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Dispelling Budgetary Gloom

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Copies of the Union Budget 2015 being brought to Parliament House for distribution to MPs and media after Union Finance minister Arun Jaitley presented the Union Budget-2015, in New Delhi. File photo: Sandeep Saxena

*Ahead of the Union Budget, Finance Minister Arun Jaitley is presented with a few challenges. Plan allocation is down and several centrally-sponsored schemes stopped. Non-performing assets of public sector banks are at an all-time high while rural demand is low. Exports and private investments have not contributed much to the growth. Former Union Finance and Economic Affairs Secretary **S. Narayan** says Jaitley's Budget this year should focus more on fiscal and monetary management initiatives and look to revive rural demand, pump up small and medium enterprises and push export, besides improving the investment climate.*

In the run up to the Union Budget, articles in newspapers and comments in the media have been focusing on the difficulties that Union Finance Minister Arun Jaitley would face in meeting fiscal deficit targets. There is also concern over growth, stress faced by the banking sector, as well as the global economic scene. Very few of the comments express optimism, and most conclude that the Finance Minister has a tough task ahead.

Firstly, there is concern over the GDP arithmetic. The nominal GDP rates are turning out to be lower than real GDP rates, for the first time in over two decades. This is due to the declining WPI, which, again, is caused by the sharp decline in oil and commodity prices. The budget presented by the Finance Minister in February 2015 anticipated a real growth of around 7.5 per cent, and a nominal growth of around 14 per cent. Now with WPI inflation [1] numbers in the negative range, analysts predict that nominal GDP figures will turn out to be lower than the real GDP figures. With the denominator getting squeezed, fiscal deficit figures will appear to be much more than anticipated. Purists argue that there should be further reductions in Government borrowings or greater revenue receipts to ensure that the Fiscal Responsibility and Budget Management guidelines are not breached yet again. Others argue that given the additional expenditure commitments of the expected Pay Commission awards, it is necessary to yet again give a pause to the fiscal consolidation roadmap.

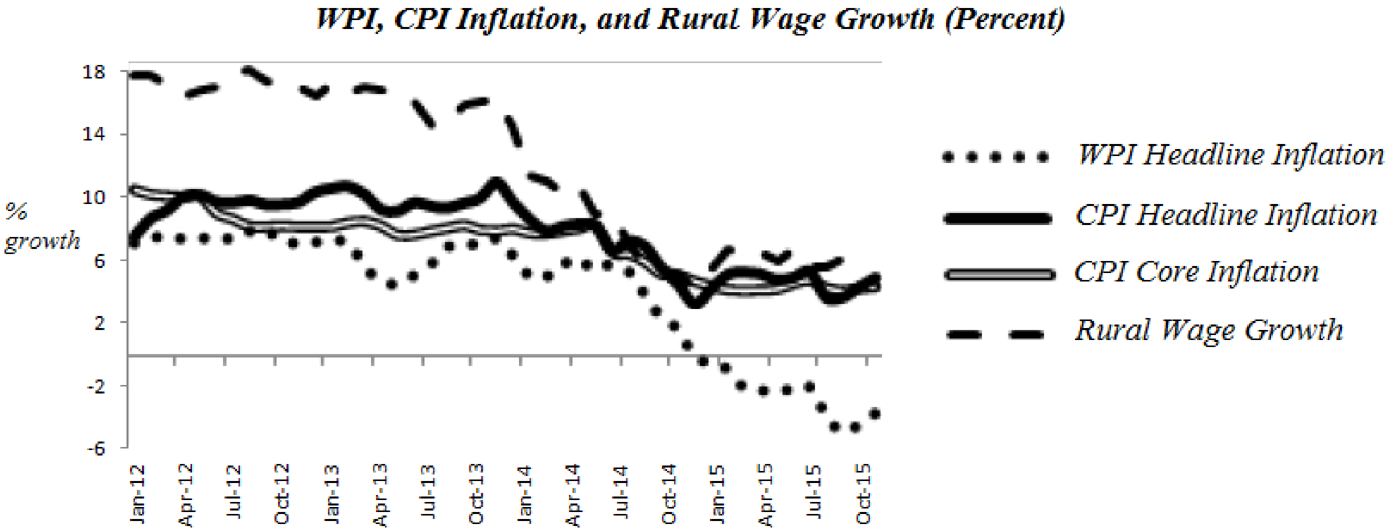

Figure 1: WPI, CPI, Rural Wage Growth Trends (Source: Mid-Year Economic Analysis 2015-16, Ministry of Finance)

