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A fiscal-consolidation budget that falls short on reforms

The most urgent reform unfortunately omitted is the resolution of non-performing loans and the clean-up of corporate and bank balance sheets

Had the GST been rolled out in this budget, it would have been the most far-reaching reform since economic liberalization in 1991. Photo: Bloomberg

In the budget he presented two weeks ago, finance minister Arun Jaitley stayed the course on fiscal consolidation but fell short in outlining an agenda for structural reforms. In this assessment, an analysis of the fiscal stance of the budget is followed by a review of some major aspects of expenditure and revenue and finally, a discussion of the reform agenda or, rather, the missing reform agenda.

The overall fiscal stance has to be assessed in the context of declining growth, modest inflation and moderate public debt. Even without factoring in demonetisation, the Central Statistics Office forecast that growth would slip to 7.1% in 2016-17, down from 7.6% in 2015-16. My colleague and I forecast a more modest 6.8% growth in 2016-17, which had to be further reduced to 6.1% on account of demonetization (See: "Growth Deficit And The Fiscal Deficit", *Mint*, 20 January). This is only slightly lower than the 6.5% forecast in the Economic Survey and remarkably close to the implicit forecast of 6.2% real growth, with an assumed inflation rate of 4.8%, in the medium-term fiscal policy statement of the budget.

Another aspect of the macroeconomic scenario is public debt. Central government liabilities currently stand at 44.7% of gross domestic product (GDP), down from 46.7% last year. Thus, it is on a declining path, approaching the 40% target recommended by the fiscal responsibility and budget management (FRBM) review committee.

Though growth has dipped, inflation remains moderate and public debt is on a safe trajectory, the 2017-18 budget has limited the fiscal deficit to 3.2% of GDP, just marginally higher than the earlier target of 3%. Clearly, fiscal consolidation is a major focus of this budget. But it is overly conservative in my view. Without compromising the downward glide towards the 40% level of sustainable debt, the budget could have allowed for, say, a 0.2% higher deficit. That plus savings from cutting unwarranted subsidies could have enhanced the measly provisions for irrigation, education and health as discussed below.

In line with its conservative fiscal stance, the budget has allowed only a 6.6% growth in total expenditure, way below the expected nominal GDP growth of 11%. Within this overall cap, however, spending will grow quite sharply in some sectors and very little in others. In this context, the following points are worth noting regarding expenditure allocations.

Barring interest payment, a committed expenditure inherited from the past, major subsidies are the largest component of expenditure, accounting for 12% of total expenditure. The largest of these, amounting to Rs1.45 trillion, is the food subsidy, a merit subsidy mandated under the National Food Security Act. Considerable savings could be realized by better managing the food subsidy and eliminating all the other non-merit subsidies. The petroleum and diesel subsidies have indeed been eliminated. But kerosene and LPG are still being subsidized and the fertilizer subsidy has also been maintained at Rs70,000 crore. Evidently, political considerations have constrained firmer action on these fronts.

Defence expenditure is the next largest item, accounting for 12% of total expenditure and nearly a third of capital expenditure. Limiting the increase in defence expenditure to 5% has raised concerns, but I trust that the finance minister and the cabinet committee on security know what they are doing.

Infrastructure, a major priority of this government, absorbs 9% of total expenditure excluding railway revenue expenditure, and 40% of capital expenditure. That goes up to 56% if we also count railway capital expenditure from extra-budgetary resources. But most of this expenditure is allocated to transport, especially roads and railways. New investment in other infrastructure has been left largely to the private sector. This is justifiable for energy and communications, but not for irrigation, where large externalities are involved, requiring public action. State governments are responsible for medium and small irrigation projects, but the Central government alone is responsible for large irrigation projects with command areas and canal systems that stretch beyond individual states. Hence, the virtual exit of the government from irrigation is deplorable.

In sharp contrast to defence and infrastructure, the allocations for all the social services taken together are only 5% of total expenditure, i.e., less than half the total spending on defence. The core social services, education, health and sanitation and water supply get shares of 1%, 1%, and 0.6%, respectively. These are state subjects but also merit services of vital national importance, essential for the rapid growth of

productive employment. Per capita public expenditure on education and health is the lowest in India among all emerging market economies and all major Asian economies. Hence, the paltry allocation for social services is another unfortunate lacuna in the expenditure budget.

