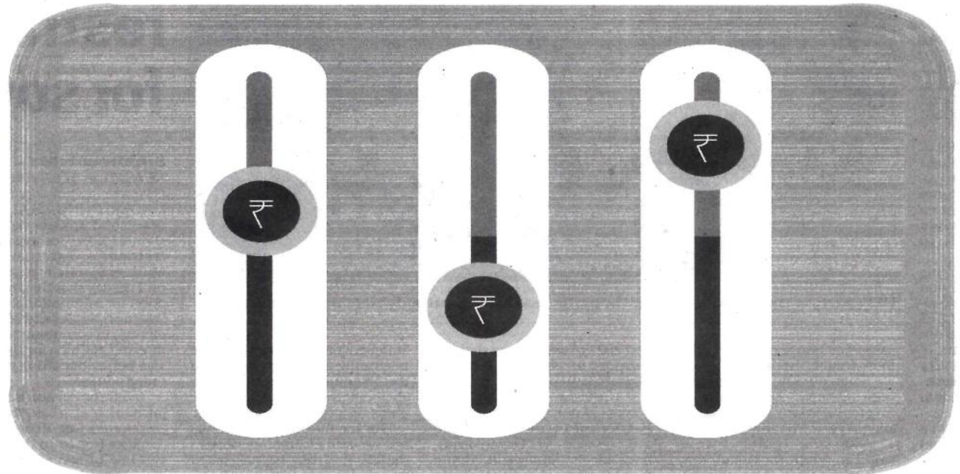
The fiscal rethink

Government must reconsider cut in food subsidies, be attentive to risks of high fiscal deficit and relax conditions on state borrowings

C RANGARAJAN AND D K SRIVASTAVA



C R Sasikumar

THE BUDGET FOR 2022-23 has been discussed from several angles. In this article, we want to raise three important issues, which have a bearing not only on the current year but also on the coming years. One, is enhancing capital expenditure the best way to stimulate an economy in the current situation? Two, can the government function with a high fiscal deficit for several years in a row? And three, what should be the mechanism to determine the level of borrowing of states?

What stands out prominently in the budget is the emphasis on capital expenditure which is expected to rise by 24.5 per cent over the revised estimates for 2021-22. This is a welcome directional change that continues the trend of the previous year. In 2022-23, 45.2 per cent of the fiscal deficit will be used for financing capital expenditure. In the UK, they have endorsed the golden rule of fiscal prudence under which there would be no limit on fiscal deficit so long as all of it is used to finance capital expenditure. Of course, the budgetary definition of capital expenditure does not fully correspond to economists' concept of it. Even lending is treated as part of capital expenditure.

Enhancing capital expenditure not only creates additional demand immediately but also lays the base for further growth. In the planning era, all our plans were focused on raising the investment rate. Therefore, in principle, augmenting capital expenditure appears to be the right approach. Capital expenditure has a higher multiplier, but it takes a longer duration to work itself out. Revenue expenditure has a lower multiplier, but its impact is almost immediate. In the context of the situation created by Covid-19 in terms of loss of employment and income, a question arises whether revenue expenditure, such as income support for vulnerable groups, should also get high priority.

In the budget, the allocation for MGNREGA has been reduced. It is possible that as overall production increases, the need for it may come down. If this happens naturally, it is fine. Otherwise, the government should not stint on expenditure in this regard.

On subsidies, the reduction in petroleum subsidies is well taken. But on food subsidies, there has to be a rethink. Thus, there is concern about the reduction in some of the revenue expenditure. As we have argued elsewhere, there is some fiscal space available for higher spending and as revenues increase over targeted levels, revenue expenditures directed towards providing social safety nets should be raised. Even on capital expenditure, the government should bring out a separate document listing major projects in which investment will be made not only by the government directly but also by public sector enterprises.

