THE UNION BUDGET 2008-09

H.P. RANINA

FORUM
of Free Enterprise

"Free Enterprise was born with man and shall survive as long as man survives".

- A. D. Shroff

1899-1965

Founder-President

Forum of Free Enterprise

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This year's budget proposals have been formulated in the background of a difficult international environment, moderating growth scenario and decelerating exports. The strong linkage with international markets combined with rapid surge in capital inflows has imposed serious constraints on the calibration of domestic macro-economic policy instruments.

Attempts to decouple the domestic economy from the international environment have not succeeded, and will not. The recessionary environment in the United States could squeeze export demand. In this scenario, it was necessary to continue austerity and aggregate fiscal deficits which has been ably done by the Finance Minister.

The record of the Centre's fiscal adjustment since the enactment of the Fiscal Responsibility and Budget Management Act has been impressive. The fiscal deficit reduction is on target at less than 3 per cent of the GDP. The revenue deficit has been compressed to 1 percent in the budget estimates of fiscal year 2008-09.

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However, there is a build-up of large off-budget liabilities through food, fertilizer and oil sector subsidies and these could be in excess of 2.5 per cent of GDP which has been acknowledged by the Finance Minister in his budget speech. The deficit reduction has been achieved mainly by increasing revenues rather than compressing unproductive expenditure.

While the credit for increasing revenues should go to the tax information system and improvement in compliance, higher revenues have softened the resource constraint and enabled larger allocations for populist schemes, as well as the write-off of farmers' loans to the extent of roughly Rs. 60,000 crore. As the funds for populist schemes are transferred to implementing agencies and local bodies without passing through state budgets, there are questions about efficiency of delivery systems, and accountability.

Direct tax proposals

On the direct taxes front, indexation for inflation has been done in the exemption limit and tax rate brackets. The initial exemption limits for males, females and senior citizens have been increased to Rs. 1,50,000, Rs. 1,80,000 and Rs. 2,25,000 respectively. To take care of inflation, the slabs have also been stretched. The first slab of taxable income has been extended to Rs. 3,00,000 attracting a 10% rate of tax; the second slab of Rs. three to five lakhs will attract 20% rate of tax, and the maximum marginal rate of 30% will now be applicable in all cases to income over Rs. five lakhs. Therefore, for the fiscal year 2008-09,

a male, female, and a senior citizen having an income of Rs. five lakhs per annum will save tax of Rs. 44,000, Rs. 43,500 and Rs. 38,500 respectively, compared to the current year.

Senior citizens have also been benefited by enabling their children to take out a medical insurance policy separately for them by giving additional deduction of Rs. 15,000 for the premium paid by the children. It is proposed that if either of the individual assessee's parents, who has been medically insured, is a senior citizen, the deduction would be allowed up to twenty thousand rupees.

Section 80-C provides for a deduction of up to rupees one lakh to an individual or a Hindu undivided family (HUF) for–

(i) investments in certain saving instruments; or

(ii) expenditure on tuition fee and repayment of housing loan.

With a view to encourage small savings, it is proposed to enlarge the scope of eligible saving instruments by inserting two new clauses in section 80-C(2). The following investments made by the assessee will be eligible for deduction under section 80-C within the overall ceiling of rupees one lakh:-

(i) five year time deposit in an account under Post Office Time Deposit Rules, 1981; and

(ii) deposit in an account under the Senior Citizens Scheme Rules, 2004.

Further, it is also proposed to provide that where any amount is withdrawn by the assessee from such account before the expiry of a period of 5 years from the date of its deposit, the amount so withdrawn will be deemed to be the income of the assessee of the previous year in which the amount is withdrawn. The amount liable to tax shall also include that part of the amount withdrawn which represents interest accrued on the deposit.

The Finance Minister, in paragraph 89 of his speech last year, while presenting the Union Budget for fiscal year 2007-08, had announced that the National Housing Bank will introduce a reverse mortgage scheme for senior citizens. In pursuance of this announcement, some of the banks have already formulated a scheme for reverse mortgage.

In the context of this scheme, it is necessary to resolve the tax issues arising therefrom. The first issue is whether the mortgage of property for obtaining a loan under the reverse mortgage scheme is transfer within the meaning of the Income-tax Act thereby giving rise to capital gains. Section 2(47) provides an inclusive definition of 'transfer'.

Further, 'transfer' within the meaning of the Transfer of Properties Act includes some types of mortgage. Therefore, a mortgage of property, in certain cases, is a transfer within the meaning of section 2(47). Consequently, any gain arising upon mortgage of a property may give rise to capital gains under section 45.