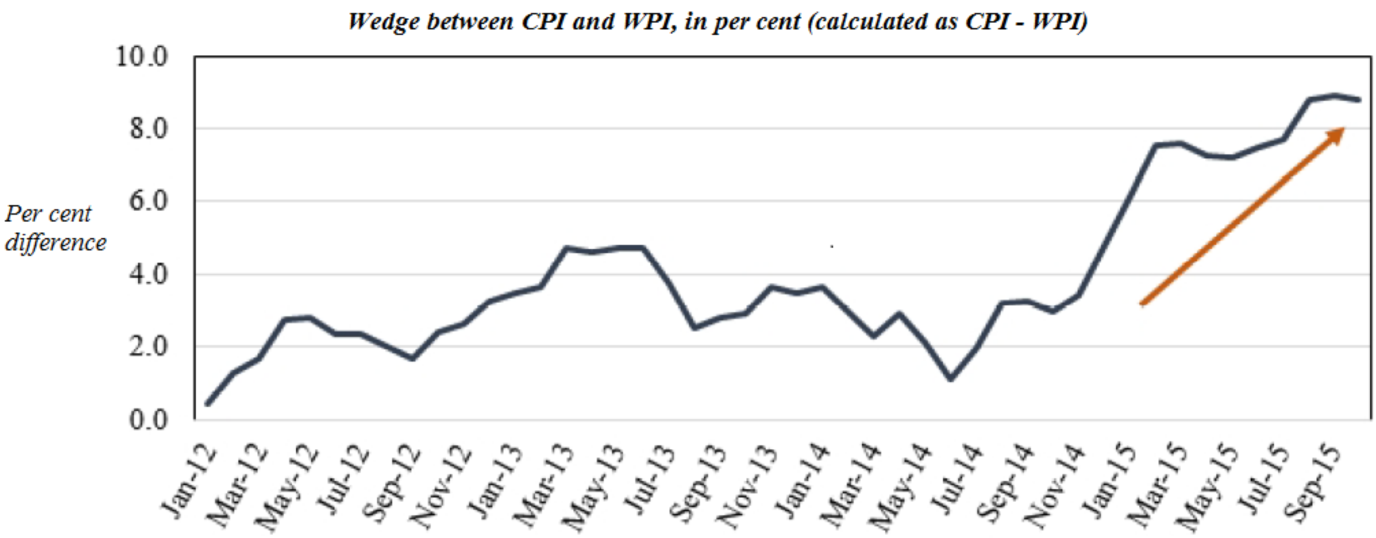

Figure 2: Difference between CPI and WPI (Source: Mid-Year Economic Analysis 2015-16, Ministry of Finance)

There are some problems in this conceptualisation. First, the reliance on the WPI for GDP calculations, rather than the CPI, which is clocking inflation at five per cent, appears to be paradoxical. Is it possible to argue that if we replaced the WPI by the CPI in GDP calculations, the denominator would remain healthy and fiscal deficit would be seen to be under control? There is surely some speciousness in this arithmetic, which, by a sleight of hand, can turn fiscal deficit worries into comfort, without leaving the real economy any better. Second, more importantly, why is there so much stress? We are told that indirect tax collections [2] have been far higher than budget estimates, and that excise duty hikes on petroleum products have contributed substantially to revenue flows. We are also told that subsidies have been reduced, diesel, petrol and aviation gasoline are not subsidised, and that leakages in LPG subsidies have been eliminated. There is a reduction in Plan allocations and a number of centrally sponsored schemes have been given up. So why is the expenditure not under control? The Reserve Bank of India (RBI) Governor, Raghuram Rajan, has raised this issue more than once, arguing that the Government needs to focus on expenditure management. This puzzle needs to be solved. (Please also see Box2, p5 of the Mid-Year Economic Review, Ministry of Finance, 2015-16, dated 18 Dec 2015). The figures indicate some real cause for concern.

The next major issue relates to the infrastructure sector. Non-Performing Assets (NPAs) in banks, especially Public Sector Banks, are at all-time highs. Debts of over Rs 8 lakh crores are stressed. In the power sector, there is a combination of project delays, lack of approvals and investor apathy that is making a number of projects unviable. The RBI Governor has been firm about provisioning for bad assets: the worry of the banks is capital adequacy. Several clever schemes have been tried out, including the 5/25 solutions, asset reconstruction as well as attempts to offload stressed assets into alternate entities. At the end of all this, there is not much improvement, and the Government seems to be getting dragged ever deeper into this mire. In parallel, there is a push for solar power with prices falling and banks eager to lend. There are also bottlenecks in the transmission and distribution networks. Again, there is a clamour for sorting out this mess, and everyone expects some magic on bank capitalisation from the Finance Minister.

