

Millennium Budget

Behind Its Time?

The clearest signal coming from the budget is that political stability is irrelevant when it comes to the pace of economic reforms in India. Why, otherwise, does the budget have the appearance of the same old annual exercise in which finance ministers practise the art of offering minimal policy changes necessary to maintain their image as reformers? Why is there no attempt to use the first budget of the NDA government's five-year mandate as the launch pad for a programme that would take India to its deserved status of a mature economy by the year 2010?

ARVIND PANAGARIYA

In two short years," concluded Yashwant Sinha in his budget speech, "we have sent notice to the world that India will be an economic superpower in the 21st century". That was a little too fast on the part of Sinha. For the notice he actually sent in the two long hours he spoke was that the world had better wait till the 22nd century for India to arrive – and count on China to fill the gap. At the pace Sinha has set for himself in this budget, it may take more than two generations to complete the second-generation reforms.

To be sure, there is much in the budget for which Sinha deserves commendation. Leaving the nuances and qualifications aside for the moment, consider the list of the announcements he has made to advance the cause of the second-generation reforms: rationalisation of indirect taxes, plans to bring services into the tax net, increase in the dividend tax, reduction in the highest tariff rate, reduction in and eventual elimination of tax exemption on export earnings, reduction in fertiliser and food subsidies, plans to bring down the government's share in equity to 26 per cent in most public-sector enterprises and to 33 per cent in public-sector banks, reduction in inequities in the tax and regulatory treatments of venture capital in relation to mutual funds, and a variety of procedural simplifications. These announcements give ample evidence of continued commitment to economic reforms on the part of Sinha and the Vajpayee government.

The bad news, however, is that despite receiving a clear mandate from the electorate and freeing themselves of the menace of Jayalalitha, Vajpayee and Sinha have been timid in their approach. The clearest signal coming out of the budget is that political stability is irrelevant when it comes to the pace of economic reforms in India. Our fate is to continue to muddle through the reforms, chipping inefficiencies here and there but never chopping them off in big chunks. Every so often, we may still achieve a 7 to 8 per cent annual rate of growth but we are unlikely to hit double-digit growth rates – rates that are well within our grasp under bolder policy actions.

Thus, my dissatisfaction with the budget stems principally from the failure of the Vajpayee government to use the occasion to launch broader and bolder long-term reforms. In the recent past, when the coalition governments were fragile, the absence of such a strategy was explicable: even the tiniest group within the coalition carried the power to veto any policy change. But now the National Democratic Alliance is virtually guaranteed its full five-year term and, with the Congress Party in total disarray, highly likely to win another term. Why, then, does the budget have the appearance of the same old *annual* exercise in which finance ministers practise the art of offering minimal policy changes necessary to maintain their image as reformers? Why is there no attempt on the part of Sinha to use the first budget of the five-year-plus mandate as the launch pad for

a programme that would take India to its deserved status of a mature economy by the year 2010?

In the following, I discuss the budget under six major headings: fiscal deficit, tax policy changes, food and fertiliser subsidies, privatisation and voluntary separation schemes, small-scale industries and banking. As far as possible, in each case, I assess the changes announced in the budget and comment on what needs to be done if India is to achieve the status of a mature economy in the foreseeable future.

Fiscal Deficit

Let us begin at the traditional starting point – the budget deficit. This is the subject that has generated most heat in the press though often without much light. Fiscal deficit, which measures the borrowing and other liabilities the government must incur to bridge the gap between total expenditures and receipts from tax and non-tax revenues and loan receipts, is estimated to be 5.1 per cent of the GDP for the year 2000-01. This comes on the heels of equally large deficits under Sinha in the preceding two years: 5.1 per cent in 1998-99 and 5.6 per cent in 1999-2000. By comparison, annual deficits during 1995-98 had been 4.1, 4 and 4.7 per cent in that chronological order.¹

Commentators in the Indian press have given much grief to Sinha for the high deficit. Oddly, with rare exceptions, they have themselves failed to suggest ways in which the deficit could have been held at substantially lower levels, say, between 3 and 4 per cent of the GDP. Some suggestions have been made but they do not amount to so much as half per cent of the GDP and carry disproportionately large political risks. Indeed, Rakesh Mohan, who confronted the issue frontally, concluded that "there is no magical remedy to improving the country's fiscal situation overnight."²

