India's Budget 2004-05: A Disappointing Blend

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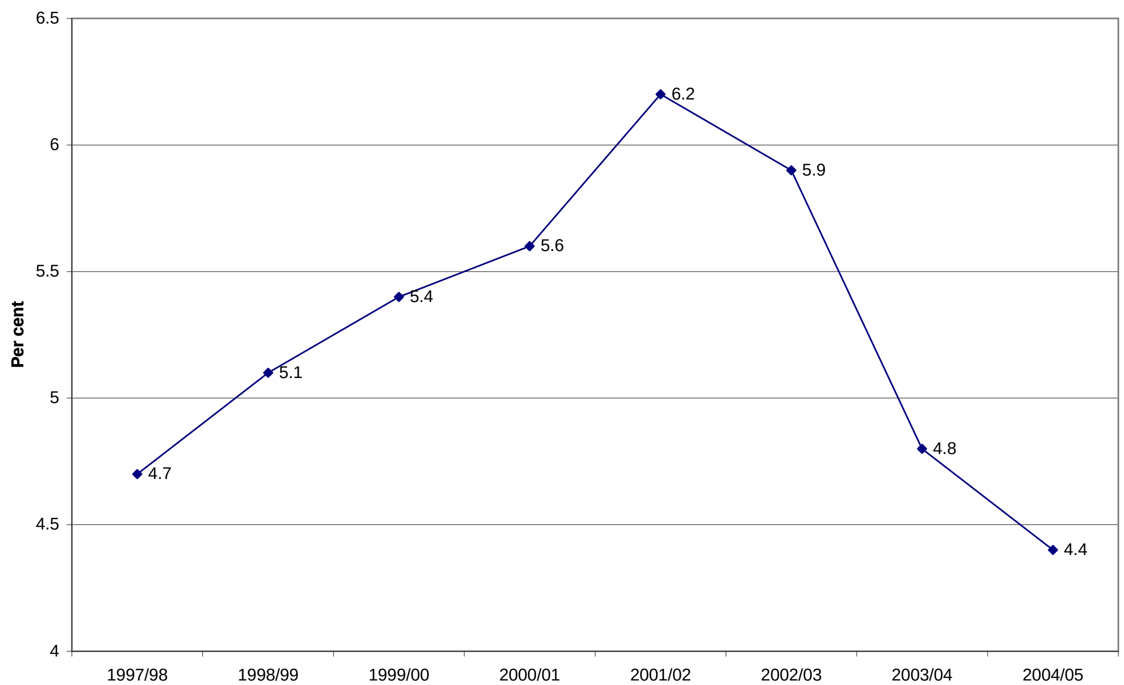
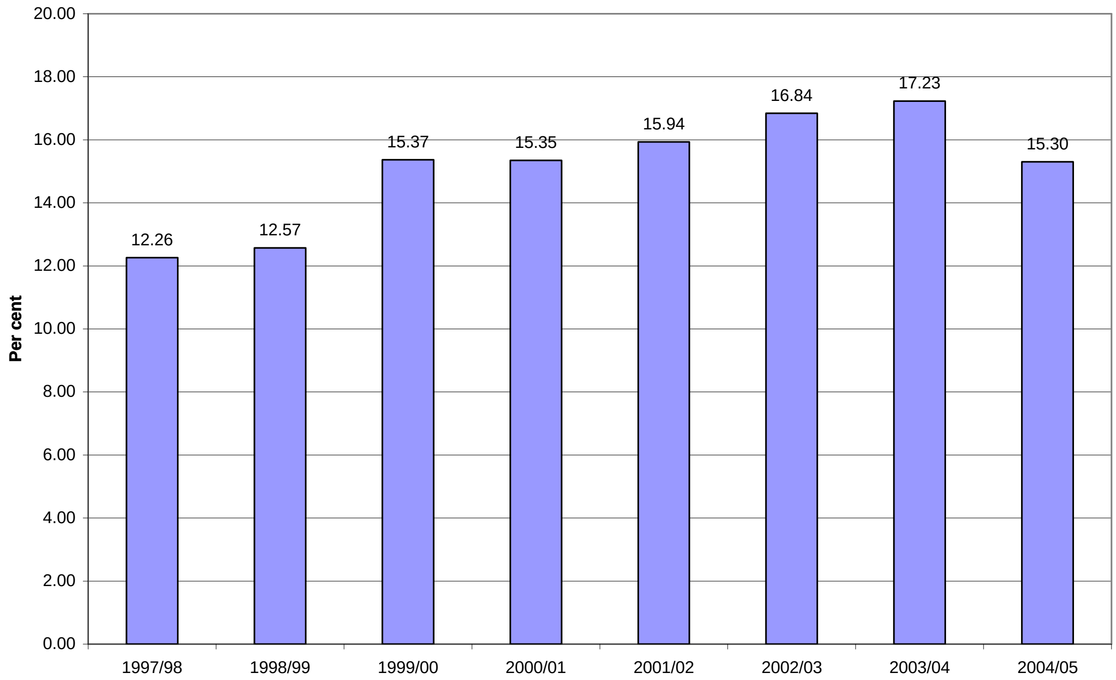
Despite periodic statements to the contrary, the annual budget of the Government of India is a major instrument of its economic policy. It reveals the fiscal stance – expansionary, neutral or deflationary – of the government at each point in time; it reflects its economic policy priorities; and it discloses the way in which the burden of financing the pursuit of those priorities is sought to be distributed. To these features characteristic of all budgets must be added the special nature of Budget 2004-05. Coming as it did in the wake of what to many was a surprise election verdict against the NDA and its economic policies, this budget was expected to mark a departure from the neo-liberal economic regime of the 1990s that had resulted in agrarian distress, near-stagnant employment growth, inadequate progress in poverty alleviation and a sharp increase in urban inequality.

