) repo rate, the predetermined interest rate it uses for the purchase of securities, and a reduction in various administratively determined savings deposit rates. These will ease the pressure on interest rates from the continuing high deficits, and the Indian bond market has reacted favorably. However, the impact on small savers is bound to be controversial.

Defense Expenditures: The budget raises defense spending by 17 percent over estimated spending in the current year, increasing projected defense expenditure to 653 billion rupees ($13.6 billion). This is the fourth consecutive year in which defense expenditures have risen by more than 12 percent. In this case, the increase reflects both the anticipated costs of military modernization and administrative support costs. Actual budget expenditures have been below the budgetary estimates in each of these years; the current year's shortfall is 10 percent. This reflects the difficulty of ramping up large procurement programs. Defense spending represents about 2.6 percent of India's GDP, but continuing increases on this scale, especially taken together with the stubborn deficit, make it harder to fund the country's development needs.

Foreign Exchange in the Black: In contrast to its difficult fiscal outlook, India's foreign accounts are quite healthy. Figures for the first nine months of the fiscal year show exports up 20 percent, and the current account surplus is projected at $1.67 billion (Apr.-Sept., 2002–2003). Foreign exchange reserves total approximately U.S.$75 billion, equivalent to 11 months' imports. International rating agencies have kept India's sovereign debt rating stable. This should position India well to weather temporary external shocks, including a possible war-induced increase in oil prices. However, a prolonged war in Iraq could disrupt the oil supply and increase India's oil import bill, currently about $60 billion or 27 percent of imports.

Accelerating growth not yet in hand

Growth Sustainability: The government's economists project a GDP growth rate of 4.4 percent, and outside estimates of next year's growth range from 4 to 7 percent. This is well below the 8 percent rate that many economists believe is needed to make a significant dent in poverty. The budget's direct poverty-reduction measures are rather modest, and the government has come in for some criticism for the small size of its investment in rural development, especially after a year of very weak agricultural performance. Other factors will of course also affect both GDP growth and the prospects for reducing poverty, including both local and foreign investment and the effectiveness of India's social investments.

Despite its fiscal difficulties, India does not face a dire outlook. Its current account is in surplus, its reserves are healthy, and its financial sector will remain accommodating. However, it is in good economic times that the core issues of fiscal reform can best be tackled to achieve results that help all constituencies. This is the opportunity that may be lost, unless the government manages the piecemeal reform process on which it has embarked with great dexterity.

Amir Ahmad 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).

© 2003 by the Center for Strategic and International Studies.