At the outset, one may ask whether deficits of 5 to 6 per cent should necessarily worry us; could it be that we are overreacting? Some may view the mere mention of this question as an act of irresponsibility. But consider just two facts. In the last year, despite the whopping 5.6 per cent fiscal deficit, at 4 per cent, our inflation rate has been remarkably low even by our own hard-to-match historical

standards. And faster growth has brought down our debt-to-GDP ratio from 65 per cent in 1993-94 to 56.6 per cent in 1998-99. If we continue to grow at current rates, this ratio will decline further. Indeed, in a provocative article entitled 'Ponzi Gambles Work: The Big Picture', T T Ram Mohan states that the probability of a Ponzi gamble (i.e., raising more debt to payoff interest) failing is approximately 18 per cent for India.³

I should confess to having no real expertise in macroeconomics: this is an area that has often eluded me. But, like most others, I prefer to err on the side of caution. That translates into a concern for a high proportion of the total expenditure being devoted to interest payments on the public debt. These payments stand at 30 per cent of total expenditures currently and must be met by cutting other important public expenditures, levying higher taxes or running larger deficits. No matter how one solves the problem, investment and, hence, growth is likely to be affected adversely.

What Sinha needs to do is think long-term on this problem. The key question is whether the current debt-to-GDP ratio needs to be brought down. If not, let him say so and confront his detractors head on. If yes, he must decide by how much the ratio should be brought down and how to achieve this goal over a period of, say, five years. Gestures like zero-budget financing in eight departments, leading to the discontinuation or merger of 69 schemes, will simply not deliver. Similarly, the reduction in the interest rate from 12 to 11 per cent on General Provident Funds is a step in the right direction but grossly insufficient.

Tax Policy Changes

The finance minister has introduced a number of changes in this area that must be applauded. Indeed, for some of these changes, he has been wrongly criticised in the press.

Take trade taxes first. The peak custom duty has been brought down from 40 to 35 per cent. This is clearly a step in the right direction. When the Rao government left office, the peak tariff rate was 50 per cent. In 1997-98, Chidambaram brought this rate down to 40 per cent but slapped a 5 per cent across-the-board Special Custom Duty. In 1998-99, Sinha added a Special Additional Duty (SAD) that amounted to 6 per cent in the case of goods subject to the peak rate. Last year, Sinha let Chidambaram's Special Custom Duty

run out but introduced a 10 per cent surcharge on the custom duty. For goods subject to the peak custom duty, this surcharge amounted to 4 per cent. Thus, taking the 6 per cent SAD into account, the effective peak custom duty became 50 per cent. This was precisely the rate applicable in the last year of the Rao government! The 5-percentage points reduction in the peak tariff rate in the current budget finally moves tariff reform forward. Its beneficial impact is likely to be reinforced by the recent WTO ruling that forces the government to abolish licensing on 1,429 items, which are mostly consumer goods and subject to the peak rate.

Sinha has also decided to phase out the income tax exemption for exporters in five years. In the WTO parlance, this exemption is an export subsidy and, in principle, subject to being countervailed. With our per capita income below \$ 1,000, we have some flexibility in dodging countervailing duties by our trading partners but this flexibility is limited. As such, sooner or later, our trading partners were bound to challenge the exemption in the WTO.

But even leaving aside this risk, in my judgment, Sinha showed great courage and good economic sense in opting to phase out the exemption. On national welfare grounds, exports subsidies have even less justification than tariffs. Why should our taxpayers subsidise the consumers in other countries since ultimately it is they who will benefit from the subsidy through lower prices of our exports?⁴

Some commentators have argued that the withdrawal of the exemption will affect our exports adversely. These commentators need to remind themselves that any encouragement to exports should come through the exchange rate rather than tax exemptions or export subsidies. Indeed, it is regrettable that such technology giants as Wipro, Infosys and Satyam Computers will be able to maintain their exemption for some time longer. Under a separate rule in the Income Tax Act of India, software units located in the Software Technology Parks of India (STPI) are exempt from income tax for 10 years from the day of commencement of operations. Most of the big software companies are located in one of the 14 STPIs.

Turning to domestic indirect taxes next, Sinha has decided to replace the multiple Modified Value Added Tax (MODVAT) system by a single, Central Value Added Tax (CENVAT) rate of 16 per cent. This is the main indirect tax to be applied to

most inputs and machinery and will be rebated in full to firms purchasing these items. But many goods, mainly consisting of final goods, are subject to an additional special excise duty that can be applied at three different rates of 8, 16 and 24 per cent. The special excise duty cannot be rebated.

As Govinda Rao has pointed out, in terms of real impact, these changes are largely symbolic.⁵ To quote him, "The overall rates are likely to change only marginally, and this is particularly true of commodities facing the 24 per cent special excise duty". The danger is that the state governments may emulate the central government by levying a VAT at a single rate and special sales taxes at multiple rates.

