BUDGET 2005: NOT BOLD ENOUGH

— BB Bhattacharya

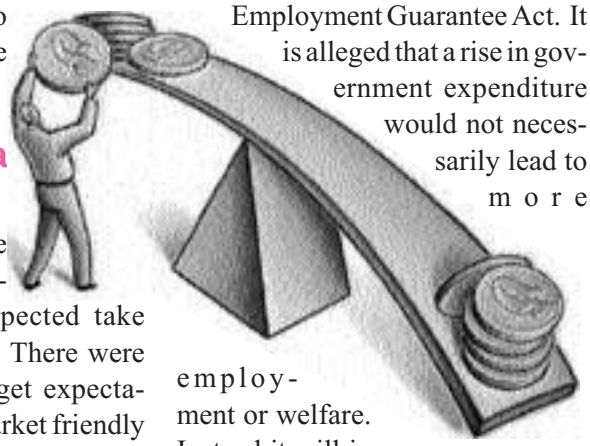
The Finance Minister has deferred the zero revenue deficit target from 2007-08 to 2008-09. This budget appears to be balanced but not bold. It would probably maintain the current 5-6 per cent growth with stagnant unemployment and not lead to a higher growth with full employment. This article provides an analysis of the Budget 2005.

The Union Budget is the most important economic policy instrument in India. The budget determines Central Government revenues and expenditure under various heads, rates of taxation and subsidies and fiscal deficit and it's financing. The Union Budget also influences the State budgets in various ways: it mobilises tax revenues for the States through income tax and excise duties etc., and allocates resources for the States' plan outlay. Currently, tax devolution from the Centre accounts for almost 50 % of States' total tax receipts. The Union Budget also provides a broad framework of monetary policy and trade and exchange rates policies. No wonder, the presentation of the Union Budget gets so much public attention.

The importance of Government budget was expected to diminish after the introduction of economic reforms. The share of government expenditure in gross domestic product has declined since 1991. The tax rates have been reduced over the years, and contrary to the budgetary expectation, the tax GDP ratio has also declined during the last decade. However, despite the downsizing of the government – both at the Centre and at the state levels – the Union Budget continues to play a crucial role in the Indian economy.

Budget in a Nutshell

Given the favourable circumstances, the budget was therefore expected take some bold initiatives. There were two kinds of pre-budget expectations. On one hand, market friendly reformists wanted the budget to make a rapid deregulation of foreign direct investment and public enterprises, including disinvestments in public sector banks and 'Navratna' companies. They also advocated further cuts in taxes, both direct and indirect. In particular, it was recommended that the tax rates in India should be aligned to the East Asian countries' standard. The reformists were also against any increase in government expenditure, particularly against the Employment Guarantee Act. It is alleged that a rise in government expenditure would not necessarily lead to more employment or welfare. Instead it will increase the wasteful budgetary resources and raise the fiscal deficit. On the contrary, not only the Left but also many others were advocating a big boost to public investment and welfare to implement the NCMP. The



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Left were opposed to further deregulation of FDI and public enterprises. Eventually, Mr. Chidambaram presented the budget combining elements from both ideologies. He has cut taxes significantly but has not touched subsidies. He has neither accelerated nor gone back on the deregulations of FDI, FII and public enterprises. There is no mention of the labour reform, which was another item in the wish list of the reformers. The budget does not make any provision for disinvestments. Instead there is an announcement of the review of the banking act for future possible disinvestments in public sector banks. The EGA is accepted but instead there would be a limited scope rural employment generation programme. Education cess is retained and extra budgetary provision is made for health care. The plan outlay is raised substantially, but consequent upon the recommendation of the 12th Finance Commission the Centre will not make market borrowings for the State plan outlays. Finally, the Budget re-emphasises the importance of cutting fiscal deficit, but postpones the zero revenue deficit target year by another year to 2008-09, the terminal year of the current government.

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Taxation

The budget has reduced personal income tax rates significantly. The limit for tax exemption is now raised to Rs.1 lakh per annum in general, Rs.1.25 lakh for women and Rs.1.50 lakh for senior citizens. The tax slabs are also readjusted with 10 % tax rates for income between Rs.1 lakh to Rs.1.5 lakhs, 20 % for income between Rs.1.5 lakhs to Rs.2.5 lakhs and 30% for income above Rs.2.5 lakh. The minimum income for surcharge of 10 % is raised from taxable income of Rs. 5 lakhs to 10 lakhs. However, the standard deduction, which is allowed for salaried income group is abolished. The budget also provides a substantial incentive for saving. Every tax payer is now entitled to tax rebate for saving up to Rs.1 lakh irrespective of income category. The amount of saving up to Rs.1 lakh would now be deducted from the income for the determination of taxable income. All prevailing sectoral caps are removed. The Sections 88 and 80L are abolished. However, deduction for interest on housing loans, medical insurance and expenditure for disability and medical treatment and higher studies will continue. The income tax exemption on interest income from NRI deposits is extended for one more year.

