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The art and craft of Budget formulation

Crafting a growth-oriented Budget that is fiscally sound and has wide political appeal is possible. Here's how

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The Budget will be the first big formal opportunity for the incoming government to set the tone for its economic agenda. Arun Jaitley will have to manage the, often conflicting, expectations of a range of distinct stakeholders: businesses, banks, investors, farmers, state governments, and, of course, households.

The business community is hurting because of flagging growth, a breakdown of trust with government, an onerous burden of debt accumulated in the good times, and half-finished projects stuck on account of delayed regulatory approvals. They want a decisive government.

Banks, particularly domestic public sector banks, are weighed down by deteriorating asset quality. They want some relief.

Investors are keen to participate in our equity markets, but expect the government to deliver macro-economic stability and demonstrate a commitment to market-friendly economic reforms.

State governments want more resources from the Centre and they want greater autonomy over deployment of those resources.

Farmers are another important political constituency. They are anxious about the monsoons and are keen to ensure that generous minimum support prices for their staple crops are maintained, as is their access to cheap inputs.

And households across the country are concerned about *arthik vikas* (development) and *mehengai* (the rising cost of living). To disappoint them in this Budget would be to risk losing valuable political goodwill prematurely in the new government's term.

The art of Budget formulation is to try and satisfy all these disparate stakeholders without allowing spending to spin out of control. Above all, the Narendra Modi government has been given a mandate to deliver on development. The revival of growth is the thread that is common to all stakeholders. The Budget must, therefore, be widely perceived as pro-growth and development. In fiscal terms, this would normally imply an expansionary budget. But we also know that fiscal profligacy will not be tolerated by the markets, nor would it help the Reserve Bank of India's efforts to fight inflation. So is it possible to craft a growth-oriented Budget that is fiscally sound and that has wide political appeal? The answer, I believe, is yes.

Re-igniting growth will require the Budget to deliver on three goals: (a) boosting business and investor confidence; (b) facilitating the flow of debt and equity capital to businesses and banks; and (c) re-orienting government spending from consumption to investment. The first does not require any government spending. The second can be achieved with much less spending than people think, provided, however, some bold decisions are made. And the third can be achieved in a manner that is spending neutral and, under the new dispensation, also politically acceptable. Let's consider each in turn.

Boosting confidence: Confidence can be built if the business community is treated as a partner in growth, rather than a partner in crime, or an adversary to be policed! Many things can be done in this respect, none of which require the government to spend a penny. Consider three examples.

First, simple initiatives could bring about much-needed behavioural and procedural change in tax administration, delivering material relief to business. Tax officials are currently driven by rigid collection targets handed down from the top. This results in aggressive behaviour from officials and contributes to notorious delays in settling even the legitimate reimbursement claims of assessees. The incentive system for tax officials could be changed, so that bullies are not rewarded. Similarly, a plan could be announced to resolve tax disputes in a time-bound manner, with officials incentivised to speed up the process. There is no reason the government should litigate everything all the way to the Supreme Court. Our tax authorities should be content, barring in exceptional circumstances, to abide by the decisions of our Appellate Tribunals.

Second, no single act of the United Progressive Alliance government did more to undermine investor confidence than their crusade on retroactive taxation — the infamous Vodafone case. Using this Budget to revoke the relevant provision in the Income Tax Act would be a simple and powerful signal of the incoming government's support for markets.

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Third, the Budget should make some announcements that burnish the government's reform credentials. A simple one would be to raise the foreign direct investment (FDI) limit in insurance to at least 49 per cent. Along similar lines, the Budget could announce a slightly more relaxed stance on FDI and private domestic participation in defence production. These announcements would cost nothing either in terms of budgetary resources or political capital. They would help bury investor concerns about the Bharatiya Janata Party's supposed aversion to FDI and provide an important boost to confidence.

Facilitating recapitalisation: Reviving growth means reviving investment spending. But large segments of the business community cannot contemplate expanding capacity until they have fixed their over-levered balance sheets. For this, access to fresh equity capital is essential. The banks are but a mirror image of their corporate clients. Public sector banks, in particular, also need an equity infusion to allow them to absorb the losses relating to non-performing assets. Without additional equity, these banks will be unable to support sustained credit growth. Facilitating the recapitalisation of corporate and bank balance sheets must, therefore, be a critical objective for the Budget. This goal can largely be met by harnessing the power of equity markets, rather than relying on budgetary spending. If the Budget is used effectively to boost investor confidence, our equity markets are likely to remain sufficiently buoyant to allow at least corporate India to recapitalise itself.

Persuading the market to also recapitalise public sector banks will require more effort and bolder action. Estimates of the equity required to clean-up public sector bank balance sheets range from ₹2 lakh-crore to about 6 lakh-crore spread over the next five years*. If this government was willing to significantly dilute its economic ownership in these banks and offer a credible commitment to make their governance more autonomous and their management more meritocratic (through an overhaul, for example, of compensation, performance evaluation and promotion systems for managerial staff), the market would most likely rise to the occasion. This would facilitate the recapitalisation of public sector banks with a relatively modest budgetary contribution from government. If, however, the government comes across as tentative or ambivalent about improving the governance of these banks, the market will be unforgiving, making the challenge of recapitalising these banks that much harder.

Improving the quality of government spending: There is growing empirical evidence that voters do not see value in many of the central government's entitlement schemes. With no equivalent of the National Advisory Council looking over its shoulder, this government does have political space to overhaul the portfolio of proliferating central government social schemes. This Budget could reduce diesel and LPG subsidies, and downscale schemes such as the employment guarantee Act. It could also try to contain spending on food subsidies as well as mitigate upward pressure on food prices, by releasing some portion of the accumulated stock of wheat and paddy into the open market. Savings from these measures should create fiscal space for supporting additional spending on priority infrastructure such as rural roads and/or a small clutch of high-profile projects of national importance such as the Delhi-Mumbai Industrial Corridor.

Finally, to further widen its political appeal, the Budget could allow greater flexibility to states in how they choose to spend their respective plan allocations. This would encourage a sense of partnership between Centre and states that would stand the government in good stead as it seeks to build consensus for more ambitious reforms such as the Goods and Services Tax later in its term.

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**Report of the Committee to Review Governance of Boards of Banks in India, March 2014.*