It is important to realise that this problem will not go away. Fundamentally, even the promoters are not interested in the projects — there is surplus capacity in generation, and the state distribution companies have no funds to pick up generated power — they would rather live with power outages than add to their losses. Therefore, even if the new capacity gets added, it would not yield a return, and the debt would continue to be stressed. It is not clear why the Government has taken on this project problem as a policy problem — perhaps the remedy is for the Government to back away from short term solutions and to focus on the distribution issues. Meanwhile, the banks should deal with the problems themselves. Some ventures will face distress sales, some banks will have to rewrite their books etc. Painful, but perhaps necessary at this stage, and will enable these assets to be properly valued a few years down the line, with losses being absorbed by equity as well as debt. In short, this is not an area that the Finance Minister should venture into in the Budget, whatever the clamour from the corporates.

The states are also not happy. The Finance Commission recommendations resulted in devolution of 42 per cent of tax revenues to the states, a steep increase over the earlier 32 per cent. However, Plan allocations have been reduced, and several centrally sponsored schemes axed. The net benefit to the states has been small. Since implementation of programmes is at the state level, organisations and structures that were dependant on central funds would now feel the pinch, and since structures cannot be dismantled quickly, there would be people with little funds to deploy in state schemes. Getting the participation of states in development programmes becomes more difficult as the states face their own budgetary constraints.

Next, there is the issue of rural distress. Rainfall has been below average in the last monsoon, and agricultural growth has been less than two per cent. Rural demand is low, and Fast Moving Consumer Goods (FMCG) companies are reporting flat sales from the tier two and tier three cities. International weather forecasts are that 2016 will see high temperatures and low rainfall. None of the Government initiatives so far has focused effectively on the rural economy or on agro-processing, and there is an opportunity to do just that during this budget.

The growth this year has been driven by private consumption and Government capital expenditure, and not by exports or private investments. There are issues of restoring middle class confidence, of reviving growth and investment, and, of course, the big elephant, the Goods and Services Tax (GST). The Government hopes that opposition would enable it to pass the GST Bill. This single legislation is likely to be a game changer in terms of reviving the economy, and perhaps this is the single reason that the opposition is not wanting it to happen, for then all credit would go to the Government.

Against this backdrop, it is possible to look at some of the options available to the Finance Minister in the forthcoming budget.

At the outset, it appears to be important for the Finance Minister to state the emerging problems. The global economic outlook remains uncertain. Commodity prices are likely to remain low, and while this may reduce import bills for petroleum-related products, it would adversely affect the natural resources industries like iron, steel and coal. On WPI numbers, inflation would be low, but CPI inflation would continue to be high. Low commodity prices would affect Indian workers overseas, and significant return migration from West Asia and the Gulf can be expected, adding to unemployment. Lack of capital formation would affect employment opportunities. All this would be compounded by lack of fiscal room to undertake any big budget expenditures.

At this stage, the world would be looking at fiscal and monetary management initiatives. Revenue growth this year has been driven by greater levies on petroleum products and a larger net for service tax. At six to seven per cent real GDP growth and low WPI inflation, additional revenues may not come from buoyancy. The focus is likely to be on better infrastructure to enlarge the tax base, and speedy delivery of tax refunds and finalisation of pending matters to increase the flow and volume of revenues. There is an opportunity to bring in changes in the Income Tax Act that would reduce exemptions and make tax filing and computation simpler. Though there is little chance of a direct tax code being implemented, there could be changes that would enable volumes to increase. On the Customs side, there is a clamour from the industry against dumping of products like steel, tyres, aluminium etc., and there may be an opportunity to levy some short term duties.

Fiscal control is only about increasing revenues and reducing expenditure. The only other source of revenue is stake sales in public sector undertakings. Somehow, this has not taken off this year, and it is important that next year, there is a real effort to achieve disinvestment targets. On the expenditure front, there is an opportunity of tackling a number of implicit subsidies that exist in several sectors, including health, education, railways, shipping and small industry. A Task force to identify and remove them should start with a notification of removal of all subsidies and examine only those that need restoration.

General Government (Centre + State) Expenditures as per cent of GDP for 1st Half of Fiscal Year