On the receipts side, total revenue is projected to grow at 12.2%, which is reasonable. However, direct taxes are assumed to grow at 15.6%, implying a high direct tax buoyancy of over 1.4. This is entirely attributable to the exceptionally high growth of about 25% assumed for personal income-tax receipts. No justification is provided for such an optimistic projection.

Barring agriculture, which is exempt from direct taxes, the finance minister has provided direct tax relief for all segments of the economy most affected by demonetization. Medium and small enterprises which account for the bulk of non-agricultural employment, real estate which was already in the doldrums before demonetization, and white-collar workers from the lower middle class. The relief is welcome. Whether it is enough to adequately compensate for the damage done, the closed businesses and lost jobs is another question.

Indirect tax revenue is projected to grow at only 8.8%, compared to actual growth of 20% last year. Excise duty receipts which grew by 35% last year are projected to grow by only 5.5%. This is presumably because the recent hardening of oil prices will preempt the windfall revenue the government collected when oil prices had dipped. In any case, the indirect-tax projections are only of academic interest as they will be overtaken by events when the new goods and services tax (GST) regime becomes operational, at the latest by September 2017.

Among other receipts, the receipts from disinvestment are again unduly optimistic. In 2016-17, the actual realization was only Rs45,500 crore compared to a budget projection of Rs56,500 crore. Despite this, the budget for 2017-18 makes an even more optimistic projection of Rs72,500 crore.

Finally, coming to debt receipts, the budgeted market borrowing and short-term borrowing were reduced by Rs18,000 crore and Rs52,000 crore, respectively, in 2016-17. This was because a larger share of the deficit is now being financed by National Small Savings Fund (NSSF) receipts. As recommended by the 14th Finance Commission, NSSF receipts are now mostly retained by the Centre and its share in financing the deficit has been going up.

Apart from expenditure and revenue proposals, the budget is usually used as a platform to announce structural reforms which may or may not be directly related to the budget. This component is largely missing in the present budget. Had the GST been rolled out in this budget, it would have been the most far-reaching reform since economic liberalization in 1991. Unfortunately, negotiations in the GST council could not be concluded in time. Minus GST, the only significant reform visible in the budget is the move towards digitization, compression of the cash economy and curbing the generation of black money.

Digitization began with Aadhaar under the previous government, but it has been actively pursued by the present government. Aadhaar was followed up by the JAM trinity—Jan Dhan Yojana, Aadhaar and mobile telephony—in the last two years. The present budget has announced several elements to take this agenda forward, e.g. the BharatNet high-speed broadband project, online education courses, introduction of telemedicine, extending the online e-NAM coverage of agricultural produce market committee markets, BHIM and other Aadhaar-enabled e-payment platforms. The budget has also provided incentives to encourage digital financial transactions. Finally, a computer emergency response team is being set up to deal with cybercrime.

Digitization and efforts to compress the scale of cash transactions are also important interventions to curb the growth of black money because unrecorded cash transactions are the natural medium for tax evasion. A related move is the introduction of measures to limit cash contributions to political parties, a major driver of tax evasion and black money. Despite the obvious loopholes, the measures should be welcomed because they have put the spotlight on the close nexus between black money and political funding. Regulated and transparent political funding is now on the reform agenda.

Digitization and the push towards a less cash-dependent economy and polity are arguably the only significant reform elements in this budget. There is some further liberalization of foreign direct investment provisions, such as the abolition of the Foreign Investment Promotion Board, and a few initiatives on the public enterprises front. That apart, the budget offers very little by way of a structural reform agenda. The most urgent reform unfortunately omitted is the resolution of non-performing loans and the clean-up of corporate and bank balance sheets. As the Economic Survey has again pointed out, without addressing this “twin balance sheet” problem, private investment will remain gridlocked. And without the revival of the private investment cycle, India cannot return to its potential growth path.

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