Chart 1: Fiscal Deficit to GDP



The first impression is that Finance Minister P. Chidambaram has responded to the election mandate for a redirection of economic policy. Part A of his budget speech is peppered with copious references to agriculture, education, health and employment, even if the financial allocation for many programmes under these heads amounts to mere tokenism. In addition, he has made a special allocation of Rs. 10,000 crore for the Planning Commission to implement the National Common Minimum Programme (NCMP) of the UPA.

Chart 2: Ratio of Total Budgetary Expenditure to GDP

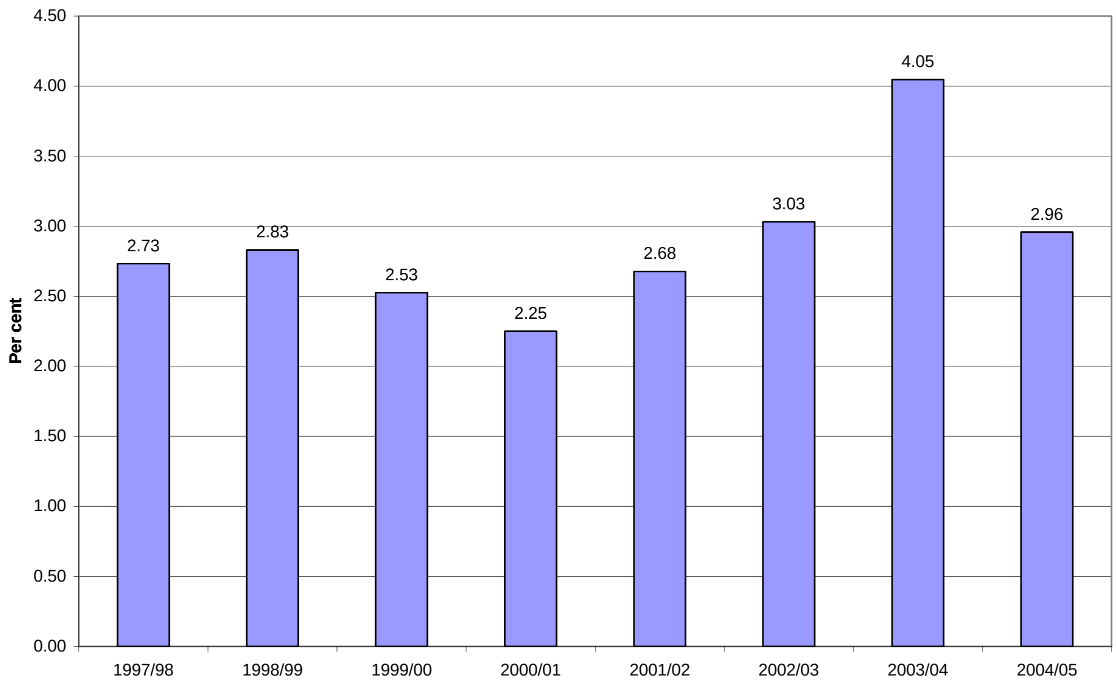


To finance these commitments, he appears to have made some efforts at resource mobilization as well. He has stuck by the promise made in the NCMP to impose a 2 per cent cess to mobilise about Rs. 4,000 crore for education. He has imposed a tax, even if only a marginal 0.15 per cent, on stock market transactions. He has increased the service tax from 8 to 10 per cent and extended its reach by adding a number of sectors to the 58 already being taxed.

While all these can be seen as positive steps forward in redeeming election promises and fulfilling the election mandate, a close look at the budget results in disappointment. To start with, the new government has chosen not to depart from the macroeconomic framework typical of the pre-existing neo-liberal regime. As the Economic Survey had noted, India's food stocks are still at relatively comfortable levels; it has access to an embarrassingly high reserve of foreign exchange; and industry is characterized by substantial excess capacity. This offers an opportunity to launch an expansionary fiscal programme, which, if focused on investments in irrigation and the infrastructural areas, can result in output and employment growth and help raise savings and government revenues that can partly finance the expenditure undertaken to realize that expansion. However, accepting the irrational constraints on fiscal policy set by the Fiscal Responsibility and Budget Management Act, the Finance Minister has chosen to limit the fiscal deficit at 4.4 per cent of GDP.

The result of this fiscal conservatism parading as fiscal prudence is that the aggregate expenditure budgeted for 2004-05 is, at Rs.4,77,829 crore, more or less the same as the Rs. 4,74, 255 crore spent in 2003-04. Since plan expenditure is budgeted to rise by Rs. 24,000 crore, from Rs. 1,21,507 crore to Rs. 1,45,590 crore, the Finance Minister has had to budget for an almost equivalent reduction in non-plan expenditure from Rs. 3,52,748 crore to Rs. 3,32,239 crore. This has been ensured through a huge reduction of budgeted ***capital expenditures on the non-plan account*** from Rs. 67.946 crore to Rs. 38,589 crore, which has not been matched by the increase in plan capital expenditures from Rs. 43,421 crore to Rs. 53,747 crore. In sum, the immediate casualty of fiscal conservatism is much needed capital expenditure which would have helped relax crucial supply constraints in the infrastructural area, even while stimulating demand and ensuring growth.

