

OPINION

Economic slowdown: What should the Budget address?

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The possibility of a lower-than-expected revenue growth will constrain fiscal stimulus measures. In this context, the government should increase non-defence capital expenditure

The Budget to be presented on February 1 must reckon with three disturbing trends in the Indian economy — first, the slowing of growth rate; second, a declining investment rate; and third, a stressed financial system.

The Budget for 2020-21 must not only address the problem of taking the economy out of the current slowdown, but also lay the foundation for a faster economic growth.

Economic slowdown

The Indian economy has been slowing down since 2016-17 when real GDP growth had peaked at 8.2 per cent. According to the CSO's advance estimates, it has fallen to 5 per cent in 2019-20 — the lowest since 2008-09, which was the year of the global economic and financial crisis. Nominal GDP growth in 2019-20 is expected to be 7.5 per cent, which is the lowest level since 1975-76 — a 44-year low.

India's ongoing slowdown has been accompanied by the erosion of saving and investment rates since 2011-12, when these had peaked at 34.6 per cent and 39 per cent of the GDP respectively, measured in current prices.

Since then, the saving and investment rates have fallen steadily to 30.5 per cent and 32.3 per cent respectively in 2017-18.

Although information on the saving rate is not available for more recent years, the investment rate for 2019-20 can be estimated at 30.1 per cent of the GDP by summing up gross fixed capital formation, valuables and change in stocks.

This persistent erosion of the saving and investment rates has reduced India's potential growth rate to close to 6.5 per cent. In fact, the fall in actual growth is even below this reduced potential growth at 5 per cent in 2019-20.

This is due to weak aggregate demand, and priority has to be given to stimulating the overall demand using monetary and fiscal policy tools.

The financial system — and more particularly, the banking system — is in distress. The non-performing assets ratio of public sector banks as of September 2019 stood at 12.7 per cent. The non-banking financial companies are also under pressure, and any further deterioration in their position would also affect the banking system.

Had the banking system been strong, it could have been used as a lever for stimulating growth. This is hardly so. In fact, it has become a drag on the fisc.

On the monetary side, the RBI has reduced the repo rate since January 2019 by 135 basis points in five incremental steps. However, the transmission mechanism has been extremely slow due to problems and rigidities in India's financial sector.

Any room for further reduction in the repo rate does not appear to be round the corner, as the CPI inflation rate has spiked in December 2019 at 7.35 per cent, which is well outside RBI's comfort limit of 6 per cent. All eyes are, therefore, on Budget 2020-21 and the available fiscal policy options.

Revenue prospects

The revenue prospects for 2019-20, which will serve as the base year for 2020-21, may be examined in light of the actual performance of the Centre's taxes in the first eight months of the fiscal year, covering the period from April to November, 2019. In this eight-month period, compared to the corresponding period of the previous year, the growth rates in personal income tax (PIT), corporate income tax (CIT) and the Centre's indirect taxes are respectively at 7 per cent, (-) 0.9 per cent and (-) 0.9 per cent.

The overall tax revenue growth of the Centre's gross taxes during the first eight months of 2019-20 is only 0.8 per cent. According to available information, there may be a slippage in the disinvestment receipts relative to the Budget estimates. As against the budgeted disinvestment target of Rs. 1,05,000 crore for 2019-20, only Rs. 18,094 crore has been achieved till date. To some extent, the revenue shortfall may be partially made up by additional dividends from the RBI.

Thus, both gross and net tax revenues of the Central government may fall considerably short of the Budget estimates for 2019-20.

Estimates of the Centre's net tax revenue shortfall from various media sources for 2019-20 range between Rs. 1.7 lakh crore and Rs. 3 lakh crore. This means that the 2020-21 projections will have to be based on much lower base figures. Even with some expenditure compression, fiscal deficit relative to the GDP may slip to 3.6 per cent in 2019-20.

For assessing the broad contours of tax revenue prospects for 2020-21, we require growth and buoyancy assumptions. It is expected that compared to 2019-20, real and nominal GDP growth may increase to some extent in 2020-21. The RBI in its December 2019 monetary policy review had given its CPI inflation expectation in the range of 3.8-4 per cent in the first half of 2020-21. Given the recent inflationary pressures, these numbers may have to be revised upwards, even though food inflation — which peaked — may come down.

However, for determining the nominal GDP growth, it is the implicit price deflator-based inflation which is relevant. This rate has historically tended to be below the CPI inflation rate. We may assume it to be in the range of 3.5-4.0 per cent for 2020-21. If real GDP growth picks up to 5.5-6.0 per cent, we may assume a nominal GDP growth of 10 per cent for

2020-21. The overall tax buoyancy may not improve much, because the reduction in the CIT rates may take time to result in a widening of tax base. The overall tax buoyancy may at best be in the range of 0.8-1.0.

Thus, a growth rate of 10 per cent in the Centre's gross tax revenues in 2020-21 may be assumed. This puts an upper limit to the growth in government expenditures and therefore any fiscal stimulus, unless we consider a relaxation of the FRBM norms.

Reform options

In this background the immediate task before the forthcoming Budget is to use fiscal policy to stimulate demand. The available policy options can be divided into two broad groups. The first is increasing household disposable income through concessions in the personal income tax and/or making additional income transfers through schemes such as the Kisan Samman Nidhi. The second option is to increase government expenditure directly. Here also, the increase can be in revenue expenditure or capital expenditure.

In our view, the most effective policy option is to increase government non-defence capital expenditure. A study by the RBI estimates the impact and peak multipliers for non-defence capital expenditure at 1.81 and 5.88 respectively. Non-defence capital expenditure may, therefore, have the most immediate and stimulating effect. It will also be in line with the recently proposed National Infrastructure Pipeline. Reforms in PIT, although needed in the medium term, may have to be postponed by one year since they would also entail significant revenue sacrifice.

The GST is also due for a thorough review. It has suffered from excessive rate differentiation, periodic rate revisions, high compliance costs, and low revenue buoyancy. The IT platform has proved to be a bottleneck. We need to revise its rate structure to no more than three rates. One-to-one

invoice matching may be given up; it may be implemented only for tax assesseees with a turnover above a suitable threshold such as Rs. 50 crore per year.

Given the revenue constraints, a suitable push to government non-defence capital expenditure would require a relaxation of the fiscal deficit limit. Ideally, the 3 per cent fiscal deficit limit should be implemented over an economic cycle and not every year. During the years in which there is an economic slowdown, the fiscal deficit limit should automatically be increased to 3.5 per cent of the GDP or more. In years of better economic growth, it should be brought down below 3 per cent; the problem is that this has not happened so far.

Perhaps in the coming Budget, we need to allow some relaxation and take the fiscal deficit to 3.6 per cent of the GDP. We must, however, make sure that the additional expenditure is only for capital expenditures. The government should also clean up the accounts and show a 'true' fiscal deficit.

The reform agenda must be carried further. While there are many things that require to be done, one area that needs immediate attention is the financial sector. Restoring the financial system to a healthy state is a must for reviving the economy. It is also true that a revival of the economy will help to reduce the non-performing assets. Over the medium term, a serious look is needed on the extent of public ownership of banks and also the relationship between government and the management of public sector banks. A reference to this in the Budget will help.

More than anything else, the focus of attention of the government must be exclusively on development.

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Views are personal.

Published on January 24, 2020



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