

# India's please-all budget points to mixed reforms

Is the reform-minded budget good for the economy or just for the new government's popularity, asks Sandeep Parekh

The first union budget from India's Congress Party-led coalition government both pleases and disappoints. And with the leftist coalition partners now seeking the reversal of several reform-oriented measures, it is difficult to arrive at a final verdict yet.

On the macro front, India had estimated its fiscal deficit at 4.8% of GDP in the year ending March 2004, down from 5.4% a year earlier, helped by buoyant tax collections on the back of growth. Parliament recently passed an Act to eliminate the country's fiscal deficit over the next several years. In line with the statute, the new government, in its budget bill, has promised to shrink the fiscal deficit to 4.3% of GDP in a year without significantly cutting subsidies or improving revenue sources. It assumes that tax collections for the next year (and several years afterwards) will be substantially higher.

With the exception of the budget's special focus on agriculture, the economic challenges identified are neither new nor exceptional. However, the approach for dealing with these challenges stands out.

## Foreign investment

The decision by the Finance Ministry to hike the cap on foreign shareholdings in the telecoms, civil aviation and insurance industries keeps pace with the rapid changes in these areas, and is in line with the need to introduce competition-based reforms or investments. The telecoms industry is capital hungry, the aviation industry should be less protected and the insurance industry, a public sector oligopoly, needs to be opened to competitive pressures instead of the previous bureaucratic ones. Each of these changes augurs well for the consumer.

The government is also keen to increase foreign institutional investor (FII) and foreign direct investment (FDI) limits in other industries. To simplify and quicken the procedures for FII registration and operations, there is a proposal to introduce a single window clearance system for any investment, instead of the two or three step process. There is also a proposal to raise the investment ceiling for investors in debt

funds from \$1 billion to \$1.75 billion. The cap had been put in place because of the government's aversion to attracting foreign debt, which though invested in the corporate sector, increases India's foreign indebtedness levels.

## Capital markets

In capital markets, the budget's proposals included abolishing tax on long-term capital gains (based on holdings of over one year) from exchange-based securities transactions, and reducing tax on short-term capital gains on such securities to 10%. Instead, a 0.15% transaction tax was to apply to trading in securities on stock exchanges.

The stock market and financial intermediaries responded negatively to this news and volumes crashed. A rate of 0.15% may sound marginal, but could severely affect volumes in three critical areas: first, day traders, speculators and arbitrage players would have found it expensive to trade in listed equity given the frequency with which they trade – people who square off transactions without taking delivery (speculators) account for nearly 75% of trades on the equity market; secondly, debt and treasury markets that operate on razor-thin spreads would have been deeply affected; and thirdly, the tax would have damaged the efficiency of the derivatives market.

Liquidity in the debt market nearly evaporated after the announcement.

In response to the critical reaction of the financial market, Palaniappan Chidambaram, the finance minister, decided to modify the tax in the following ways: delivery based equity transactions will continue to attract 0.15% tax, squared off (where delivery does not occur) transactions in equity will attract only 0.015% tax, derivatives trades will attract 0.01% tax and debt will be exempt from the tax.

However, the 0.15% levy makes the Mauritius tax treaty redundant for long-term investments in exchange-traded securities in India. Using Mauritius as a tax vehicle will now be relevant only for investing in private or unlisted securities or for escaping short-term capital gain. Yet

because the relatively small tax is not expected to make purchases of equity uncompetitive, introducing the tax at the cost of the previous treaty route will probably not by itself alter the demand for Indian equity. Thus the proposal converts direct tax to indirect tax and improves compliance in payment of tax by reducing the scope of tax planning while at the same time leaving the Mauritius tax haven route open for private equity and venture capital investments.

The proposal to change the tax rate on dividends distributed by mutual funds will also change the way various stakeholders will pay tax. Equity-oriented mutual funds will continue to be exempt from dividend tax in the hands of individuals, but debt-oriented mutual funds must now withhold 12.5% of the income distributed to unit holders. A 20% rate will be levied on corporate unit holders. This inflicts double tax on corporates holding mutual funds and for a large number of investors will reduce the attractiveness of these funds.

## Divestment

After the closure of the Ministry of Finance's Department of Disinvestment some weeks before the budget, few people were expecting good news regarding the public sector companies most in need of reforms. The new government, attempting to placate the left-wing political parties, is slowing the privatization of the public sector.

Arun Shourie, divestment minister in the previous Bharatiya Janata Party-led coalition government, justifiably believed strategic sales were the only way forward on privatization. The new government wishes only to sell by way of public offer, thus ensuring that there is no change in control (because of a diversified holding). In this way, divestment becomes a means to raise money alone instead of reforming the public sector by reducing control, while at the same time as raising money.

The budget, while maintaining the direction of reforms, has caused the pace in areas such as privatization to slow, despite Chidambaram and prime minister Manmohan Singh (who at one time was the first reform-oriented finance minister) both being advocates of reform and privatization. While it may be difficult to be overly optimistic about the immediate future, the government is likely to eventually move in the right direction and hopefully at the right pace as well. ■

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