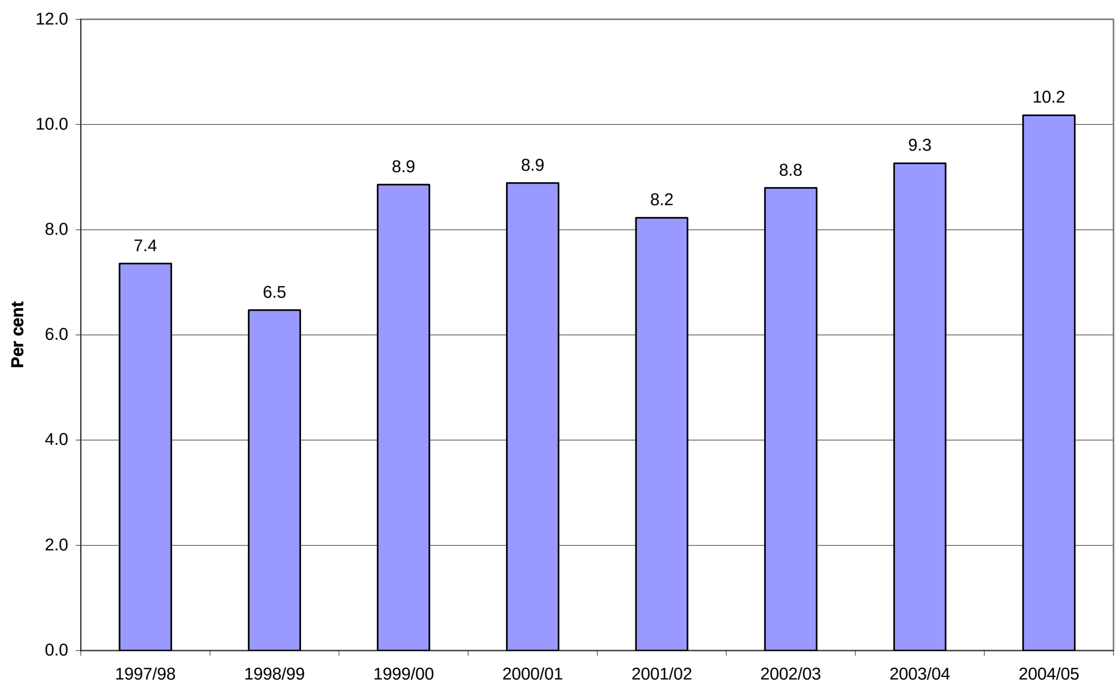
Chart 3: Capital Expenditure to GDP



This limit on aggregate spending has been accompanied by a huge increase in the defence budget. In a surprise move, the government has chosen to allocate an additional Rs. 16,700 crore for defence, by increasing the defence budget from Rs. 60,300 to Rs. 77, 000 crore over the financial year. This increase is surprising since even the interim budget had provided for only Rs. 66,000 crore for defence. Even granting that national security is an important concern, this huge increase in allocation seems unwarranted at a time when the security situation can hardly be described as critical and when problems such as an agrarian crisis, rising unemployment and persisting hunger and malnutrition are serious. In practice, the **additional** allocation for defence exceeds the special allocation for the NCMP, which sends out wrong signals about the priorities of the government. And given the government's obsession with the fiscal deficit, it is inevitable that this increased allocation would have limited its expenditures in other crucial areas.

The fall-out of this combination of fiscal conservatism and largesse for defence is visible, for example, in the reduced allocations for rural development and employment. The total expenditure incurred by the Ministry of Rural Development is estimated at Rs.15,061 crore in 2002-03 and Rs. 15,519 crore as per the revised estimates for 2003-04. As compared with these figures, the budgeted expenditure for 2004-05 is placed at just Rs. 11,456 crore. What is more, this Rs. 4,000 crore reduction in expenditure relative to the revised estimates for 2003-04 is largely on account of a sharp fall in the allocation for rural employment programmes, from Rs. 9,640 crore in 2003-04 (RE) to Rs. 4,590 crore in 2004-05 (BE). It could be argued that the expenditure in 2003-04 was unusual, since it included a Special Component of the Sampoorna Gramin Rozgar Yojana (SGRY), aimed at augmenting food security through food-for-work schemes in calamity affected areas. But given the state of agrarian distress in most parts of the country and the new government's stated commitment to augmenting employment, the sharp fall in allocation can hardly be justified.

Chart 4: Gross Tax Revenue to GDP



In fact, with the government having committed itself through the CMP to guarantee 100 days of employment at the minimum wage to one member of every needy family in the country, a substantial additional allocation for employment generation was expected. The government could argue that employment being created with existing expenditures in various sectors could be used for the purpose of implementing the guarantee. But if existing allocations were enough to realise this objective, then there would have been no need for a special guarantee.

The view that the special allocation of Rs.10,000 core to the Planning Commission can be used to realise this goal is also not defensible. The wage and capital expenditures together required for provision of 100 days of employment for a single individual in a year would total Rs. 9,000. Assuming that *on average* about one-third to two-fifths of households in the country would opt for such employment, the expenditure required to implement the employment guarantee works out to around Rs. 45,000 crore. Hence the additional allocation of Rs. 10,000 crore for the CMP would be inadequate, especially since a significant part of that allocation would have to go to meet the expenditures on education to be financed by the special cess that is expected to yield Rs. 4,000 crore for the purpose. The budgetary allocation for all levels of education is, at Rs. 11,062 crore, only around Rs.800 crore higher than the expenditure in 2003-04, indicating that the allocation aimed at raising over time the expenditure on education from 3.1 to 6 per cent of GDP has yet to be made. Funding for that purpose would have to come out of the sum earmarked for the CMP.