Therefore, the main benefit from the CENVAT is likely to accrue in terms of administrative simplification and the consequent reduction in tax disputes. Sinha has made an extra effort in this regard by promising to replace what he called "the plethora of existing rules" by a small set of simple and transparent rules. He has also promised to dispense with all statutory records in excise and to require the excise department to rely upon the manufacturer's records. For valuation purposes, the existing concept of 'normal price' is to be replaced by the 'transaction value'. These are important changes that will give tax assesses a measure of relief from the bureaucratic stranglehold. But Sinha also needs to devise mechanisms to make the excise department more accountable. A large proportion of the existing disputes are the direct result of the excise department's refusal to honour the decisions of the courts and filing of appeals when none is warranted.⁶

A number of changes have been made with respect to direct taxes. The one-by-six taxation scheme has been extended from the existing 54 cities to an additional 79 cities in the country. All cities with a population of 2 lakh or more are now covered by this scheme. This scheme has been a key factor in raising the number of taxpayers from 1 crore in 1996-97 to 2 crore currently.

The surcharge on personal income tax has been raised from 10 to 15 per cent. For those in the 30 per cent tax bracket, this is an increase of 1.5 per cent in their tax burden. Thrown in with this tax increase is the tax rebate of Rs 5,000 for women taxpayers along with an increase in the rebate to senior citizens from the current level of Rs 10,000 to Rs 15,000.

Various exemptions currently available in calculating the Minimum Alternate Tax

(MAT) have been eliminated. To compensate for this, the tax rate has been reduced to 7.5 per cent of the 'book profits' from the current effective rate of 10.5 per cent. The MAT has been extended uniformly to all zero-tax companies. The only remaining exception applies to exporters who remain free from this tax.

The tax to be paid by corporations on the dividend they distribute and by debt oriented Mutual Funds and UTI on the income they distribute has been raised from 10 to 20 per cent. On the other hand, banks and financial institutions have been given a reprieve from the 2 per cent interest tax they currently pay. Also, venture capital funds have been given some breaks that remove inequities they suffered vis-a-vis mutual funds.

Virtually all the changes in tax policy Sinha has made are defensible in view of the need for simplification and raising revenues. Some giveaways such as the tax rebate to women taxpayers and the increase in tax rebate to senior citizens may be criticised on grounds of revenue loss in the wake of tight fiscal conditions but these are small potatoes and, moreover, Sinha is entitled to a few goodwill gestures.

The real problem with the tax proposals is that they appear ad hoc, lacking a sense of the long-term direction. For instance, suppose the goal is, as it should be, to bring all custom duties down to 10 per cent or less by the year 2010. Even making the assumption that such liberalisation will significantly increase the imports-to-GDP ratio and that many of the existing duty exemptions will be eliminated, the reduction in tariff rates will lead to a substantial decline in customs duties as a proportion of the total tax revenue. Are we realigning the other direct and indirect taxes in a way that they will be able to compensate this revenue loss? Or is the plan to continue to realign the tax rates every year depending on the needs of that particular year?

Likewise, where are we headed with other indirect taxes? Should we not be moving to a genuine value added tax? After all, what is the rationale for rebating taxes on some items but not others? If the objective is to move towards a genuine value added tax at a single rate, why go through the current circuitous route of the CENVAT and special excise duties? Why not go directly to a single VAT rate properly calibrated to yield the requisite amount of revenue?

And what do we want to do with the sectors that are entirely out of the tax net, namely, services and agriculture? Sinha

has stated in his budget speech that he is setting up an expert group on the taxation of services. This is a very welcome announcement but he needs to move faster. Furthermore, how are we to interpret his silence on agriculture? Is it to be understood that agriculture will stay out of the tax net in perpetuity? If so, what is the rationale for taxing a factory worker earning Rs 75,000 even in the face of high urban cost of living but not a farmer earning even hundred times that amount? In an economy where we are now airlifting a million dollars worth of roses to the Netherlands on Valentine Day, farming is not necessarily just a poor man's source of livelihood.

Food and Fertiliser Subsidies

The reduction in and eventual elimination of food and fertiliser subsidies, which account for nearly 10 per cent of non-plan expenditures on the revenue account, has been a vexed issue since the beginning of reforms in 1991. Successive governments have got nowhere with cutting them. Sinha himself tried and failed to raise the price of urea by so much as Re 1 per kilogram when he presented his first budget. This time, he appears to have made significant progress (assuming he is not forced to roll back once more) and deserves kudos for it.

