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From the ringside

The devil is in the detail

By now, P Chidambaram does not need any more certificates applauding him for what is widely regarded as a balanced Budget designed to please all stakeholders. It should be gratifying to him that even four weeks after the Budget, endorsements outstrip criticism, even though some endorsements are cautiously couched, suggesting that the Budget atleast does no harm to the economy's current growth momentum. In the present context, this is regarded as no mean achievement.

Certainly, the Budget carries forward the tax reform agenda, lowering corporate taxes to highest marginal rate for personal Income Tax, (we hope 10% surcharge would be temporary), greater convergence of excise rates towards the 16% CENVAT, alignment of Customs duties towards ASEAN rates and personal Income-Tax slabs mirroring more closely the impact of inflation since last determined. Enhanced outlay for social sector, infrastructure and weaving together rural programmes under the Bharat Nirman initiative are well conceived. Notwithstanding these positives, there are some issues which deserve consideration.

• First, it must be conceded that the clever balancing act, winning wide endorsement, has been achieved by keeping all contentious issues out of the Budget. Apart from a commitment to review Plan schemes every five years instead of their automatic carry forward, there is no commitment to subject schemes carried forward for the last 10 Five Year Plans to any intensive scrutiny without awaiting the 11th Plan! Nor can vague statements on subsidy reviews or better targeting add comfort. Privatisation is on the back-burner and banking reforms left to the best judgement of the Reserve Bank. There are no other significant moves on Foreign Direct Investment not to mention Labour Reforms, and what is equally surprising is absence of any commitment on continuation of structural reforms in infrastructure. By pushing the pause button on the FRBM, Chidambaram is being honest because clearly you cannot have tax breaks, mounting expenditure and fiscal rectitude all at the same time! Needless to say, this has medium-term implications. All in all, it would be fair to suggest that Chidambaram has ducked all contentious issues to receive popular applause. Economic policy-making is a continuing exercise and if Chidambaram proposes to address the more contentious issues during the course of the year, there is merit in this approach.

• Second, there is ample evidence of Chidambaram's ''touching faith'' in public expenditure! Expenditure outlays both for social sector and infrastructure have been significantly enhanced though there is no evidence of improving the quality of public expenditure on which there has been more talk than substance. Reforming expenditure approval procedures, assigning accountability on time and cost overrun in a more meaningful way, tracking utilisation of large outlay spent by federal entities and ensuring greater symmetry between enhanced outlays on education and health with long postponed reforms in these sector remain neglected. Enhancement of outlays must be accompanied by evidence of enhanced vigil on expenditure quality. Successive studies, for instance, have brought out that increased education outlays do not result in better education outcomes. These must inter alia be accompanied by measures intended to increase enrollment, minimise dropout ratios, define a teacher recruitment policy, improve quality of teaching, create greater competition among schools to compete for funds and greater ownership with parents association. In the area of higher and technical education, issues are equally complex relating to faculty retention, greater autonomy and other new challenges.

• Third, enough has been written raising doubts regarding the efficiency of the proposed fringe benefit or cash withdrawal tax. These taxes are likely to be onerous to implement, would enlarge discretion of revenue officials, and go against the objective of tax simplification. They are weak revenue instruments and ill-designed to address tax evasion. In Brazil, the Provisory Contribution on Financial Transaction (CPMP) is controversial. In Australia, it has acquired the nomenclature of BAD Tax or the Bank Account Debit levy being phased out this year, and variations in Argentina, Columbia and Ecuador have been tried without great success. Finance Ministers are vulnerable when faced with revenue shortfalls, and tax officials come up with innovative ways to help his arithmetic. The basic principle of sparing financial intermediation escapes attention. It is unsound economics, distortionary in altering consumer choice on preferred financial instruments and with some passing exceptions, has been generally discarded.

• Finally, there is a creature in the Budget called the Special Purpose Vehicle (SPV). This paragraph in his speech remains rather opaque, both conceptually and operationally. Is the SPV designed to create a new debt window for infrastructure borrowing both for para-statals and private entities? Is it a recognition that the existing financial institutions have failed or are handicapped by lack in adequacy of resources? What about the Infrastructure Development Finance Company (IDFC) which was created precisely for financing infrastructure? Is there much value in creating a new entity instead of integrating it with one of the existing institutions? Presumably, the SPV with modest seed capital will borrow from the market based on a sovereign guarantee, and would therefore increase the sovereign's contingent liability. Assuming that the SPV does borrow on attractive terms, how are these funds to be on-lent to project entities and who will undertake the necessary project due diligence, both technical and financial? Assessing risk in project finance is a complex task that specialised entities like IDFC do well, through comprehensive due diligence. But such risk assessment translates into a higher cost of debt for projects. If the objective is to reduce the cost of debt to infrastructure while not compromising on the quality of the diligence process, one solution would be to on-lend funds raised at lower rates appropriate to the sovereign-backed SPV through IDFC. This would make the SPV an instrument for delivery of ''subsidised debt'' to infrastructure projects that may otherwise not be financed. But debt financing by itself is not enough for infrastructure development. Equity must also be mobilised and the debt and equity components of projects need to be properly structured. In fact, having created a specialised entity for infrastructure finance like the IDFC, its expertise should be deployed to include not merely to on-lend SPV funds but also to ensure that this debt is appropriately structured and combined with the requisite equity financing. These are areas on which there is still lack of clarity.

Budget proposals are invariably reviewed in the light of subsequent analysis and fine-tuned to meet desired ends. This one can be no different. The Devil, as they say, is always in the detail.

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