The Finance Minister has also brought down the corporate tax rate for domestic companies to 30%, the highest personal income tax rate. However, there is no change in tax rate for foreign companies. The surcharge of 10% would continue for all companies. The corporate sector would, however, have to bear two burdens. First, the fringe benefits provided to employees in the form of membership of clubs, entertainment allowance etc. would now be taxed at a flat rate of 30%. The budget lists 17 items to be covered under the fringe benefit tax. Secondly, the rebate for depreciation is reduced from 25% to 10%. Mr. Chidambaram stated that despite the additional burden in the form of fringe benefit tax and lower depreciation allowance, the effective corporate tax rate would decline by nearly 3% and thereby encourage new investments in the corporate sector. The corporate sector is however not happy with the fringe benefit tax because the items covered under this includes many legitimate business expenses.

In the last budget, Mr. Chidambaram introduced the security transaction tax at the rate of 0.015%. This budget raises it to 0.02%. This year he proposes a new scheme to discourage illegal transactions. Accordingly, all cash withdrawals of Rs.10,000 and above in a single day from any bank would now have to incur a 0.1% transaction tax. This is another proposal that has received a wide spread criticism. Critics argue that

all bank deposits are already recorded in the bank ledger, and therefore no additional information would be obtained by tracking high denomination cash withdrawals from the banks.

The budget also reduces both excise and custom duties. The custom duties are now brought down more or less to the levels of East Asian countries. As a result, imported machinery and capital goods are expected to become cheaper by 5 to 20%. The excise taxes on several items are slashed for many consumer goods like tea that would now make them cheaper. However, liquor, tobacco and petroleum products are expected to be costlier. Products using steel may also be costlier marginally. The small-scale industry exemption limit is now raised from Rs.3 crore per year to Rs.4 crore per year. CENVAT is further extended and VAT is proposed to replace sales taxes in all states except Uttar Pradesh, which has refused to accept VAT scheme. The Centre has agreed to cover 50% of possible revenue shortfall in first year and 25 % in the second year.

Expenditure

Keeping in line with the spirit of NCMP, the budget has announced National Rural Employment Guarantee scheme to provide employment among poor households in the rural areas of 150 districts. The allocation for this scheme in 2005-06 is Rs.11,000 crores. This is a diluted version of the original employment guarantee scheme proposed in the common minimum programme that would

have cost the government about 1-2 % of GDP per annum depending upon the rate of minimum wage and coverage of the scheme. The budget also allocates Rs. 8420 crore for the National Rural Health Mission. The basic aim for this scheme is to strengthen primary and community health centre system in the rural areas. The education cess would continue to provide additional fund for Sarva Siksha Abhiyan. Special allocations have been made for Bihar, Jammu & Kashmir and the North-Eastern region. Rural infrastructure is proposed to be strengthen by a new scheme Bharat Nirman, under which special emphasis would be laid on rural infrastructure, notably, irrigation, roads, water supply, housing, rural electrification and rural telecom connectivity.

Fiscal Deficit

The overall expenditure of the Government is expected to rise modestly by less than 5%, though revenue expenditure is projected to grow at a comparatively faster rate of 10%. This would continue the general trend of decline in government expenditure – GDP ratio.

The revenue receipts are however projected quite optimistically, despite sharp cuts in both direct and indirect tax rates. The budget estimate of personal income tax for the year 2005-06 is projected to be 32% more than the revised estimate for 2004-05. Similarly, corporate tax collection is also projected to be nearly 30% more than the revised estimate for 2004-05. The union excise duty collections are also expected to rise significantly despite tax cuts. Only customs revenues are projected to fall marginally. With such optimistic revenue projections, the budget hopes to keep gross fiscal deficit at 4.3% of GDP in 2005-06 against 4.5% in the current year. The revenue deficit as a ratio to GDP is however expected to remain constant at 2.7%.

On balance, the budget appears to be broadly development-oriented, though not merely growth-oriented. It has neither sided completely with the NCMP nor solely a tax cut budget. In this respect, it is different from Mr. Chidambaram's dream budget of 1997-98. It has combined tax cut with social welfare schemes and some incentives for savings. The implementation of these schemes as well as hike in general plan outlays would depend on the resource mobilisation. If the tax revenues fall short of budgetary expectations, as they are likely to be, then many of the schemes may be diluted and many projects postponed to future, as usually done in the past . In another major respect this budget is noteworthy. Unlike all budgets during the last decade this budget does not make any provision for disinvestment. Instead, it has proposed to create a special fund for investment in social sector and modernization of public enterprises out of resources mobilised through disinvestments of public

enterprises. The government therefore will not reduce the fiscal deficit by mobilising funds from selling its assets. Although no specific announcement have been made regarding disinvestments, the newly proposed Banking Reform Act might open the scope of diluting shares of government in the nationalised public sector banks. The public sector banks have performed quite well in the stock market in the recent years. If the government sells a significant amount of shares of public sector banks in the market, as indicated in the government pronouncements from time to time, then it will generate a substantial amount for investment in health, education and modernisation of public enterprises. This would however require cooperation of trade unions and left parties.