However, in the context of a reverse mortgage, the intention is to secure a stream of cash flow against the mortgage of a residential house and not to alienate the property. It is, therefore, proposed to insert a new clause (xa) in section 47 to provide that any transfer of a capital asset in a transaction of reverse mortgage under a scheme made and notified by the Central Government will not be regarded as a transfer and therefore will not attract capital gains tax.

The second issue is whether the loan, either in lump sum or in instalment, received under a reverse mortgage scheme amounts to income. Receipt of such loan is in the nature of a capital receipt. However with a view to providing certainty in the tax regime for senior citizens, it is proposed to amend section 10 to provide that such loan amounts will be exempt from income-tax.

Consequent to these amendments, a borrower, under a reverse mortgage scheme, will, be liable to income tax (in the 'nature of tax on capital gains) only at the point of alienation of the mortgaged property by the mortgagee for the purposes of recovering the loan.

The corporate sector has been left untouched to a substantial extent but there is no deduction in surcharge as was generally expected. More incentive has been given to research and development and the benefit of set-off of dividend distribution tax has been given to holding companies. New hotels and hospitals will now have the incentive to go to two-tier and three-tier cities of India.

Write-off of farmers' loans

A controversial proposal made by the Finance Minister in his budget speech pertains to the farm loan waiver which will make a dent of Rs. 60,000 crore in public resources. The problem of rural indebtedness is far too complex to be fixed by a one-time waiver. The Dr. Radhakrishna Committee, which had studied the subject, came to the conclusion that it is the farmers' debt obligations to private moneylenders that kill them, not outstanding bank dues.

The committee found that 36 per cent of the private farm loans are taken at interest rates of 20-25 per cent, and 38 per cent of the loans at above 36 per cent rate of interest. The panel also found that small farmers, who account for 80 per cent of the indebtedness, depend more (50 per cent) on private lenders. The loan waiver scheme does not apply to loans taken from private lenders. Therefore, debt-ridden farmers will not stop committing suicide.

Consider the scheme from the viewpoint of other beneficiaries: commercial banks, co-operative banks and Regional Rural Banks. Banks are saddled with irrecoverable loans, which they could not have recovered any way. These will now be made good by the Government, helping banks to cleanse their balance sheets.

Even amongst banks, most of the funds will not go to the best. Scheduled commercial banks have bad farm loans of just over Rs. 10,000 crore on their books, whereas co-operative banks have around Rs. 37,000 crore. So, over half the cash infusion from the Government will go to a

group of banks that is arguably the worst-managed segment in the Indian financial system. Their business records manage to anger even the normally sedate Reserve Bank of India. The idea of giving cash to co-operative banks seems even more perverse when one considers the plain fact that most of these banks are family enterprises of political leaders rather than banks in a commercial sense.

The worst part of the waiver, for banks, is the undermining of credit discipline by the Government. Hereafter, it will be difficult for banks to recover loans given to farmers because the recipients will nave good reason to believe that eventually the loan will be waived. Constituting nearly 60 per cent of the population, farmers have enough electoral clout to ensure that parties champion their cause.

Banks will stand to gain to a marked extent as a result of the Government providing Rs. 60,000 crore of budgetary support in respect of irrecoverable loans from marginal and small farmers. Had this support not been given, the banks would have been weakened to the extent of these non-performing assets. Banks, which will be reimbursed this loss over a period of three years, will now have in their hands, adequate funds for lending to the priority sector.

The capital market

A few bank stocks will perform well on the capital market together with other sectors like pharmaceuticals, two-

wheelers, small-car manufacturers, and others who have been given excise duty concessions. The increase in the rate of short-term capital gains tax from 10 to 15% will encourage individuals to stay invested for at least one year so that they secure full capital gains tax exemption.

The corporate debt market has been given the right impetus by removing the withholding tax. Companies will also stand to gain when stamp duties are rationalized by the State Governments which will eventually lead to a fall in the duty burden.

In the last few weeks, the stock market in India has performed poorly showing a downward bias. This is not on account of any budgetary proposal announced on 29th February. The turmoil in the global economy has contributed to the sliding capital market not only in India but in all emerging economies.

Since the start of the global financial crisis from August 2007, monetary policy has been remarkably ineffective. The US Federal Reserve Bank has cut short-term rates by a cumulative 225 basis points since then. Yet, borrowing costs for US consumers and companies have actually gone up. While the European Central Bank has stoically kept short-term interest rates at 4 per cent, rates charged to consumers and companies have increased.

This crisis is first and foremost a financial solvency crisis. If a liquidity problem is faced, the rate of interest matters a great deal, since it determines the price to regain liquidity. However, this is not a liquidity crisis, but a contagious

solvency crisis, affecting sector after sector, starting with sub prime mortgages, spilling over to the rest of the mortgage market, into municipal debt, corporate debt and many obscure sectors of the financial market.

