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## Time to Tackle India's Budget Deficit

*Development of broader financial markets has to be promoted to finance the infrastructure India needs.*

By **ESWAR PRASAD**

The Indian economy proved resilient during the global financial crisis, partly as a result of aggressive measures to boost government expenditures and cut taxes. These measures, which pushed the central government deficit to nearly 7% of GDP and reversed the downward trajectory of public debt, helped maintain robust growth during a difficult period. Now that the recovery seems on track, it is time to pay the piper and rein in the budget deficit.

Deficit reduction poses a big challenge but also provides an opportunity to reorder spending priorities in a way that will support future growth. Indeed, there is much at stake in Finance Minister Pranab Mukherjee's budget speech this week as it will set the tone not just for the fiscal picture but also the contours of India's growth.

General government debt now stands at 82% of GDP according to International Monetary Fund estimates, up three percentage points from two years ago. High levels of deficits and debt increase the vulnerability of public finances. The first order of business is clearly to bring the deficit down to a more moderate level and to put public debt back on a downward path. There are a few steps that will help attain these goals and also serve to make progress towards longer-term objectives.

On the expenditure side, there are a number of inefficient subsidies that cost a lot of money and do not serve their intended purpose. For instance, fuel subsidies ostensibly help the poor but most of the benefits in fact go to middle- and high-income households. These subsidies are costly and perpetuate a high level of dependence on fuel imports. It would be far better, as a government commission recently recommended, to cut these subsidies and replace these and other subsidies with direct cash transfers to poor households. Overly generous sops to public-sector employees also need to be reined in.

There are some important changes overdue on the revenue side, too. Introduction of a goods and services tax, a far more efficient form of taxation than the present central state tax and a hodgepodge of other levies, would in fact raise revenues even if tax rates were kept at low levels. By making the tax system more transparent, it could also reduce opportunities for corruption by public officials.

Such steps are necessary to create room for the government to meet the real priorities for its expenditures, including direly needed spending on education, health care and most important of all, infrastructure. While the government must play an important role in catalyzing progress in these areas, an equally important objective is to unleash the power of the private sector rather than just counting on government to solve all problems.

On this front, the budget speech will be scanned carefully for signs of the government's intentions. And here again there are opportunities to attain multiple goals with some steps, many of which the government had earlier indicated support for but that were set aside in the midst of fending off the crisis.

Reducing government stakes in public-sector enterprises through a process of disinvestment will help pay down some of the accumulated public debt and create space for other expenditure priorities. The government has already identified public-sector enterprises that are ripe for disinvestment, could benefit from private management and for which there is demand from private sector investors. It is important to get a fair price for these assets but populist politics should not be permitted to thwart these actions that are in the broader public interest.

Mr. Mukherjee may also signal wider reforms. One key area to watch is financial services, which will be crucial to sustaining and deepening future growth. The Indian banking system held up remarkably well during the global financial crisis but is near the limits of its capacity to manage the financing needs of India's corporate sector. Selling government stakes in many of the public-sector banks and freeing up banks from strictures to buy government bonds and make

development loans would improve banking system efficiency and the availability of funding for enterprises.

Development of broader financial markets, especially corporate bond markets, has to be actively promoted if India is to finance the physical infrastructure it desperately needs. Rather than trying to clamp down on inflows of foreign capital attracted by India's growth potential, these should be welcomed and steps taken to move forward quickly with bond market development to absorb and effectively use these inflows.

The measures in this year's budget will be about far more than just mundane matters such as taxes and government expenditures. They have the potential to determine India's growth prospects for many years to come.

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