

WebMemo



Published by The Heritage Foundation

No. 2541
July 13, 2009

India Heads in the Wrong Direction with New Budget

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As Secretary of State Hillary Clinton has noted in advance of her trip to India toward the end of July, the U.S. has an important stake in Indian success.¹ As its clout on the world stage increases, India can play a stabilizing role in the broader Asia region, partnering with the U.S. on a range of issues including maritime cooperation, nuclear nonproliferation, education, science, and defense trade. India also serves as a powerful example of a successful democracy in the developing world.

On the economic side, unlike many of its Asian counterparts, India is consumption-driven, not export-driven. Its growth and greater prosperity therefore offer outstanding opportunities for American agriculture, industry, and services.

The flip side of America's stake in India is that America loses when India takes a step backward. And that seems to have happened with the anxiously awaited Indian government budget for the next fiscal year, which puts political gain over long-term economic progress. This kind of fiscal irresponsibility may help India's ruling Congress Party win more elections, but it will not help the country live up to its economic promise.

Mistakenly Expecting Reform. In May, a new government won a surprisingly strong mandate in national elections. The reaction from some of those seeking market-oriented reform was euphoric: The Sensex Index on the Bombay Stock Exchange rose a staggering 17 percent in one day. It peaked at a total 28 percent gain on the 20th trading day after the election results were announced.² The broader response was more subdued but also upbeat about reform.³

But the optimism appears to have been misplaced. Prior to both this election and the global financial crisis, the same Congress Party led the coalition United Progressive Alliance (UPA) government that slowed or even halted the liberalization process.⁴ This was attributed by some to the need to placate left-wing coalition partners, but Congress also ran on a populist platform in this spring's election.⁵

More specifically, the UPA previously ran large federal deficits for the sake of populist programs. After taking power in the 2004 election, its first budget expanded the gross fiscal deficit 17 percent despite strong economic growth and the pronounced absence of any need for stimulus at the time. The UPA then failed to curb that deficit during ensuing strong years.⁶

In that light, it should not be surprising that the deficit is now exploding. Already hefty in the fiscal year 2007–08 budget, the federal deficit *more than doubled* for 2008–09. Congress is now arguing that the economy is doing exceptionally well,⁷ but the government nonetheless needs to run an even bigger deficit for the sake of stimulus. And so the deficit is to climb another 20–25 percent.⁸

Much more likely, Congress officials assess that they won the elections largely because of rural sup-

This paper, in its entirety, can be found at:
www.heritage.org/Research/AsiaandthePacific/wm2541.cfm

Produced by the Asian Studies Center

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002-4999
(202) 546-4400 • heritage.org

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port programs and thus want to continue large-scale subsidies to maintain or augment political support. The Sensex fell 6 percent the day the budget was unveiled, and reformers despaired at just how irresponsible the budget had turned out to be.⁹

Harmful Long-Term Priorities. The budget in general will have pernicious long-term effects. The huge deficit is a heavy tax on the future that lowers India's growth trajectory. But there are additional devils in the details, in particular with regard to education and liberalization.

A great deal of faith has been placed in India's demographics, i.e., that India is a young nation and will remain young over the next several decades while the world's other large economies age.¹⁰ This faith is not entirely misplaced, but a demographics-led economic boom will not occur automatically. The swelling Indian labor force needs productive jobs to be available—and the education and training necessary to fill those jobs properly.

This budget does very little to facilitate that. Liberalization is stark in its absence. A primary task in promoting long-term economic growth is sharpening property rights. Public control of large swaths of

Highlights of the Indian Budget

- Spending increases four times faster than projected GDP growth.
- The deficit increases three times faster than projected GDP growth, after soaring 125 percent the previous year.
- Fertilizer subsidies alone are the equivalent of almost 5 percent of the total budget.
- Subsidies for small exporters are more than three times larger than the amount to be raised from all privatization.
- There is no change in the structure of corporate taxes.

Source: newKerala.com, "Budget of India 2009-2010: Summary/Highlights of India General Budget 2009-10," at <http://www.newkerala.com/nkfullnews-1-67991.html> (July 10, 2009).

industry creates a situation where no one is responsible for weakness in much of the manufacturing sector and arbitrary government rules hamper operation of a slew of companies.¹¹ Loud talk of divest-

