Spend to grow

Government should explore all avenues to expand capital expenditures

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FROM A LEVEL of 8.1 per cent in the fourth quarter of 2017-18, quarterly GDP growth fell to 5 per cent in the first quarter of 2019-20, a fall of 3.1 percentage points. The slowdown of the Indian economy is no longer in dispute. Thankfully, the government has come out of denial mode. The critical question is: What should be done to reverse the process? Is the downturn cyclical or structural? Any downturn that happens because of a weakening of demand is cyclical. On the other hand, if there are fundamental weaknesses in the structure of the economy, these need to be removed to sustain high growth. Successful implementation of the structural reforms in 1991 pushed India's potential growth rate to a high level. What we are witnessing in the Indian economy is a combination of the two. Several sectors such as automobiles and housing are facing a sharp weakening of demand. And there has been a significant fall in the savings and investment rate. Within household savings, the proportion of savings in financial assets has sharply declined. Apart from these, a significant growth-stifling factor is the weakness of the banking and non-bank finance sectors due to both cyclical and structural reasons.

The central government and the RBI have responded with a number of policy initiatives. The RBI has reduced the repo rate by 110 basis points since February 2019, reducing it from 6.5 per cent to 5.4 per cent. The central government has also undertaken a number of steps post the 2019-20 budget which include — withdrawal of enhanced surcharge on foreign portfolio investors, a public sector bank consolidation plan, additional depreciation rates for vehicle manufacturers, additional credit support for housing finance companies and recapitalisation of public sector banks. The slowdown appears to be continuing in spite of these measures.

The saving rate has fallen from 34.6 per cent in 2011-12 to 30.5 per cent in 2017-18. The investment rate, which is dependent on the saving rate supplemented by net capital inflows, has also fallen from 39 per cent of GDP in 2011-12 to 32.3 per cent in 2017-18. This persistent downward trend of the saving and investment rates has led to a fall in India's potential growth rate to below 7 per cent. Any additional fall below the potential growth rate may be due to cyclical factors.

The standard response to a recession is to enhance government expenditure. In the present context of a declining investment rate along with declining demand, a good solution will be to enhance government expenditure, especially capital expenditure. On the scope for increased spending, the bonanza from the RBI will go only to meet the shortfall in revenues. Perhaps, a larger disinvestment may help.

The monetary authorities have reduced the policy rate but banks have not followed suit due to structural problems against the background of rising non-performing assets. As one commentator on the central banking system said several decades ago, "The central banking system is equipped with efficient brakes but the accelerator is uncertain." While the RBI can play a supportive role in expanding liquidity, we must understand the basic limitations. Banks must also be careful while expanding credit. Inappropriate lending can land them in trouble later. Recapitalisation of public sector banks does not "infuse" fresh funds. The mechanism adopted only enlarges their freedom for lending. The bank consolidation plan could have been introduced at a more favourable time.

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Other changes in the fiscal sector during recent years may also have had a structural impact. For example, GST has changed the structure of indirect taxes, affecting the balance between goods and services, formal and informal sectors, and central and state tax revenues compared to the pre-GST period. Since its implementation, the compliance cost has risen considerably for the assesses, particularly the small and medium enterprises. The buoyancy of centre's indirect taxes in the post-GST period has been at low levels — 0.5 in 2017-18, 0.2 in 2018-19 and is budgeted to be 0.6 in 2019-20.

The decline in price level in recent years partly because of the new monetary policy framework has affected the nominal GDP growth rate and growth rate of tax revenues. The implicit price deflator has fallen more than 3 percentage points compared to the average of 2012-13 to 2013-14 and 2017-18 to 2018-19. The growth in central tax revenues fell by 3.5 percentage points and that in the states' own tax revenues by 4.7 percentage points during the same periods. These changes have left limited space for augmenting capital expenditure. The Centre's capital expenditure is currently languishing at 1.6 per cent of GDP.

Countercyclical policy is primarily the responsibility of the Centre. Given the revenue trends, it may not be in a position to increase its capital expenditure relative to GDP. Other available options include bringing on board state governments for increasing their capital expenditure relative to their respective gross state domestic products (GSDPs). Second, the Centre may invest through central public sector enterprises (CPSEs) an additional one percentage point of GDP compared to the present levels. Further, through the public-private partnership (PPP) mode, the private sector may be induced to supplement the government's investment in select projects. The amended FRBM Act has a provision for increasing the fiscal deficit by 0.5 per cent of GDP under certain circumstances. The government can make use of this provision.

The present slowdown is happening at a time when industrialised countries are themselves passing through a recession. Boosting export demand in this context becomes difficult. Our share in the world's exports is still small. Despite the recessionary conditions in the industrialised countries, it may still be possible to pitch for a higher growth in exports. The recent announcements on boosting exports is a recognition of this. Allowing the rupee to depreciate steadily may help exporters. The scope of monetary policy, as already explained, is limited. The government should explore all avenues to expand its capital expenditures. Public investment in the present context may crowd in private investment. Perhaps, one redeeming feature of the current situation is that despite floods, agricultural production may pick-up leading to a possible pick-up in rural demand. The government should also address sector-specific problems and these need not be fiscal in nature. A cautious expansion in banking credit can also help. It is also the time to look at structural reforms in the banking sector, governance in general and fiscal reforms relating to direct taxes and GST.

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