The next issue is the level of fiscal deficit. The question is how long can we continue with a very high level of fiscal deficit. Fiscal deficits are way beyond what was considered to be appropriate under the FRBM Act. The Centre's fiscal deficit in 2020-21 was 9.2 per cent of the GDP. Part of it was, of course, due to some cleaning up operations, which is desirable. Even then it is extremely high. In 2021-22, it is 6.9 per cent of the GDP and is expected to be 6.4 per cent in 2022-23. The norm that we had set was 3 per cent of GDP. As a consequence, the Centre's debt-GDP ratio is expected to be at 60.2 per cent of the GDP in 2022-23 as against the desired level of 40 per cent of the GDP. For the Centre and states taken together, it would touch 90 per cent of the GDP. One can understand the compulsions; the impact of Covid-19 had brought the economy to a grinding halt. In 2021-22, the economy is expected to touch the level of where we were in 2020. Extraordinary measures had to be taken to kickstart the economy. Government expenditures had to rise. But we should not belittle the situation that we are facing.

It is argued sometimes that our debt-GDP ratio is low compared to other countries such as Japan. But that is not an appropriate comparison as tax revenue to GDP is high and interest rate is low in Japan — interest payment on debt constitutes only 4.7 per cent of revenue receipts. The corresponding figure for India, considering the Centre and the states together, was 25.8 per cent in 2019-20. In the case of the Centre alone, interest payments will equal 42.7 per cent of revenue receipts in 2022-23. This is a large preemption, leaving less for other productive expenditures. Such a large public borrowing poses a problem. In 2022-23, the Centre and states will borrow an amount equivalent to 10.4 per cent of the GDP. The savings of the household sector (which is the only surplus sector) in financial assets do not exceed 7.5 per cent of GDP. Thus the borrowing programme can be completed only with the support (though indirectly) of the RBI. This is what we used to do in the 1980s. Such support from the RBI will have an impact on inflation, if not immediately at least with a lag. Of course, one has to take into account its favourable impact on output. At present, the target appears to be to take the Centre's deficit to 4.5 per cent by 2025-26. Even this may or may not be achieved. But will it be adequate? A medium-term plan of fiscal consolidation is urgently needed, showing the period over which a sustainable level of fiscal deficit will be reached. "Crowding out" of private investments may not happen now. But eventually, it will become a problem, if we have prolonged high fiscal deficits.

Article 293 of the Constitution stipulates that states need permission from the Centre to borrow so long as they are indebted to it. Prior to the 12th Finance Commission, the Centre used to borrow for the purpose of lending to the states. The 12th FC recommended that this system be stopped and that at least all major states should be allowed to acquire their entire borrowing directly from the market. It was our hope that as this new system takes root, a stage would be reached when the states would not be indebted to the Centre and that they would then borrow based on their own assessment.

The last issue relates to borrowing by state governments and the Centre's role in it. The government has agreed to raise the borrowing limit of states to 4 per cent of the GSDP for 2022-23. But it imposed the condition that 0.5 per cent of this will be contingent on the states implementing power sector reforms. This condition is unnecessary. Power sector reforms are needed and inducement can be provided through other means. The limit for 2022-23 should have been raised without imposing any condition. Article 293 of the Constitution stipulates that states need permission from the Centre to borrow so long as they are indebted to it. Prior to the 12th Finance Commission, the Centre used to borrow for the purpose of lending to the states. The 12th FC recommended that this system be stopped and that at least all major states should be allowed to acquire their entire borrowing directly from the market. It was our hope that as this new system takes root, a stage would be reached when the states would not be indebted to the Centre and that they would then borrow based on their own assessment.

Against this background, the proposal in the budget of the Centre to provide an interest-free loan for a 50-year period needs reexamination. If the Government of India feels that states need to spend more on infrastructure, they should just be allowed to borrow more. Of course, under the present proposal, there is no interest burden on the states. That's a sweetener. It is also appropriate here to recall one recommendation of the 12th FC which was to set up a loan council comprising the Union government, states and the RBI which could take the decision on how much states should be allowed to borrow. This recommendation was not acted upon earlier. This needs a relook.

Rangarajan is former chairman, Prime Minister's Economic Advisory Council and former governor, RBI. Srivastava is chief policy advisor, EY India and former director, Madras School of Economics. Views are personal