A bet on reforms-driven growth despite India’s fiscal compression

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- The budget has announced some laudable reform initiatives but their success will depend on how well they get implemented
- The budget has surprisingly opted for fiscal compression at a time when our economy needed higher spending. Thankfully, capital expenditure has risen, which can offer multiplier gains.

A game-changing 2021-22 budget was required to reboot the economy and revive growth, apart from one with greater transparency, especially with regard to extra-budgetary resources. Three key requirements included: (i) high expenditure growth to pump-prime demand, (ii) a shift in expenditure allocation in favour of income support and public investment, combining their high demand multiplier effects with urgent relief to contain immiserization from livelihoods lost in the pandemic, and (iii) wide-ranging structural reforms, especially in the financial and banking sector, to position the economy for high growth in the medium- to long-term (See ‘A Proposed Fiscal Strategy for Sustainable Economic Recovery’, Mint, 18 December 2020). While the budget of 1 February was widely appreciated for its transparency, how does it measure up to these requirements?

The first requirement was of high expenditure growth. However, the budget has adopted a surprisingly restrictive stance. In 2020-21, the central government has ramped up expenditure to ₹30.4 trillion (revised estimate), a 28% increase compared to the actual expenditure in 2019-20. It has accomplished this despite an estimated 7.7% decline in revenues through a massive increase in borrowing to ₹18.4 trillion, a 132% increase over the budgeted level of ₹8 trillion. But for this, gross domestic product (GDP) would have contracted significantly more than the estimated 7.7%. The strong expenditure push should have been sustained in 2021-22 to help revive growth, especially since the budget has assumed fairly high revenue growth at 15% and a huge increase of over 300% in non-debt capital receipts.

But expenditure has been budgeted to grow by only 1% in nominal terms, implying a decrease in real terms even if inflation remains subdued at 4% to 5%. The fiscal deficit has been projected to decline from an exceptional 9.5% of GDP in 2020-21 to 6.8% in 2021-22, an 18% decline in absolute terms. Such strong fiscal compression at a time when it is so urgent to revive growth seems illogical. Perhaps the budget team (i) expects a large shortfall in budgeted receipts, especially, non-debt capital receipts, and (ii) assumes, correctly, that the base effect of a sharp contraction in 2020-21 will lead to high growth in 2021-22 despite the strong fiscal compression.

The second requirement is an expenditure allocation shift in favour of capital expenditure, income support and social services. The allocation for capital expenditure at over 14% of total expenditure is not only much higher than the 10% allocated in 2020-21, an abnormal year, but also higher than the 13% actual share in 2019-20. However, allocations have been slashed from ₹4.2 trillion in 2020-21 to ₹2.4 trillion in 2021-22 for food subsidy and from ₹1.1 trillion to ₹0.7 trillion for the Mahatma Gandhi National Rural Employment Guarantee scheme. The PM-Kisan allocation has remained the same at ₹0.65 trillion, implying a reduction in real terms. The allocation for education and related activities is only 5.6% more than in the last normal year 2019-20, again implying a reduction in real terms. The allocation for health at ₹70 trillion is much higher than ₹29 trillion in 2019-20, but virtually all of it is on account of the covid vaccination programme (₹35,000 crore). The significant increases in other health-related expenditures such as water supply and sanitation are mainly on account of grant awards of the 15th Finance Commission. This parsimonious treatment of income support and social spending is the weakest aspect of this budget.

The third requirement is a big push on reforms, especially in the financial sector. The budget has done rather well on this count, barring the continued protectionist tampering with tariff rates, mostly raising them. Several reforms have been announced, such as the ambitious programmes of privatization, asset monetization and infrastructure investment. Given the space constraints, however, I limit my remarks here to reforms in banking and finance. The creation of an asset reconstruction company and an asset management company to take over and manage the stressed assets of public sector banks (PSBs) will leave them with cleaned up balance sheets, enabling them to resume normal lending and help revive the flow of credit and economic activity. Another key reform is the decision to privatize two PSBs, in addition to IDBI Bank. However, raising fresh equity in excess of government holdings would have been a more effective way of privatizing and recapitalizing them at the same time (See ‘Recapitalization of State-Owned Banks: Privatization Should Do It,’ Mint, 14 January 2021).

Allowing foreign direct investment up to 74% in insurance companies and the proposed public offering of Life Insurance Corporation of India’s shares are also important moves towards a progressive privatization of the financial sector. Finally, the proposal to set up a new development financial institution (DFI) recognizes the gap in long-term investment financing. However, institutions like ICICI and IDBI started out as DFIs and several public sector DFIs are still operational, though they are also burdened with stressed assets. Hence, this proposal needs to be more clearly thought through.

In summary, the reform proposals are important initiatives to reset the economy for high growth. But as usual, much will depend on how these reforms are actually implemented.

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