The fiscal overrun caused by the covid crisis poses policymakers the hard choice of either reining in the deficit for sustainable future growth or spending heavily to support a recovery **(Photo: iStock)**

A proposed fiscal strategy for a sustainable economic recovery

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High government expenditure rising at a rate less than nominal GDP growth will aid a revival and reduce the fiscal deficit

The forthcoming budget for 2021-22 (FY22) is surely the most challenging that any finance minister has had to deal with since Independence. The covid pandemic and the lockdown led to an unprecedented 24% contraction in gross domestic product (GDP) in the first quarter (Q1) of 2020-21 (FY21). However, the sharp contraction in April was followed by an equally sharp recovery during May and June, the 'bow string' effect, as the economy was progressively unlocked, supported by strong liquidity injection by the Reserve Bank of India (RBI). The pace of recovery moderated thereafter, though it is still continuing. At the National Council of Applied Economic Research (NCAER), we are now forecasting that in FY21, GDP will contract by 7.3%. Where do we go from here, and what should be the fiscal policy stance in FY22?

The effects of the shock can last a very long time (see 'Navigating the Narrow Passage Between Recovery and Inflation,' Mint, 16 October 2020). Hence, fiscal policy needs to focus on priming demand to return to the trend growth path. On the other hand, the recovery has been accompanied by rising inflation, the central government fiscal deficit has ballooned, and yields on government securities have consequently remained elevated, crowding out private investment. Meanwhile, the public debt-to-GDP ratio may rise to a record 90% and high debt-servicing costs will further crowd out productive public expenditure. Should the budget then pump-prime growth, or should it start reining in the deficit? It's a tough call. Fortunately, the sharp contraction and strong recovery themselves make possible a fiscal strategy for sustaining the recovery even while gradually reining in the deficit.

The base effect of FY21's contraction will translate into high growth in FY22, especially in the first half of the year. The combined fiscal deficit (Centre plus states) for FY21 is now projected at over 14% of GDP (factoring in a 7.3% GDP contraction). The fiscal impulse, or the excess of FY21's deficit over that of FY20, will amount to over 7% of GDP. That, plus the liquidity infusion by RBI of over 6% of GDP, amounts to a fairly strong stimulus. The full impact of these measures will be felt over the next few months, setting the stage for high growth in FY22.

Assuming conservatively that GDP will grow at 10% and inflation will be contained at 5%, again thanks to the base effect of elevated inflation in FY21, nominal GDP will probably grow at 15% in FY22. This provides space for sustaining the recovery while simultaneously reining in the deficit. The core of the strategy is to set an expenditure target that is significantly higher than in FY21, but with a growth rate that is lower than the expected nominal GDP growth rate. Assuming a revenue buoyancy of 1, which is the historically observed norm, revenue will then grow faster than expenditure, thereby reducing the deficit.

To illustrate, if real GDP and nominal GDP grow at 10% and 15% respectively, revenue will also grow at 15%. If expenditure is set to grow at, say, 12%, i.e., 7% in real terms, the fiscal deficit in FY22 will be less than in FY21. The same strategy could be repeated through a rolling three-year medium-term strategy framework till the combined fiscal deficit is gradually brought back to tolerable levels of around 5-6% of GDP over the next four to five years. These numbers are only illustrative. The essential point is to set expenditure in FY22 and subsequent years at levels that are well above the preceding year, but represent growth rates lower than that of nominal GDP, and hence revenue.

Can such a strategy of rising public expenditure but a declining deficit, implying a compression of the fiscal impulse, really sustain India's recovery? Note that there are several factors other than public expenditure that can also drive growth. First, liquidity infusion by RBI has been central to stimulating demand this year. It can continue to play that role during the next few years to enable fiscal consolidation. Second, though the pandemic continues, it has been tapering down since mid-September. Covid vaccines, already rolled out in some countries, are also likely to be available in India in early 2021. These positive pandemic-related developments can also boost growth. Third, high- frequency indicators suggest that the uptick in investment and exports seen in Q2 are continuing in Q3. Unless there are further shocks, this is likely to go on. Finally, if the government launches deep and wide-ranging structural reforms, like we saw in 1991, it too would shift India onto a higher long-term growth path.

Two points require further clarification. The composition of budgeted expenditure can be altered to provide more income support to those who have lost livelihoods. In addition to providing humanitarian support to such distressed households, their high consumption propensity would simultaneously strengthen the multiplier impact of government spending. The Pradhan Mantri Gram Sadak Yojana , which combines infrastructure development with income support for the poor, is a good example.

Finally, the foregoing discussion on public expenditure and the fiscal deficit refers to all governments—i.e., the Centre plus states. This will require close Centre-state coordination, or cooperative federalism. The Goods and Services Tax (GST) Council's agreement on the extension and financing of the GST compensation fund illustrates that, given the right conditions, such cooperation can actually work. These are the author's personal views.

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