Growth compulsions, fiscal arithmetic

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The economic situation warrants enhanced government expenditure; the policy challenge is to minimise the growth fall

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India's growth in the first quarter of 2020-21 at (-) 23.9% showed one of the highest contractions globally. Global growth prospects for 2020 have been projected by a number of multilateral institutions and rating agencies including that for India. The 2020-21 real GDP growth for India is forecasted in the range of (-) 5.8% (the Reserve Bank of India's Survey of Professional Forecasters) to (-) 14.8% (Goldman Sachs). The Organisation for Economic Co-operation and Development (OECD) in its September 2020 Interim Economic Outlook has projected a contraction of (-) 10.2% in FY21 for India.

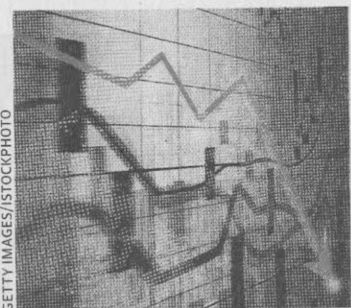
The annual projections also indicate a strong likelihood of even the nominal GDP growth showing a contraction for 2020-21. The latest data released by the Ministry of Statistics indicate a Consumer Price Index (CPI) inflation rate of 6.7% for August 2020. The average CPI inflation during the first five months of 2020-21 is estimated at 6.6%. Given the injection of periodic liquidity into the system and the inflation trends, the year as a whole may show a CPI inflation of close to 7%. Since deflator-based inflation tends to be lower than the CPI inflation, it may be about 5% or less. In fact, in the first quarter of 2020-21, the GDP-based deflator was only 1.8%. If we take the OECD's real GDP growth projection at (-) 10.2% and a deflator-based inflation of about 5%, the implied contraction in nominal GDP is about (-) 5.0% for 2020-21.

It is true that some of us felt at one time that the economy might not do too badly because some key sectors such as agriculture and related sectors, public administration, defence services and other services may perform normally or better than normal given the demand for health, relief and revival expenditures. We had even expected that a small positive growth might be possible. The recently released national income figures for Quarter I of 2020-21 hold no such hope.

What is most surprising in the Q1 data is that the sector 'Public Administration, Defence and other Services' contracted at (-) 10.3%. This means that there was no fiscal stimulus. Independent estimates show that States' capital spending fell by 43.5%. The worsening of the fiscal deficit appears to be because of decline in revenue than increase in expenditure.

Revenue erosion

The policy challenge for the remaining part of the fiscal year is to minimise this sharp contractionary momentum in real and nominal growth. A sharp contraction in nominal GDP growth has significantly adverse implications for the prospects of central and State tax revenues, which may both contract. In the first quarter of 2020-21, the Centre's gross tax revenues contracted by (-) 32.6% and the CAG-based data pertaining to 19 States show a contraction of (-) 45% in their own tax revenues. This implies a negative buoyancy of about 1.65 in the combined tax revenues of central and State governments in the first quarter. Given the adverse impact of the lockdown, even the budgeted non-tax revenues are not likely to be realised. The revenue calculations of the Budget were made on the assumption that the nominal income of the country would grow at 10%. With the prospect of a contraction in nominal growth, tax revenues of the Centre would show a considerable shortfall as compared to the budgeted amounts. Some estimates indicate that the tax and non-tax revenue and non-debt capital receipts in the current fiscal may fall well short of the budget estimates by an amount higher than ₹5-lakh crore. The combined fiscal deficit of the Centre and the States will have to make up for the shortfall in tax and non-tax revenues, if the level of budgeted expenditures is to be maintained.



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Fiscal deficit

In order for the central government to maintain the level of budgeted expenditure and also provide for additional stimulus, its fiscal deficit may have to be increased to close to an estimated 8.8% of GDP. This consists of an estimated revised budgeted fiscal deficit of about 4% of GDP due to a lower denominator value of GDP-plus 2.5% to make up for the shortfall in tax and non-tax revenues plus 2.3% for the additionality over the budgeted expenditures in the already announced stimulus package (including the recently announced first batch of supplementary demand for grants). If one adds the Centre's and States' fiscal deficit, the combined fiscal deficit amounts to 13.8% of GDP. If the nominal GDP actually contracts in 2020-21, the fiscal deficit as the percent of GDP would go up further. This also does not take into account any additionality to borrowing because of the Goods and Services Tax (GST) compensation. It may be noted that the Centre's fiscal deficit to GDP ratio for the Q1 of 2021 was 17.4%. The Centre's fiscal during the first four months of 2020-21 as a per cent of annual budgeted target was at 103.1%.

Limits to deficit

How high can fiscal deficit go? The International Monetary Fund, in its June 2020 update of the World Economic Outlook, estimated the fiscal deficit of India and China at 12.1% of GDP. All the other countries except the United States and a few others have a deficit lower than this. The dollar as a reserve currency has its own advantages and this benefits the U.S. Coming back to India's fiscal deficit, there are not adequate resources to support a fiscal deficit of nearly 14% of GDP. All this will therefore require substantial support from the Reserve Bank of India which will have to take on itself, either directly or indirectly, a part of the central government debt. In the direct mode, the RBI takes on the debt directly from government at an agreed rate. It took India long to move away from the automatic monetisation of debt. It happened in the early 1990s. Even if the RBI wants to support the borrowing programmes, it should not do so directly. The indirect method is preferable as the market still sends out the signals on interest rate. In both cases, the RBI is the provider of liquidity. The indirect route is not new. The question ultimately relates to the extent of debt monetisation that may be undertaken. The country has also to guard against high inflation.

This Fisc is caught in a serious dilemma. The economic situation warrants enhanced government expenditure. The fiscal deficit will go well beyond the mandated level – more than twice the mandated level. This has to be accepted. It appears that governments are withholding expenditure. That is not the right approach. At the same time, there is a limit to monetisation of debt. Perhaps the best course of action would be to keep the combined fiscal deficit at around 14% of GDP in the current year and find ways to finance it. This will have to be brought down gradually. It may take several years of normalisation.

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