On food subsidies, the finance minister has gone for increasing the benefits to families below the poverty line (BPL) and essentially easing out households above the poverty line (APL). He has doubled the allocation of foodgrains to BPL families from 10 to 20 kilograms and set the price at 50 per cent of the economic cost. As a consequence, prices per kilogram facing these families will rise from Rs 2.50 to Rs 4.20 for wheat and from Rs 3.50 to Rs 5.89 for rice. In the case of sugar, the price hike is from Rs 12 to Rs 13 per kg.⁷ For APL families, the price of foodgrains has been fixed at economic cost and, hence, double of the corresponding price facing BPL families. Moreover, income tax assesses will no longer be entitled to a sugar allocation from the public distribution system (PDS).

These are all welcome changes. Though the prices faced by the BPL families have been raised, the increased allocation of foodgrains will more than make up for it. They can easily recover the increased expenditure on the original 10 kilograms by selling the new 10 kilograms at the market price. Furthermore, the increase in the price of foodgrains for APL families to economic cost will effectively pull them

out of the PDS altogether. There is no reason for them to go to the PDS if they can buy foodgrains in the private market at similar prices. Since these families account for as much as 40 per cent of total PDS disbursements while leakage accounts for another 30 per cent, we can look forward to a substantial shrinkage of the system.⁸ In turn, this will lead to increased pressure on the government to do something about the bloated bureaucracy and wastage in the Food Corporation of India, an issue from which Sinha has shied away in this budget.

Fertiliser is a more complicated story. Here, as the finance minister himself noted, the real beneficiaries of the subsidy are fertiliser producers rather than farmers. Under the Retention Price Scheme (RPS) for nitrogenous fertilisers, the government assesses and underwrites the cost of production for every single fertiliser factory. Farmers, on the other hand, pay a fixed price that is well below what would be necessary to cover the costs. Government subsidy fills the gap. Increases in the subsidy are essentially the outcome of increases in the costs of production of fertiliser.⁹

It is evident that under RPS, fertiliser producers have no incentive to improve efficiency: a reduction in the cost results in exactly equal reduction in the subsidy. Therefore, there is no solution to the problem short of scrapping the RPS and forcing fertiliser producers to face competition from imports and each other while letting the price facing farmers to be aligned to the world price. There may be a case for gradual phasing in of these policies but not for a different eventual outcome. Some commentators argue for maintaining a genuine fertiliser subsidy to farmers so as to ensure food security. But in my view, this is a mistake. Even if we wish to encourage food production beyond what will obtain at world prices, a policy I do not endorse, the first best intervention is a higher support price for foodgrains rather than subsidy on a specific input such as fertiliser.

Sinha has not taken this course, however. Rather than begin scrapping the RPS, he has raised the urea price facing farmers by 15 per cent. Assuming the price paid by farmers is below the world price currently, this is a defensible move, at least on efficiency grounds. But it is hardly a solution to the problem of fertiliser subsidy. Sinha needs to start cleaning the RPS so that, by 2010 if not sooner, we have the same regime in the fertiliser sector as in other sectors.

Privatisation and VSS

While the Vajpayee government has undoubtedly speeded up the reforms in this important area, the process remains piecemeal and actions half-hearted. The finance minister has announced his clear intention to bring down the government equity in all non-strategic public sector units (PSUs) to 26 per cent or lower. This is clearly a vast improvement over the past approach whereby governments had been often reluctant to disinvest to the point that the management will pass into private hands. At the same time, Sinha has not defined which PSUs are non-strategic so that one wonders how many PSUs will actually qualify for 74 per cent disinvestment. Will the units being successfully restructured go on sale in the near future? And what is the target date for the completion of the privatisation process and other restructuring? Specifically, does the finance minister plan the exit of the government from manufacturing activity except in well-defined, truly strategic areas by the year 2010?

It has been recognised for some time that the resources under the National Renewal Fund are insufficient to meet the cost of Voluntary Separation Scheme (VSS) for PSUs that are too sick to be revived and must, consequently, be closed down. These PSUs have assets, which can be used for funding VSS. Sinha has promised to put in place mechanisms to raise resources from the market against the security of these assets and to use the proceeds to provide safety nets to workers.

While this is clearly a welcome step that had been overdue for some time, the problem of sick industries cannot disappear for good until labour laws are reformed. This is a sacred cow that no one seems to be willing to touch. Yet, the absence of labour laws that allow the hiring and firing of workers on judicious terms serves the interests of neither the firms nor workers. The current laws on layoffs by firms with 100 or more workers impossible constitute a formidable barrier to the entry of new large-scale establishments. At the same time, workers in smaller establishments and unorganised sector have virtually no rights. One also wonders what will happen to workers when more of the existing firms with 100 or more workers become sick. Will the government have any option other than adding them to the rolls of VSS at the taxpayer's expense?