Fiscal Deficit vs. Growth & Employment

The budget calculations are made on the assumption of 7 to 8 per cent real GDP growth and 12 to13 per cent nominal GDP growth during the year 2005-06. The year 2004-05 may eventually turn out to be a good year with real GDP growth rate around 7 percent and inflation rate of about 5 percent. However, to sustain 7-8% GDP growth in the next year and thereafter would require a big increase in investment in general, and the infrastructure in particular. For a balanced growth it would also require a substantial increase in investment in the agriculture and rural development. This budget efforts in this respect is quite modest. The government wants the banks to provide more credit for agriculture and infrastructure. But the institutional bottlenecks in both of these respects are quite serious. Farmers do not have the capacity to invest in medium and large scale irrigation projects, or road and electrification projects. Nor are they capable of investing in cold storage, warehousing and agro-processing industries, which are essential for agricultural diversification. Not only foreign, but also the domestic companies in India are not encouraged to invest in agriculture. This leaves the option open only for the public sector. Most state governments are fiscally bankrupt. The aggregate subsidy for agriculture is now higher than public investment for agriculture, and the gap is widening. No attempt is made to correct this anomaly in this budget. On the contrary, the central food and fertilizer subsidies are projected to rise by another about Rs.1000 crore in the next year. While the government has stated its concerns about deficiency in infrastructure, no major initiative is taken to step-up investment in infrastructure. The Bharat Nirman Scheme would make only a modest effort in this respect.

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Under these circumstances the government concern about fiscal deficit appears to be a very conservative in its approach towards growth and employment. It is well known that there is always a trade off between fiscal deficit and growth and via growth between employment and fiscal deficit.

The Indian economy right now needs a boost in investment, growth and employment. According to the last quinquinnial NSS Survey, the employment growth has declined sharply in the rural sector. While there has been a rise in employment intensity in industry and tertiary, the overall employment intensity has fallen. Even with 5-6 percent GDP growth the economy is unable to generate adequate employment for the labour force. The investment rate has also stagnated. What is needed therefore, is a big push in investment particularly in the rural sector to generate employment. Since there is no foreign exchange constraint, and the food situation is reasonably comfortable the economy can absorb more public investment.

This is the right time therefore to go ahead with employment generation programmes, even if it requires some extra budgetary resources. The fiscal deficit of the Centre and the states combined has been around 10 % of GDP for now more than a decade. This has been largely due to stagnation and the decline in the tax GDP ratio. The quality of expenditure is also adverse. Public investment and

development expenditures on health, education and social welfare have been crowded out by the resource constraint. This budget could have initiated some bold steps to tackle this problem.

It is true that a big rise in government expenditure even in infrastructure and health and education would generate initially more demand than supply. However, if the expenditures are incurred properly then with a lag it would generate more output. In the case of infrastructure the output lag could be two to five years depending upon the nature of projects. In health and education it could be even longer. Once output increases, the government can collect more tax revenue and reduce fiscal deficit. Thus even if the fiscal deficit rises in the short run there is no need for panic because in the medium run higher growth would generate more tax revenues and there by reduce fiscal deficit. The welfare gains from higher output and employment would also compensate for the welfare loss on account of short-run inflation and fiscal deficit. In any case if the inflation rate tends to go beyond a limit, say 10 % or more, then it can be controlled by importing goods and services utilising the huge foreign exchange reserve. Currently, the foreign exchange reserves are about 18 times the annual imports, well above the international norm.

The foreign exchange reserves can also be utilised for investment in infrastructure. Out of the $130 billion worth of foreign exchange reserves, the government can easily take out $5 billion every year for infrastructural investment. Once again, the short run trade off between inflation on the one hand and growth and employment on the other can be reversed by the long run benefits from infrastructural projects.

There are two basic criticisms against higher government expenditure. First is the potential inflation and crowding out phenomenon mentioned above. The other criticism is about the delivery mechanism. Critics allege that the government expenditure leads to wasteful spending with no benefits to the society. Similar expenditure in the private sector would derive more benefits with lower costs. This may be partially true. However in the absence of any private investment in both infrastructure and agriculture the government will have to breach the gap even it leads to a lower efficiency in the utilisation of resources. A bad rural road is better than no rural road. Of course, the government should improve the efficiency of expenditure through better monitoring and projects election. The Prime Minister, Prof. Manmohan Singh has recently called for an administrative reform to improve the efficiency of government functioning. This is a welcome step. But even if some positive benefits accrue from the public spending, then there is a case for higher government expenditure, even though it may lead to a marginally higher fiscal deficit. In any case, the Finance Minister has deferred the zero revenue deficit target from 2007-08 to 2008-09. On balance this budget appears to be balanced but not bold. It would probably maintain the current 5-6 percent growth with stagnant unemployment and not lead to a higher growth with full employment. ■

ERRATA

In the Group Photograph of the Members of the Nineteenth Council published at page 1159 of the March 2005 issue of this Journal, against the heading "*Not in Picture*", the name of Shri Sidharth Kumar Birla was inadvertently omitted to be included. Non-inclusion of the same is deeply regretted.