ISAS Brief

No. 115 – Date: 8 July 2009

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

Indian Budget 2009-10: Carefully Crafted but Not Without Risks

S. Narayan[1]

The budgetary numbers for the year 2009-10 were unveiled by Indian Finance Minister Pranab Mukherjee on 6 July 2009.

For international credit rating agencies and foreign financial institutions, the foremost concern would be the fiscal deficit, which is budgeted to be the highest ever, at 6.8 percent. Net tax receipts to the central government, at Rs 4.74 trillion, are lower than the estimates for 2008-09, mainly due to a give-away of about Rs 10 billion of personal tax revenues in relief to the middle class. Market borrowings, at about Rs 3.97 trillion, are slated to be the highest ever, and repayment of debt instalments and interest payments exceeds net receipt of revenues to the centre.

On the face of it, the Finance Minister is walking a fiscal tightrope, with the finances strained at close to unsustainable levels. The stock markets have reacted downwards and there have been no announcements about any large ticket reforms or disinvestment in government undertakings. The *Business Standard*, New Delhi, had this editorial on the budget:

> *The only explanation for the broad calculation underlying the Budget is that the government is more nervous about the state of the economy than it lets on. A fiscal deficit of 6.8 percent of GDP [Gross Domestic Product], up from 5.5 percent postulated in February's Interim Budget, means an additional stimulus of nearly Rs 80,000 crore. No government, already saddled with a big public debt overhang, undertakes such spending unless it feels compelled by the circumstances. A finance minister who believed that the worst of the economic slowdown was over would have moderated spending, and capped the deficit at last year's 6.2 percent. To not do that, and to provide for a significant step-up in spending (about Rs 67,000 crore more than indicated in February), implies a lack of faith in the revival of private demand and therefore the need for additional public spending stimulus. It is interesting in this context that the nominal (that is, real plus inflation) GDP growth assumed in the budget numbers is only about 8.5 percent – the slowest in a long, long while. If the economy is indeed stuck in the slow lane and, therefore, in need of turbo-charging, then one cannot quarrel with the budgetary arithmetic. If not, the government has committed a serious error of judgment. Deficit spending on this*

---

[1] Dr S. Narayan is Head of Research and Visiting Senior Research Fellow at the Institute of South Asian Studies, an autonomous research institute within the National University of Singapore. He is the former economic adviser to the Prime Minister of India. He can be reached at snarayan43@gmail.com.

scale risks an international rating review with consequences for the rupee's external value, potential inflation down the road, and higher interest rate – which would have the unintended effect of crowding out private sector activity because of the increased cost of money. Admittedly, the money market is ruling easy just now, and the impact of additional government borrowing will be at the long end, not in short-term rates that affect the cash credit market. Also, inflation is not a live issue; and ratings are fallible and therefore possible to counter. So the government could make a case for what it has done. But one simply has to countenance the scale of the government's borrowing programme (up an astonishing four-fold from the Budget in February 2008 to this one, to nearly Rs 4 lakh crore) to realise that something extraordinary has happened, and that this is not sustainable. The total spending by the government has increased in the last two years from Rs 7.1 lakh crore to Rs 10.2 lakh crore; almost the entire increase has been funded by additional borrowing. Suffice it to say that this level of deficit spending will make a lot of people uneasy and eventual correction more difficult.[2]

The outlay for the National Rural Employment Guarantee Scheme (NREGS) has been hiked by 144 percent (Rs 39,100 crores). Bharat Nirman Programme has an increase of 45 percent and there is substantial increase for the Rural Health Mission as well. Most people believed that the Budget would significantly increase allocations on highways, railways and urban infrastructure. These happened as well. The National Highways Authority of India has received 23 percent more than last year's budget; the railways have received a generous dollop of funds; and the Jawaharlal Nehru Urban Renewal Mission has had its financing increased by 87 percent to Rs 12,887 crore.

