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ISB Budget 2010: The Grand Bargain

'The curious task of Economics is to demonstrate to men how little they know about what they imagine they can lesign."

- F.A.Hayek, The Fatal Conceit.

The union budget is a curious anachronism from our colonial past that survives to this day. In the information age and vith efficient markets where policy announcements can be quickly digested, one wonders why the most important policy announcements of the government still need to be clubbed together into a mega single day event. Nonetheless, he canvass afforded to the Finance Minister to shape the policies and priorities of the nation through what he says, and what he leaves unsaid, is impressive and merits a careful analysis.

This year's budget had outlined three overarching goals for our economy – reverting to a path of high gross domestic product growth, inclusive development and institutional reforms – and so it is useful to examine if the budget proposals will indeed help us in achieving these goals.

A positive outlook on many forward-looking economic indices gave the finance minister the maneuverability to take some prudent measures to take us back on the path of fiscal consolidation.

To his credit, he accepted the spirit of the 13th Financial Commission's recommendations. The fiscal deficit target was kept at 5.5% of GDP and the government's borrowing program was limited to 3.45 trillion rupees. In a break from the past practices of accounting jugglery, the so-called "below-the-line" items which masked the true extent of the fiscal deficit have been included into the government's mainstream fiscal accounting.

While much has been made out of the unprecedented inclusion of rolling deficit targets for the future years, it is instructive to remember that those pronouncements are subject to the vagaries of monsoons, the whims of irreverent allies, electoral outcomes and the political flavor of the day. Unsurprisingly, the details for achieving those targets will follow after six months through the recommendations of a pliant government-appointed committee.

There were a number of progressive proposals in the budget for creating a favorable environment for the growth of sunrise sectors and reducing distortions in others. The concerted effort to give an impetus to clean energy through a combination of indirect cash infusion, transfer payments from polluting sectors, favorable tax treatment and fostering greater competition should bear fruit in coming years.

The move toward a nutrient-based subsidy policy for fertilizers was a big improvement in a sensitive area that has been a holy cow for successive governments. While the system is still not perfect as it does not tackle the issue of production inefficiencies, it is a giant step in the right direction. Hopefully, this will create the necessary political will to correct the galactic distortions in other sectors.

It is clear that the profound inequities in our society will not be solved by purely market-based solutions thus making government interventions a necessity.

Unlike previous years, the outlays for various large programs were increased modestly this time. Most of these programs are well-intentioned but hugely misguided, unsuccessful attempts at social engineering. Take the case of the agriculture sector where, over the years, the government has created loan waiver programs, set mandatory lending targets, instructed banks to charge below-market interest rates and repeatedly restructured loans.

Unfortunately, these measures have created perverse incentives, huge inefficiencies and leakages in the system mean that they have barely made a dent to the human development indices of the vulnerable sections. Similarly, in the case of healthcare, education and rural employment programs, the focus has been on the inputs provided to the programs instead of measuring and rewarding the outcomes.

While no single budget speech can solve this, it is clear that throwing more money at the problem without reforming the service delivery mechanisms is not going to help either. The budget failed to seize the opportunity and make some meaningful reforms in this area.

With the Goods and Services Tax rollout being postponed to next year, there were no major structural changes in the overall tax code. The decrease in personal income taxes, which was clearly the headline for the personal finances of millions of middle-class Indians, should help in driving up private consumption. The revenue shortfall in the direct taxes was largely made up by increases in indirect taxes and higher price level for fuels. This was a curious choice considering that in real terms the burden of indirect taxes falls disproportionately on the poorer sections of the society and tends to drive up inflation.

Notwithstanding the espoused principle of rationalizing the tax structure and moving away from the labyrinth of exemptions and grants which create all sorts of distortions and compliance issues, they are an enduring feature of every budget including this one.

While some of these exceptions remove process inefficiencies or merely reflect law catching up with technological change, the vast majority range from the outright silly (exempting toy balloons from excise duty) to downright ugly (a 2 billion rupee grant for a zero liquid discharge system at a textile park in Tamil Nadu.)

The Economic Survey of India, a document prepared by some of North Block's finest technocrats, not only outlines the state of the economy but also includes thoughtful commentary on guiding tenets for policy making, policy prescriptions and an objective evaluation of the efficacy of various government programs.

Indeed, the ESI should guide and simplify the decision-making for the finance minister's budget proposals to the extent of making the process mechanistic. Instead, the budget is a grand bargain crafted by the ruling party which has to overcome internal party inconsistencies, incorporate ideological preferences devoid of any empirical backing, accommodate rent-seeking entrenched interests and be made resilient enough to undergo the catharsis of a shrill legislative process which prefers adolescent rallying cries to reasoned economic arguments.

To emerge relatively unscathed from this while delivering the political goods for a grand coalition and avoiding spooking away investors is no small feat.

Perhaps it is Hayek who should have learnt about the curious task of Politics from Mr. Mukherjee.

ABOUT THE AUTHOR:

Jaydeep Mody is currently pursuing his MBA at the Indian School of Business, Hyderabad. Over the years, he has developed a keen interest in the areas of finance, applied economics and public policy with a particular emphasis on how they relate to emerging market economies. Prior to joining ISB, he has co-authored a number of whitepapers on the dynamics of the U.S. aerospace and automotive sectors.