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2. Yahoo! Finance, "BSE SENSEX Historical Prices," 2009, at <http://finance.yahoo.com/q/hp?s=%5EBSESN> (July 10, 2009).
3. Erika Kinetz, "India Election Paves Way for Economic Reform," ABC News, May 17, 2009, at <http://abcnews.go.com/International/wireStory?id=7606730> (July 10, 2009).
4. See, for example, "India's Reforms Slow, but on Track: PM," *Rediff News*, July 19, 2005, at <http://in.rediff.com/money/2005/jul/19pm.htm> (July 10, 2009); Manjeet Kripalani, "India's Economy Hits the Wall," *BusinessWeek*, July 1, 2008, at http://www.businessweek.com/globalbiz/content/jul2008/gb2008071_743900.htm (July 10, 2009).
5. C. T. Nilesh, "Congress Party Issues Campaign Platform," *AsiaNews.it*, March 26, 2009, at <http://www.asianews.it/index.php?l=en&art=14830> (July 10, 2009).
6. Budget Documents of the Government of India, Table 102: Key Deficit Indicators of the Central Government, 1970 to 2009, at <http://rbidocs.rbi.org.in/rdocs/Publications/DOCs/87484.xls> (July 10, 2009).
7. India Fared Better Than Others during Economic Crisis" *The Economic Times*, June 28, 2009, at <http://economictimes.indiatimes.com/News/Economy/Indicators/India-fared-better-than-others-during-economic-crisis/articleshow/4705114.cms> (July 10, 2009).
8. Amol Agrawal, "India Union Budget 2009-10," *Mostly Economics*, July 6, 2009, at <http://mostlyeconomics.wordpress.com/2009/07/06/india-union-budget-2009-10> (July 10, 2009).
9. S. Gurumurthy, "A Budget That Is Sleight All the Way," *Hindu Business Line*, July 9, 2009, at <http://www.thehindubusinessline.com/2009/07/09/stories/2009070950270800.htm> (July 10, 2009).
10. Population Reference Bureau, "The World's 15 'Oldest' Countries and the U.S.," 2006, at http://www.prb.org/presentations/gb-aging_all.ppt (April 22, 2009).

ment notwithstanding, the budget envisions raising less than \$250 million from selling down stakes in public companies despite recommendations of up to \$5 billion.¹²

In contrast, the budget boosts subsidies, worsening government-wreaked distortions and reducing efficiency further.¹³ There is no appreciable tax reform, either on the corporate side or as a federal push toward harmonizing what are now divergent and obstructive tax differences across states.¹⁴ Rather, Indian states will remain separate economic entities, inhibiting economies of scale and specialization by sector.

Regarding education, the clock is ticking. The education system is broadly acknowledged as flawed, and India must hurry if it is to better educate the coming influx of workers. Moreover, the stress must be on primary education. Over one-third of Indians are illiterate,¹⁵ which will eventually translate to close to 500 million people as the population mushrooms. A demographic expansion that adds nearly 100 million illiterate workers will not produce the rapid economic rise so widely anticipated.

The budget, however, is overwhelmingly oriented toward current income support. Money set aside for the national rural employment guarantee scheme is to more than double. Other large sops include tax breaks for the elderly and financial support for exporters.¹⁶ This goes hand-in-hand with the deficit in sacrificing the future for the present,

even though education will be an even more pressing need as time goes on.

Even within education spending, the priorities are misplaced. The budget emphasizes higher education. There is certainly value to a better university system, but higher education cannot possibly accommodate the flood of young people presently in the education system or bound for it in the next 15 years. If the government declines to emphasize primary education, it could open the door to the private sector. But there was no provision for that in the budget (or elsewhere).¹⁷

Suppressing the Ascent. This is only one year's budget, of course, and there is already a campaign of reassurance that reform will come later. But the Congress Party's credibility on this is very low. For most of this decade, India thrived, benefiting tremendously from earlier liberalization, which, among other things, drew large inflows of foreign investment. Now India is heading the wrong way on the economy.

The U.S.–India relationship is multifaceted and can certainly thrive based on political affinity and geostrategic considerations. But the direction that Congress has set for the past five years, topped off by this budget, is going to slow and perhaps limit India's ascension to a global economic force. That could limit the value of the partnership.

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11. For example, in textiles, see T. Thomas, "Can India Dress the World?" Rediff.com, August 26, 2005, at <http://in.rediff.com/money/2005/aug/26guest.htm> (July 10, 2009).
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13. Sangeeta Singh, "Subsidies Cross Trillion-Rupee Mark, Stretch Finances," Livemint.com, at <http://www.livemint.com/2009/07/07010047/Subsidies-cross-trillionrupee.html?h=B> (July 10, 2009).
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17. Urmi Goswami and Sushmi Dey, "Union Budget 2009-'10: Varsities Gain Most, Schools Given Go-By," *Economic Times*, July 7, 2009, at <http://economictimes.indiatimes.com/News/Economy/Policy/Union-Budget-2009-10-Varsities-gain-most-schools-given-go-by/articleshow/4746703.cms> (July 10, 2009).