A Precarious Balancing Act

Budget 2011-12 is all about fiscal consolidation sans inclusive growth

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The finance minister had an exceptionally challenging task in this year's Budget. He was faced with three major goals pulling in different directions. With headline inflation close to double digit, and food prices having risen over 20% in February, his main goal was fighting inflation. However, he needed to do this without compromising on high growth, which is now back on track. Moreover, he also needed to address the inclusion agenda being energetically pursued by the Sonia Gandhi's National Advisory Council. It turns out that he focussed on fighting inflation, taking a risk on compromising growth and postponing the inclusion agenda.

His main tool for fighting inflation is deficit reduction, supplementing the monetary tightening policies already being pursued by the RBI. Deficit reduction is also the core of the fiscal consolidation strategy recommended by the 13th Finance Commission to reduce public debt and contain pre-emption of public resources for debt servicing at the cost of social and development spending. The Budget has accordingly focussed quite aggressively on containing the deficit. The central government fiscal deficit declined to 5.1% of GDP in 2010-11, as against a target of 5.5%. This is now to be reduced further to 4.6% by 2011-12 en route to 3% by 2014-15. The game plan is to achieve this target by containing the growth of expenditure, not raising more tax revenue.

In fact, not much has changed on the taxation side. In direct taxes there is a small increase in the income tax exemption, additional tax relief to senior citizens and a reduction in the corporate tax surcharge. But there's also an increase in MAT, withdrawal of excise exemptions from 130 items, extension of some customs duty exemptions to some items and a marginal expansion of the service tax base for high-end healthcare, restaurants, and air travel. The net effect of all these measures will be additional tax revenue of less than Rs 5,000 crore.

Even without a significant tax effort, tax revenue will still grow because of GDP growth. With assumed tax buoyancy, assumed GDP growth of 9% and 5% inflation tax revenue will grow by 18%. However, non-tax revenues will be lower at Rs 1.25 lakh crore compared to Rs 2.20 lakh crore last year with no exceptional bonanza from 3G spectrum sales. Hence the main plank for deficit reduction will be compression of expenditure. In fact, the Budget assumes expenditure growth of only 3.4%. This is lower than assumed inflation, hence an absolute reduction in real terms. Against the nominal GDP growth of 14%, this implies a very severe expenditure compression. Whether such a target is realistic is questionable since so far the government has not managed to compress expenditure. The deficit target is being met mainly on account of more than expected gain from spectrum sale and tax revenue.

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More in one place will mean less in another

If, on the other hand, tough expenditure compression targets are actually realised, this would help contain inflation but compromise growth. When the 13th Finance Commission recommended deficit reduction, it also recommended an increase in the share of capital expenditure, requiring a squeeze only on revenue (current) expenditure. The revenue deficit is to be reduced to zero by 2014-15. Unlike current expenditure, capital expenditure, i.e., public investment, also stimulates private investment, the main growth driver, thereby generating a strong multiplier effect on GDP growth.

However, the government has found it extremely difficult to curtail only revenue expenditure. The Budget makes a valid qualification about grants to states from revenue expenditure that actually create capital assets. However, even after adjusting for this, planned expenditure compression is not public investment enhancing. It will likely lead to a significant reduction in the growth stimulus.

The business community was upbeat when the Budget was presented and the stock market gained around 2.5% in an hour. It was reacting to the absence of much additional taxation, the Rs 40,000 crore provision for sale of public sector equity, liberalisation of foreign investment regulations, and a modest public borrowing programme of Rs 4.12 lakh crore that will ease pressure on the interest rate. Clearly, the market had not fully factored in the Budget's negative growth impact. Combined with the external effects of the sovereign debt crisis in Europe, the Middle East crisis and the spike in oil prices to over $130 a barrel, the growth outcome for 2011-12 is likely to be distinctly lower than the assumed 9%.

Finally, the Budget has postponed the inclusion agenda. The NAC has been pressing for pro-poor spending on employment programmes like NREGA, food security and social sector spending on education, health, etc. However, proposed spending on most of these items is either lower or about the same in 2011-12 as in the revised estimates for 2010-11. Allowing for inflation, that means an actual decrease in real terms. In the rural employment programme, for instance, the finance minister announced that wages will be indexed to inflation, but the absolute allocation is no more than in 2010-11.

This is not surprising. Economists talk about the political business cycle in fiscal policy. Hard measures are taken only in the first half of an elected government's tenure. Popular measures take over as elections approach. Given all his competing goals, and with elections still three years away, the finance minister has postponed the inclusion agenda. However, that agenda will become increasingly visible during the next two years.

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