Consumer prices in the 30-member Organisation for Economic Co-operation and Development (OECD) surged 3.5 per cent in January, the most in seven years. The Paris-based group forecast the weakest global growth since 2003. The agency expects growth in its 30 member states will slow to below 2 per cent this year from 2.7 per cent in 2007. Thus, the capital market in India and elsewhere will continue its downward slide, punctuated with price spurts from time to time.

Gold in turbulent times

With the looming uncertainty in the stock markets, gold, as a medium of investment and as a cushion for security, is gaining in importance. The prevailing price levels of gold reflect investor concern about the turbulence in the world economy and the global political tensions. Gold price has been increasing for the past two decades and has touched $ 1000 (an ounce) in the recent past. Gold and dollar are closely related but move in opposite directions. When the dollar weakens, investors take to gold as a sound alternative. The U.S. Federal Reserve's cuts in interest rates to minimize downside risks to growth have not helped.

On a micro-level, the introduction of exchange traded funds that would enable small investors to invest in gold funds

has increased the demand for gold. It is reported the holdings of such exchange traded gold funds hover around 800-900 tonnes, surpassing the holdings of many central banks. These funds enable investors to invest without the hassle of holding on to the physical commodity.

India is the largest market for gold in the world. The strengthening of the rupee against the dollar has raised the demand for the yellow metal by as much as 72 per cent during the first half of 2007. According to the World Gold Council, India's demand reached an all-time high in 2007. While the plunging stock market has wiped out roughly 30% of investors' wealth, the rise in the price of gold (more than Rs. 13,000 for 10 gms.) which is held by more than half of the Indian population has increased their value of savings to unprecedented levels, having regard to the fact that around 29,000 tons of gold is estimated to be held by Indians.

Inflation in India

The Union Budget 2008-09, in its 'Medium-term Fiscal Policy Statement', assumes 13 per cent growth in nominal GDP in 2008-09. The Statement further notes that the "annual GDP growth that averaged around 8.7 per cent is set to accelerate further in the range of 9-10 per cent, as set out in the Eleventh Five Year Plan". Assuming the real GDP growth to be on this trend for 2008-09, implicit inflation works out to about 4 per cent. The various measures announced in the Budget are expected to reduce the input costs to some extent in key items, such as metal scrap, machinery, chemical and cement. However, this implicit

inflation worked out from the Budget document appears to be on a lower side even along with the ongoing average trends.

There are several upside risks which need to be recognized in drawing out the inflation outlook for 2008-09. First, the international oil price pass-through has been incomplete; although, international crude prices (Indian basket) increased by over 57 per cent from US $ 56.6 a barrel in February 2007 to US $ 96 a barrel by February 2008, domestic prices of petrol and diesel were increased by 4.4 per cent and 3.4 per cent, respectively, on February 15, 2008. Further, domestic prices of kerosene and liquefied petroleum gas have also not been raised by the Government since April 2002 and November 2004, respectively, in view of societal concerns.

Second, the actual outcome on inflation would critically depend on the movements in the international prices of various commodities. Domestic food prices, especially of wheat, oilseeds and edible oils continue to remain at elevated levels in line with international trends.

It is expected that the industrial growth rate will slow down in the financial year 2008-09. Industrial output growth in January 2008 registered a 10-month low of 5.3 per cent against 11.6 per cent in the same month last year and a revised 7.7 per cent in December, raising doubts over whether India will grow at 9 per cent in fiscal 2008-09. The fall took place chiefly because of an unexpected decline in capital goods and a continuing downtrend in consumer durables.

Conclusion

Despite the bleak global scenario and inflationary pressures in India, the Finance Minister through his budget proposals has ensured that India's economy continues to perform at more or less the same pace as in the last four years. While the economy will continue to .be under stress for reasons beyond the control of the Government, the virtuous cycle of growth will be sustained.

This is a growth-oriented budget because more disposable income will now be left in the hands of millions of taxpayers who will be inclined to spend more money in view of the fact that there are a large number of young consumers.

The deepening of the debt market will result in more investments flowing in the corporate sector. It is expected that foreign direct investment in infrastructure projects will flow in greater measure during the fiscal year 2008-09, despite global economic slowdown. The availability of more skilled and technically qualified professionals in the coming years, as a result of greater emphasis on higher education, will provide the information technology sector with adequate human resources to continue with their growth story.

India is undoubtedly considered to be one of the top five investment destinations in the world. This year's budget proposals will ensure that India's place as an economic superpower remains firmly entrenched in the global environment.

(*Courtesy* : AMZEL FOUNDATION)

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good".

- Eugene Black

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