Small-Scale Industries

Sinha has announced some additional credit facilities for small-scale industries

(SSI). The Reserve Bank of India (RBI) had recently dispensed with the collateral requirement for loans up to Rs1 lakh to small units. Sinha has raised this limit to Rs 5 lakhs. A credit guarantee scheme for SSI enterprises is also being launched with the provision for Rs 100 crore in the budget.

These are essentially giveaways that one can digest on grounds of promoting small entrepreneurs provided Sinha would also face up to the reality that the SSI sector is as much in need of being subject to competition as the large-scale industries were back in the the 1980s and before. It has been nearly three years since the Small Enterprises Committee, led by its dynamic chairman Abid Hussain, recommended unequivocally that reservation of products for the small-scale sector must be totally abolished. The committee found the reservation so counter-productive that it even ruled out a phased abolition of it. The committee noted that reservation had hampered the growth of important sectors like light engineering and food processing and also exports from sectors like textiles and leather where India was unable to supply large volumes of quality products in time.

Like its predecessors, the Vajpayee government has essentially refused to face up to this reality. But looking the other way will not make the problem go away. The Multi-Fibre Agreement (MFA) is due to be phased out entirely on January 1, 2005. When that happens and our small-scale enterprises fail to compete against their large-scale counterparts from China in the US and European markets, we may have a rude shock. Even more urgently, with consumer goods imports about to be liberalised, the wall of protection the SSI enterprises have enjoyed in the reserved category products is about to crumble. We can either grant entry to our own large-scale enterprises now and survive or wait until products made by large-scale enterprises in other countries enter our borders and parish.

Banking Sector

Banking sector is in dire need of reform and the budget makes a modest beginning. The most significant announcement is the acceptance of the recommendations of the Narasimham Committee on Banking Sector Reforms for reducing the minimum shareholding by the government in nationalised banks to 33 per cent. Sinha has made it clear, however, that this will be done without loss of the public sector control. He has also announced that he will not close down any public sector bank.

In order to restrain the growth of fresh non-performing assets, Sinha proposes to create institutional mechanisms for sharing of credit-related information on borrowers and potential borrowers among banks and financial institutions. Based on the recommendation of an RBI Working Group, a Credit Information Bureau will soon be established.

Given the maze of distortions in the banking sector, these announcements represent only a drop in the bucket. Space constraints do not permit elaboration but it may be stated that we have a very long way to go before we can boast of a mature banking sector. One key step the finance minister could have taken to speed up the reform process was to open the door to foreign banks wider, perhaps by easing regulations appropriately. Competitive pressure from world-class producers helps improve efficiency in the production of not just goods but services as well. Let the consumer taste the pleasures of modern banking and he will demand the same from local banks, private or public.

Concluding Remarks

There is no doubt that the millennium budget carries forward the task of the second-generation reforms. Its main disappointment lies in the timid approach the Vajpayee government has taken despite the clear five-year mandate from the electorate. If bold reforms are not launched in the first two years of this term, they are unlikely to be launched in the later years. That will be sad for the nation and its people. **EW**

Notes

- 1 See Swaminathan Aiyar, 'Did He Bite the Bullet, Or Did the Bullet Bite Him?', *The Economic Times*, March 1, 2000.
- 2 Quoted from Rakesh Mohan, 'Fiscal Correction Given the Go By', *The Economic Times*, March 1, 2000.
- 3 See *The Economic Times*, March 2, 2000. The calculation is based on Indian GDP growth rates and interest rates since 1970.
- 4 For details, see Arvind Panagariya, 'Evaluating the Case for Export Subsidies', Policy Research Working Paper 2276, World Bank, Washington, DC.
- 5 See Govinda Rao, 'Yet Another Missed Opportunity', *The Economic Times*, March 1, 2000.
- 6 S Venkatarama, 'From Manvat to Modvat to Cenvat to Vat?', *The Economic Times*, March 2, 2000.
- 7 See Gargi Parsai, 'PDS Rice, Wheat Prices Up', *The Hindu*, March 2, 2000.
- 8 These figures are taken from Ashok Gulati, 'Millennium Budget: Bitter, Sour and Sweet', *The Economic Times*, March 2, 2000.
- 9 See C Subramaniam, 'Why Subsidise Inefficiency?', *The Hindu*, March 1, 2000.