Union Budget 2016-17: Outlook

There's No Such Thing as a Free Lunch!

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Given the poorer tax collection and the inability of the government to meet the disinvestment targets the government's commitments towards the Seventh Pay Commission, the OROP and Bank recapitalisation will be difficult to keep. At best they can only be kept at the cost of vital public investments in infrastructure, both physical and social.

An online opinion poll on the forthcoming Union Budget on a leading media website reads: "Should Arun Jaitley prefer growth or fiscal deficit?" As India emerges as the fastest growing economy, the question is: How can the budget facilitate the growth story, without compromising on macro-stability?

India is projected to grow at a 7.5 per cent growth rate in fiscal year 2016 and 2017, as per IMF estimates. The government has expressed its desire to push India to an 8-9 per cent growth rate in the coming fiscal. How viable is this growth? Growth depends on investment facilitated primarily through domestic savings, accompanied by a low Incremental Capital Output Ratio (ICOR).

Table 1: Key Financial Indicators

Indicator	2011-12	2012-13	2013-14	2015-16
1. Real GDP at Market Prices (Per cent change) (New Series)	-	5.1	6.9	7.3-8.1 per cent
2. Gross Domestic Saving Rate (as a per cent of GDP at current prices)	33.9	31.8	30.6	-
2.1.Household Financial savings	7.3	7.0	7.2	-
2.2. Savings in Physical assets (including valuables)	15.5	13.2	11.0	-
3. Gross Domestic Investment Rate (as a per cent of GDP at current prices)	38.2	36.6	32.3	~34.16- 38 per cent
3.1. Public sector	7.6	7.2	8.0	-
3.2. Private sector	28.4	26.3	23.3	-
3.2.1. Corporate Sector	13.3	13.5	12.6	-
4. Saving-Investment Gap	-4.3	-4.8	-1.6	-
5. Net Capital Inflow	4.3	4.8	1.6	-
6. Estimated ICOR		7.2	4.68	~4.68
7. Gross Fiscal Deficit (as a per cent of GDP)	4.9	4.4	4.1	3.9

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Source: CSO

India's experience indicates the following (Table 1):

The Gross Savings rate has been declining, primarily due to a decline in household financial savings. The household financial savings has reduced from 11.6 per cent in 2007-08 to 7.2 per cent n 2013-14. The Gross Domestic Investment rate has declined as well from 38.1% in 2007-08 to 32.3 per cent in 2013-14. Private corporate investment fell from 17.3 per cent to 12.6 per cent over the same period. The ICOR, which had increased to 7.2 in 2012-13, fell to 4.68 in 2013-14. The Current Account Deficit fell to 1.6 per cent of GDP in 2012-13, driven primarily by a greater decline in imports.

Our calculations indicate that a growth of 7.5 per cent to 8.1 per cent, assuming the ICOR to remain at 4.68 (as in 2013-14), would require a domestic investment rate of between 34-38 per cent. This in turn, would require a growth in private corporate investment financed through household financial savings. The current growth has been driven primarily by growth in Private Final Consumption expenditure, as also an increase in public investment.

The latest numbers indicate that private investment remains weak. Consequently, the growth rate of eight core industries (especially cement and electricity) has more than halved between April-November 2014-15 and 2015-16.

At the same time, the growth in the Index of Industrial Production over April-November 2014-15 and 2015-16 marks the quality of the improvement. As Table 2 reveals, the growth has been driven by a growth in consumer durables, while basic and capital goods have at best remained the same, if not worsened. Similarly exports experienced negative growth rates of (-)18.06 per cent in the period April-December 2015-16.

Table2: Key Growth Indicators

Indicators	**April-Nov 2014-15**	**April-Nov 2015-16**
1. Growth rate of Core Industries-Overall Index	6	2
2. Growth Rate of Index of Industrial Production (IIP)		
a) Basic Goods	8.3	3.8
b) Capital Goods	4.9	4.7
c) Intermediate Goods	1.9	2.2
d) Consumer Goods (Total)	-5.7	4.1
e) Consumer Durables	-15.9	11.9
f) Consumer Nondurables	1.8	-0.5
Overall	2.5	3.9
3. Exports	-1.23	-18.06

Source: Reserve Bank of India

The need clearly is to ensure that domestic buyers replace foreign buyers, while at the same time private investment be significantly revived.

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Public Investment: Is there a free lunch?

The government's mid-term review has already indicated that the path towards fiscal consolidation may be temporarily given up, given the macroeconomic scenario. Thus, " … It is this context that the government's commitment to further fiscal consolidation of 0.4% of GDP needs to be assessed."

While the Government seeks to increase its public investment, so as to 'crowd in' private investment, it is important to keep in mind two crucial aspects:

- One, what is the size of the government expenditure multiplier? Will it be smaller or greater than the effect of the additional debt incurred and the resultant crowding out of private investment?
- Two, where will the government fund such higher expenditures from?

The adherence to the fiscal deficit and more importantly, the revenue deficit targets looks difficult, given the compulsions on both the revenue and the expenditure side. The fall in direct tax collections due to lower growth and the inability of the government to meet the disinvestment targets will make the government's commitments towards the Seventh Pay Commission, the OROP and Bank recapitalisation difficult. Such commitments may be at the cost of vital public investments in infrastructure, both physical and social.

To put the economy on to an 8% growth rate track, the following are the three top recommendations for the government:

It needs to work on significantly improving the 'Ease of Doing Business', especially in critical areas such as infrastructure in meaningful ways. The government is stuck with the GST Bill and the land Acquisition Bill. However, there are areas where the government needs to withdraw and not succumb to increasing regulation.

A case in point is that of Indian aviation. Far from relaxing the constraints which make Indian aviation one of the costliest in the world, the government's latest 'Draft National Civil Aviation Policy, 2015' exacerbates the constraints on airlines flying in India. In October 2015, the government's Draft National Civil Aviation Policy (NCAP 2015) sought to amend the Route Dispersal Guidelines (RDGs) and the 5/20 rules. The NCAP 2015 claimed that its objectives were to promote the entire aviation sector chain, enhance regional connectivity and enhance ease of doing business in India. However, the amendments clearly enhanced the scope of regulations, rather than the reverse. Route Dispersal Guidelines, which make it mandatory for airlines to fly unviable routes, have been amended such that airlines would need to fly more such routes.

Encourage Small and Medium Enterprises, especially those, which are labour intensive, so as to assist in job-creation. The budget may also provide tax incentives to SMEs which adopt green technologies. The resultant sustainability-building activities would assist in the globalisation of

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SMEs. Another aspect of modernisation of SMEs- namely digitisation of SMEs – may also be promoted through appropriate tax incentives or even the setting up of an SME Technology Transformation Funds, as in countries like Malaysia. The SMEs, which currently contribute more than 40% of our exports, apart from output and employment can then become the lodestars of the 'Make in India' campaign.

Increase farm productivity, through increasing the efficiency of capital employed in agriculture. This will require structural reforms in the agricultural sector. It is the agricultural sector that drives demand for most consumer durables- the segment, which has exhibited maximum growth in the past. The government will need to step up investment in irrigation, and at the same time think of supporting crops like pulse crops, which have been the chief contributors to food inflation in the last couple of years.

At the same time, the government will need to try to keep the Fiscal Deficit to its budget estimate and reduce fiscal deficit to its 3% target as given in in the fiscal adjustment path set by the 13th Finance Commission.

All, in all, the budget will demand some sacrifices. Clearly, there is no such thing as a free lunch!

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