Bloomberg

Modi should end his honeymoon

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July 8, 2014

In India, a new government's first post-election budget is usually a time to hand out rewards -- freebies and tax cuts for the ruling party's loyal supporters. This might seem like good politics as well as good manners. But if Indian Prime Minister Narendra Modi wants to meet the high expectations that markets have set for him, he needs to take a different path when he presents his budget on July 10.

In fact, India's troubled finances are going to require two tough budgets in a row. At 7 to 9 percent, the combined fiscal deficit of the central and state governments has been unsustainably high for years. Blame for this can be laid upon the previous Congress Party-led government, which produced two soft budgets after being elected for a second term in 2009. The ruling coalition had already slashed taxes in 2008 to combat the fiscal crisis, and it decided to go slow in rolling these back. It increased subsidies for oil, fertilizers and food. It announced big increases in government support prices for crops, helping farmers but stoking food inflation.

At first, this spending spree stimulated the economy. Gross domestic product grew by 8.6 percent in 2009-2010 and 8.9 percent in 2010-2011. But a slowdown inevitably followed, exacerbated by the global downturn. Meanwhile, high fiscal deficits helped stoke consumer price inflation of 8 to 10 percent for several years. The central bank raised interest rates, but these hit production without curbing prices. Rating agencies threatened to downgrade the country's debt, and the government responded with savage cuts in capital spending. At the same time, the threat of corruption investigations paralyzed decision making, so project approvals froze. Result: GDP growth was almost halved, to 4.6 and 4.7 percent respectively, in the Congress Party's last two years in power before Modi's blowout victory.

The lesson for Modi is clear: If you start with soft budgets, you will win only temporary popularity. Then you'll have to pay the price in the second half of your term, exactly when fast growth is needed to ensure your re-election.

Modi is enjoying a honeymoon with voters and political supporters now. Cutting it short could be the best antidote against a divorce down the line. That means disappointing all sorts of constituencies that contributed to the win. One of Modi's party allies in the southern state of Seemandhra, for instance, promised during the campaign to waive repayment of bank loans made to farmers and self-help groups. The local party now wants Modi to help pay for its foolish pledge. The prime minister should refuse. His own budget is under strain, and besides, such brazen favoritism to one state would explode all his claims to good governance. Loan waivers reward defaulters and make honest repayers look foolish. This will encourage willful default in the future, weakening the entire rural financial system.

The core support for Modi's party comes from the Indian middle class. So, the news media are full of speculation that his finance minister, Arun Jaitley, will reward these voters by raising the income tax exemption limit to 500,000 rupees ($8,384) per year from 200,000 rupees ($3,354). This would be fiscal suicide. Instead, the new government should focus on plugging loopholes, reducing the huge array of existing tax exemptions and exceptions, and improving tax administration.

Fuel subsidies account for almost 1.5 percent of GDP. They are not even targeted at the poor or needy, benefiting mostly big farmers, the middle class and owners of luxury diesel cars. Troubles in the Middle East threaten to push global prices (and hence Indian budget subsidies) even higher. Modi needs to raise the government-designated price of oil products such as diesel and kerosene immediately and phase out price controls completely within two years.

Modi's election platform promised massive new spending on infrastructure and health. Where will all this money come from? Private infrastructure companies cannot be the solution: Most are deep in the red, unable to pay their bank debts. Indeed, the swelling tide of bad debts threatens the viability of banks themselves. State-owned banks, which account for 70 percent of all banking, need almost 6 trillion rupees of fresh capital by 2018 to meet the new Basel norms. But New Delhi lacks cash for recapitalization.

In sum, the situation calls for tough decisions and stringent budget discipline. This must be accompanied by good policies and a slashing of red tape to revive economic growth. Only then should Modi embark on his promised infrastructure spending spree. This approach will disappoint his gung-ho supporters in the short run. But it will yield dividends when Modi has to face the voters again.

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