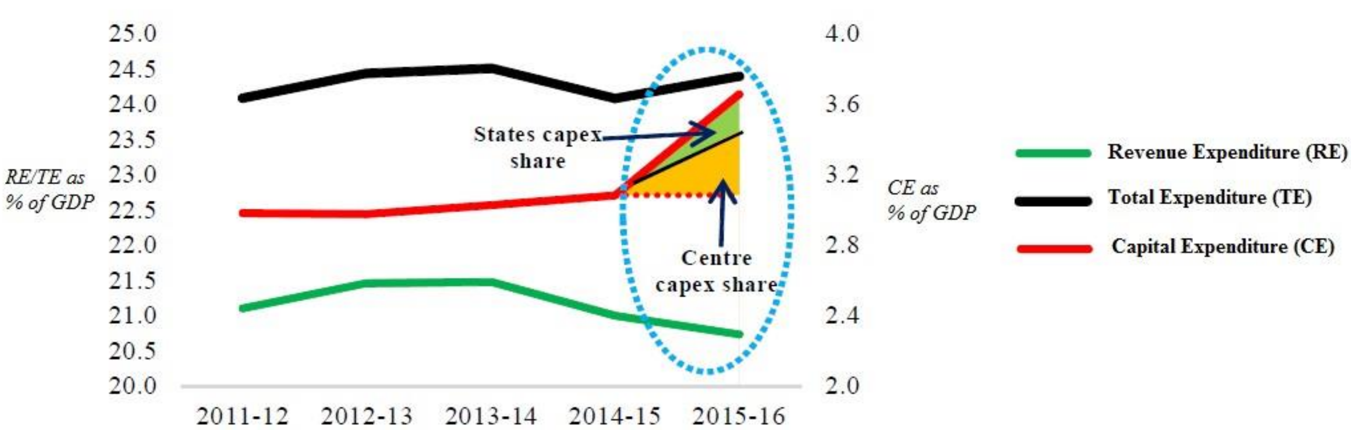

Figure 3: Disaggregated Expenditure as % of GDP (Source: Mid-Year Economic Analysis 2015-16, Ministry of Finance)
(Note: Data for States is for 20 states which constitute 91% of GDP)

The Pay Commission awards would have a bearing on the fiscal deficit. At the central as well as the state level, this would impact budgetary balances adversely. The choice of postponing fiscal consolidation, or reducing expenditure and raising revenues to match is not just an economic one, but a political one as well. It is generally expected that the Pay Commission awards will improve consumption demand and act as a stimulus. The problem is that demand contraction is happening more rapidly in the rural economy, and the Pay Commission payments may not help here.

There are problems on the monetary side as well. Investment demand and credit growth are both very muted. Liquidity is tight, though the RBI disputes this. RBI is worried about CPI, and the Government about the investment cycle. The Government believes that real interest rates are high, while the RBI would like to wait and watch.
On the foreign exchange front, the strengthening dollar, poor exports and slowing down of remittances offer challenges of management for the RBI as well as the corporate sector.

The real challenge in this budget is to revive investment and to reinvigorate demand. Perhaps there is an opportunity. There are a large number of small and medium enterprises struggling for working capital or term loans. Some have been affected by the downturn, others by natural calamities such as the floods in Chennai. A targeted intervention would bring a number of these industries back on their feet, improving employment and economic activity. Sectors such as pharmaceuticals, light engineering and auto-ancillaries, textiles and chemicals could drive growth through small interventions.

Revival of rural demand through initiatives that focus on agro-processing and infrastructure were promised in the Budget last year, but there has been little action on the ground. The challenge is not credit alone, but a holistic plan involving technology, inputs, marketing of value added agricultural goods — Maharashtra and Madhya Pradesh have made a success of this in the last decade, and it is time to replicate it elsewhere.

Finally, on exports. The present structure of export promotion relies on duty incentives and subsidies for inputs, rather than assistance through technology and business development. Exports are vital for the revival of economic activity.

The Finance Minister has a major challenge this year. Careful budgeting would focus on the arithmetic of fiscal, monetary and revenue numbers. However, it is incumbent on the Government to lay down a road map for growth and targets for implementation. That would entail a tightrope walk between fiscal management and public investment.

References:

1.^ Inflation has continued to moderate steadily. Consumer price inflation (measured by the CPI-NS) has declined from 5.4 per cent in February 2015 to five per cent in October 2015. The WPI has been in negative territory for 12 months since November 2014 and is at (-)3.8 per cent in October 2015. Rural wage growth and minimum support price increases — important determinants of inflation — have remained muted. (Mid-term economic review, Fin.Min 2015-16)
2.^ During April-September, 2015, gross tax revenues (Rs. 5,96,884 crore) registered a growth of about 21.7 per cent, whereas, revenue receipts (net to the Centre) amounting to Rs. 5,13,369 crore grew by about 22.8 per cent over the respective receipts during corresponding period of previous year (COPPY). Figure 2.1 highlights the growth in tax revenue under different heads in first half (H1) of 2015-16 vis-à-vis budgeted growth in 2015-16. The

overall growth in net tax revenue (Rs. 3,69,736 crore) was 14.4 per cent, while non-tax revenues (Rs. 1,43,633 crore) grew by about 51.7 per cent. Non-debt capital receipts (Rs. 18,613 crore) registered an increase of Rs. `13,282 crore (Mid-term Economic Review, Fin Min 2015-16)

(S. Narayan (IAS, 1965 batch), with nearly four decades (1965 to 2004) in Public Service in the State and Central Governments, in Development Administration, was the Economic Adviser to the Prime Minister during 2003-04. Dr. Narayan served the Government of India as Finance and Economic Affairs Secretary, Secretary in the Departments of Revenue, Petroleum and Industrial Development.)