Overall, therefore, the budget does not seem to have provided the finance to meet the various commitments made in the CMP and referred to in Part A of the Finance Minister's speech. But the sense of disappointment generated by the budget does not end here. Another area of concern is the fiscal relationship between the centre and the states. It has been clear for some time now that urgent measures are needed to help the states recover from the fiscal crisis they have been in, especially since the implementation of the Vth Pay Commission's recommendations. While an increase in resource transfers to the states through an increase in their share in taxes would have to wait for the Finance Commission's recommendations, immediate steps in the form of enhanced Plan and non-Plan grants and a restructuring of their debt by swapping low-interest debt for high interest debt was called for. In particular, the practice of the Centre charging the states an interest rate on their borrowing from the Centre which was much higher than the interest rate paid by the Centre on its own borrowings had to be reversed. However, even while recognising the need to strengthen the hands of the state governments, which must necessarily play an important role in implementing the CMP, the budget makes no major effort to correct the fiscal squeeze being faced by the states. Much is made of the reduction of interest rates paid by the states on borrowing from the centre from 10 to 9 per cent. What was not mentioned was that the Centre today borrows in many cases at interest rates which vary between 4 and 6 per cent, and lends to the states at 10 per cent.

Despite these measures to curtail its expenditures, even if at the expense of the realisation of its stated objectives and commitments, the government would have had to mobilise additional resources to finance its activities and meet its self-imposed fiscal deficit targets. Some effort in this direction is indeed visible in the budget: primarily, the imposition of a transactions tax on financial transactions in equity and debt markets; and, an expansion of the coverage in taxation in services. While such moves have to be welcomed, their impact has been marginal because of the extremely low rates at which those taxes have been levied, the marginal increase in coverage and the concessions in other areas that have accompanied these measures in the name of rationalisation of taxes. In the event, the additional resources mobilised through the budget is meagre, forcing the Finance Minister to fall back on an unusual source of additional revenue, viz. recovery of tax arrears due from cases where the tax claims have not been legally disputed.

Arguing that there is a kitty of close to Rs.18,000 crore under this head and assuming that he would be successful in mobilising a significant share of that kitty, the Finance Minister has made extremely optimistic projections of tax revenue collections under different heads. Corporation taxes are estimated to rise by 41 per cent, income taxes by 27 per cent and excise duties by 18 per cent. If these targets are realised, the gross tax revenue to GDP ratio would rise by one percentage point from 9.3 per cent in 2003-04 to 10.3 per cent in 2004-05.

There are no reasons whatsoever to believe that such large additional revenues from taxes would actually materialise. Hence, the final collections are likely to be much lower than projected, forcing the government either to reduce its expenditures even more than provided for in the budget or to accept a much higher fiscal deficit. Rather than lay himself open to that possibility in the very first budget of the new government, Mr. Chidambaram could have done better by making adequate expenditure provisions, ensuring a higher level of additional resource mobilisation and allowing for a substantially higher fiscal deficit, given the context of a demand constrained economy which makes that deficit benign from the point of view of inflation.

The reason why the Finance Minister and his colleagues did not choose that route seems to be their neo-liberal mindset. In the event, inadequate moves on the development front have been accompanied by policies that seem to suggest persistence with the liberalisation agenda of the previous government. Foreign Direct Investment caps have been raised substantially in telecom, civil aviation and insurance. Foreign Institutional Investors have been provided a range of concessions in the form of lower capital gains taxes, greater access to the debt market and higher ceilings for their shareholding in different sectors. Banks are to be encouraged to increase their speculative exposure to the stock market. And privatisation is to be persisted with in the name of "piggy-backing" on new share issues by profit-making companies like the NTPC.

Given the mindset these policies reflect, an adherence to fiscal conservatism and the adoption of a market-friendly taxation framework was inevitable. Unfortunately, however, the nature of the mandate obtained by the new government required it to depart from neo-liberalism and redirect economic policy in favour of the poor. Faced with this dilemma the Congress-led government has made some moves that are suggestive of a new agenda. But overall it seems to have adopted the soft option: it has dressed the budget in pro-poor rhetoric but chosen not to implement what it claims it has set out to do.