
The Hindu : The 2001-02 Budget

[Opinion](#) | [Previous](#) | [Next](#)

The 2001-02 Budget

By Nirupam Bajpai & Jeffrey D. Sachs

ONCE AGAIN it is Budget time and the Union Government needs to put together some bold decisions for 2001-02. India's political system is more than ever in consensus about the basic direction of reforms. The current Government enjoys a reasonably strong electoral mandate. A decade of opening of the economy has produced new dynamism, most dramatically in the information technology sector, but in others as well. GDP growth rates can be raised and sustained much beyond 6 to 6.5 per cent should certain critical reforms be implemented soon. In fact, India could certainly double per capita income during the current decade - a goal the Prime Minister announced in his Independence Day speech last year. The Government lost the opportunity to announce some key reforms during last year's budget - its first year in office. With several Assembly elections due in the next few months, the 2001/02 Budget may also turn out to be disappointing.

As the fiscal deficit still remains very high, the process of fiscal consolidation needs to be pursued much more vigorously in the Budget. In fact, in the Global Competitiveness Report (GCR) 2000, India ranks 52nd on fiscal deficit out of a total of 58 countries. Considering the excessive preemption of the community's savings by the Government, the potential for crowding out the requirements of the enterprise sector, the pressure on interest rates, and rising interest payments on Government debt, it is essential to reduce the fiscal deficit, mainly by lowering the revenue deficit. Correction of these

deficits would, inter alia, require considerable re-focussing and reduction of large hidden subsidies associated with underpricing in crucial areas, such as power, irrigation, urban transport, and higher education. Food and fertilizer subsidies are other major areas of expenditure control. Be that as it may, the process of fiscal consolidation needs to be accelerated through more qualitative adjustments to reduce Government dis-savings.

India's overall Government spending, currently around 33 per cent of the GDP, needs to be brought down substantially as a proportion of the national product to achieve the reform goals of macro-economic stability and long-term rapid growth. Large and persistent fiscal deficits are a serious cause for concern. First, Budget deficits could once again spill over into macroeconomic instability, if the Government resorts again to inflationary finance. This would happen, for example, if the Government meets increasingly onerous terms in financing the increasing stock of public debt on the open market, and therefore turns to the Reserve Bank for increased financing. Second, the Budget deficits imperil national saving rates, thereby reducing overall aggregate investment, and jeopardising the sustainability of high growth. The effects of low investment rates on overall GDP growth are not hard to see. Most directly, low levels of public investment have rendered India's physical infrastructure incompatible with large increases in national product. Without an increase in the scale and rate of growth of infrastructure investment, growth rates are bound to remain moderate at best. Third, continuing large Budget deficits, even if they do not spill over into macro-economic instability in the short run, will require higher taxes in the long term, to cover the heavy burden of internal debt. High tax rates will

The Hindu : The 2001-02 Budget

place India at a disadvantage relative to other fast-growing countries.

Expenditure reform in India is critical in view of the fact that Government dis-saving and overall level of Government spending remains high. There is probably little room to cut capital expenditures, as they have already been squeezed to a mere 2.4 per cent of the GDP in 1999-2000. Of course, in the future, it should be the private sector rather than the Government which meet most of the enormous infrastructure needs of a growing economy. Still it is hard to imagine that rapid growth can be accomplished with public investment spending by the Government of less than the current rate relative to GDP.

Governmental action is needed in reducing expenditure under four major heads of current spending. With respect to internal public debt, there is one important mechanism that could substantially ameliorate the fiscal situation. Privatisation of public enterprises could raise significant funds as a percentage of GDP, which could be used to buy down the public debt. Not only would the stock of debt itself be reduced, but the interest costs of servicing the debt would also decline. The cash value of these enterprises vastly exceeds the present value of profit flows that the state collects on these assets. Public sector profits are dissipated in poor productivity, over-manning, excessive public sector salaries, soft budget constraints, and generally poor public sector management. For this reason, sales of the enterprises to private sector buyers, if used to buy down the public debt, would yield annual saving in interest costs that far exceed the Government revenues from them. This is especially true as many enterprises with significant positive market value are actually loss makers in current cash flow, under state management.

The Central Government currently has equity holdings in 240 enterprises, 27 banks, and two large

insurance companies. Further spending cuts could come from liquidation of loss-making enterprises that have no positive net market value. Liquidation of these would imply a rise in domestic savings. Of course, saving would be higher if there is salvage value in part or all of some of these enterprises. To capture these savings would require implementation of an exit policy to allow the Government to close down these loss-making enterprises.

Reduction in Central subsidies is another area of expenditure control. According to the Discussion Paper on Subsidies brought out by the Finance Ministry in 1997, the total magnitude of subsidies given by the Central and State Governments was Rs. 1,372 billions during 1994-95 constituting 14.4 per cent of GDP - Rs. 430 billions of Central subsidies and Rs. 942 billion of State subsidies. The subsidies on non-merit goods and services (such as agriculture and allied activities, irrigation, power, industries, transport etc.) amounted to 10.7 per cent of GDP. The average all-India current recovery rate for non-merit goods and services was placed at 10.3 per cent in 1994-95, with the recovery rate for the Centre being slightly higher at 12.1 per cent compared to 9.3 for States.

Reforms in the current subsidy regime should be undertaken with the objective of reducing the overall scale of subsidies. Moreover, the reforms should help make the subsidies transparent, and use them for well-defined economic objectives. Subsidies should focus on final goods and services to maximise impact on the target population at minimum cost. The key to subsidy reduction lies in phased increase in user charges in sectors such as power, transport, irrigation, agriculture and education.

Reducing the size of the public administration could also cut Government spending. One step could be a freeze on new employment, matched by normal attrition through retirement and death. Existing functions could easily be met through modest improvements in computerisation.

The Hindu : The 2001-02 Budget

While some progress has been made, the tax structure in India still remains very complicated with high rates for both direct and indirect taxes. In the area of direct taxation, while rates of personal income tax are pretty much in line with those outside India (in the GCR 2000, India ranks third on median income tax rate out of 58 countries). However, corporate tax rates are high in India. As regards excise duties, there has not been much progress in moving from the modified value-added tax (MODVAT) to a full VAT. More importantly, import duties are still high. While it has come a long way from being a closed economy, India still is a highly protected economy by current international standards. In fact, as per the GCR 2000, India ranked last among the countries ranked on import fees and average tariff rate.

The Government needs to give greater attention to, and provide larger resources for, primary education and primary health. The economic and social returns from such an initiative would be huge. Additionally, aggressive public health campaigns are required to address major infectious diseases.

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