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Questions and Answers About India's New Budget

By HARI KUMAR JULY 10, 2014

Prime Minister Narendra Modi's new government in India has unveiled its first economic road map aimed at increasing investment, improving infrastructure and reviving manufacturing, even while curbing borrowing. Finance Minister Arun Jaitley said the economy would expand at an annual rate of 7 to 8 percent within three years, but warned that the global slowdown had created a difficult environment for growth. The plan received a mixed reception.

Eswar S. Prasad, a Cornell University economist who has consulted informally with Mr. Modi's economic team, answered questions over email about the budget and its implications on employment, investment and taxation.

Q. What are your thoughts on Mr. Modi's first budget?

This budget hits the right notes and emphasizes some key policy priorities, but still maintains a realistic perspective that this is only the first step of a longer process toward reviving India's growth and ensuring macroeconomic stability. The emphasis of this budget is on restoring macroeconomic stability by keeping the budget deficit and inflation under control and getting started on a modest set of reforms to build confidence and revive growth rather than instituting a full-blown package of reforms. There are many areas where the budget falls short of reforms and liberalization measures that had been hoped for. The government seems to have taken a prudent strategy of managing expectations about what it can deliver in a short time frame. Perhaps the idea is to build credibility and a track record of implementation before embarking on more ambitious reforms.

Q. How do you see the investment climate in India in the coming two to five years?

Domestic and business investors care about a stable macroeconomic environment, policy certainty, less restrictive labor laws, lower bureaucratic hurdles and a sound physical infrastructure. All of these will build confidence in India's long-term growth prospects.

In some of these dimensions — macro policies, investment in infrastructure, indications of a more stable policy environment — this budget certainly sends the right signals. If the proposed measures are implemented effectively, it would certainly inspire confidence that this government can deliver on a broader range of much-needed reforms.

Q. Do you think this budget will lead to economic recovery in India?

This budget makes a modest attempt to shift the balance from populism toward reforms, although with some nods to policies that do have a redistributive element but could also be argued for on the grounds of efficiency (higher levels of tax exemptions, some new schemes). All told, this budget should serve as a catalyst for getting the economy moving in the right direction, especially now that the global economic environment appears more stable.

Q. Do you think that this budget will be able to revive the manufacturing sector in India?

The measures in this budget are not sufficient to quickly solve the deep-rooted problems that have held back the manufacturing sector in India. Improvements in physical infrastructure, better financial markets and more openness to foreign capital are all helpful, and the budget does take modest but positive steps in these areas. However, these measures will take time to bear fruit.

Meanwhile, labor market reforms, measures to reduce bureaucracy and red tape, and other major structural reforms have not been emphasized in this budget. So a lot more needs to be done to generate a durable manufacturing sector revival in India.

Q. Will this budget help generate jobs?

This government is clearly eager to shift away from approaches such as employment guarantees toward relying on a higher rate of economic growth to increase employment generation. An improvement in manufacturing sector growth would help improve the availability of better-quality jobs.

Greater emphasis on financial market reforms that make it easier for small and medium sized enterprises to obtain financing would also aid employment growth. It is encouraging that the budget signals that the government is going to back the RBI in its efforts in this direction.

It is also encouraging that the budget pays attention to improving the skills of India's burgeoning youth population by putting more money into education. However, the amounts proposed are modest and a more substantial revamping of the education system will be needed to meet the needs of Indian enterprises.

Q. Do you think that this budget paid enough attention to the poor?

The budget, along with earlier statements from the finance minister, do herald a subtle shift away from populist measures that could hinder economic efficiency. It is encouraging, for instance, that the government has indicated it will continue to shift away from subsidies toward cash transfers, which will reduce leakage of social benefits before they reach their intended recipients and also avoid distortion of product markets. Unfortunately, in this budget the new government does not frontally tackle the costly and wasteful subsidy regime, perhaps not wanting to erode political support for other reforms.

Nevertheless, the budget does hint at the government's approach — viewing growth as the best way to alleviate poverty rather than a focus on redistribution. Thus, the notion that this budget pays inadequate attention to the poor may not be appropriate.

Q. Do you think that raising foreign direct investment limits in the defense and insurance sectors will attract more investment in India?

Foreign investors will certainly be encouraged by the raising of limits on FDI. The specific measures are in some ways less important than the signal they convey — that the government will continue reducing restrictions on foreign capital inflows and will welcome foreign capital.

However, as is the case with domestic investors, other aspects of India's macroeconomic and policy environment are likely to be far more important in determining the volume of FDI and other types of capital inflows into India.

Q. What do you think about the measures proposed in the budget about better tax administration?

Improving the efficiency of the tax and expenditure systems is a crucial component of fiscal reforms in India. The steps proposed in the budget are certainly welcome ones but quite limited in terms of what is ultimately needed for a better fiscal system. Implementation of the goods and services tax is clearly an important priority and will serve as a good measuring rod for the government's effectiveness in implementation of its broader agenda.

Q. Does this budget put a greater emphasis to corporate and urban India?

This distinction is important only insofar as it has implications for specific sets of policies. The budget's emphasis on disciplined fiscal policy and reforms that are intended to boost growth and tamp down inflation are important for all sectors of the economy.

Having said that, there is a set of reforms that are particularly important for rural India and the budget does not seem to have much on these areas. The supply and distribution of food, in particular, needs improvement through reforms of agricultural and land policies. Moreover, changes are needed to government policies have kept the distribution system, which remains dominated by small shopkeepers and multiple layers of middlemen, inefficient and wasteful.

Q. What do you think is the realistic value of the Indian rupee and how it will change in coming years?

It is likely that the budget and proposed reforms will lead foreign investors to take a closer look at India, especially with monetary conditions in advanced economies still remaining loose and a lot of capital looking for higher yields. If the government succeeds in its objective of keeping the current account deficit under tight control, capital inflows could then put upward pressure on the rupee.

If the budget sparks a growth revival and causes investors to revise upward their forecasts of medium-term productivity and output growth in India, then the rupee could come under more sustained appreciation pressures in the coming years.