It is basically an expenditure-driven budget and the promises of fiscal rectitude are for the future. The return to fiscal responsibility and budgetary management, and the introduction of a nutrient-based fertiliser subsidy and a committee to determine how to free up product prices in petroleum are all promises for the future, without any timeline. There is also no clear mention of targets for disinvestments or for the reform bills in the insurance and banking sectors.

It is important to examine the rationale for the budget to try to understand the strategy that is driving these actions. First, there is the need to restore growth and, given the sluggishness of the global economy, growth has to come from domestic consumption and not from sharp growth of export or trade. It is reasonable to expect that, in the next nine months of the financial year, commodity prices and, most importantly, oil prices, will not spike and the consequential costs of imports would be largely under control. However, there is some doubt over the monsoon and this could lead to inflationary pressures, especially in food products, edible oil and vegetables.

There is sufficient liquidity in the economy and little need to revisit interest rates again. Therefore, the push for growth has to come out of an expansionist fiscal policy and to put more money in the hands of consumers for greater consumption. The lowering of personal income taxes would help in two ways – by leaving behind more money in the hands of the consumers, it would provide a hedge against inflationary pressures that may arise due to the poor monsoon and, at the same time, make available money for consumption expenditure, should that be needed. The recent summer and the sharp increase in sales of air-conditioners,

[2] *Business Standard*, 7 July 2009.

coolers, fans, refrigerators, water coolers and soft drinks has demonstrated the capability of the Indian citizen to spend on goods and services – it is only necessary to nudge him to expand his consumption portfolio.

Second, there is the need to provide for those that are disadvantaged – the rural poor. These are likely to be affected not only by a poor monsoon but also by the losses in employment in the unorganised sector, including handicrafts, diamond-polishing, glass-making, textiles and carpet-weaving. Over a million jobs have been lost and there is a need to extend the safety net provided by the NREGS. The provisions for this programme have been increased by over Rs 39 billion. There is now sufficient evidence, supported by the balance sheets of fast-moving consumable goods companies, that rural consumption expenditure tends to increase quite sharply with available disposable incomes, and all the major companies are trying to get into rural markets in a big way.

Third, there is the need to provide for capital expenditure for the provision of public goods – most importantly, infrastructure. There is recognition that the private sector plays a very important role in the creation of infrastructure, and there has been an attempt to create new and innovative financial models for this. The Infrastructure Financing Corporation, a government-sponsored special purpose vehicle, has gotten off to a good start by being able to finance a number of infrastructure projects – there is now a proposal to give it greater flexibility. This entity can now refinance up to 60 percent of the bank loans to infrastructure and provide for take-out financing. Incentives for investments in specified sectors and the continuation of the concessional excise and customs duty regimens complete this initiative. There is a massive increase in the allocations for infrastructure spending within the budget as well.

Fourth, there also appears to be sufficient room in the arithmetic. In nominal terms, the GDP increase is taken to be around eight percent – a low figure. In fact, it is likely that the economy would grow at least by 6 to 6.5 percent in real terms, that is, over 10 percent in nominal terms, giving ample room for fiscal correction. It is also likely, given past experience, that sudden hikes in allocation are not spent. There is stickiness in expenditure in several schemes, especially those that require detailed project preparation, such as the railways and highways, and it is quite likely that there would be savings in expenditure. The removal of the fringe benefit tax is a good incentive for corporate balance sheets, and the flexibility of infrastructure spending is likely to bring back capital investment activity. There is also likely to be receipts from disinvestment to the tune of Rs 100 billion.

Finally, the promises of rationalising fertiliser subsidies, adjusting petroleum product prices, introduction of a new direct taxes bill, and the rolling out of the goods and services tax are steps in the right direction. Even if some of these events occur in the next few months, the economy would be able to stabilise itself.

In short, the Indian budget appears to be a carefully crafted exercise to push for growth. Of course, there are risks and things may go wrong but a correction is possible even in the next budget, which is only nine months away. Chances are, barring a severe drought, these initiatives may succeed.

oooOOOooo