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India's Union Budget 2021–22 and fiscal policy

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India has seen a sharp contraction in growth ^[1] over the past year. The macroeconomic policies implicit in the country's 2021–22 Union Budget ^[2], presented on 1 February, focus on stabilising growth.



Government expenditure ^[3] is estimated to be 17.7 per cent of GDP in 2020–21, a sharp increase from 13.2 per cent in 2019–20 and 12.5 per cent in 2018–19. From a macroeconomic perspective, the focus areas are the robustness of nominal GDP and revenue growth assumptions, the budget deficit — including the stimulus component — and whether the stimulus is of optimal structure and scale to bolster growth. Fiscal policy is critically important in circumstances when monetary policy is constrained ^[4] by impaired bank and corporate balance sheets.

The nominal GDP growth of 14.5 per cent in 2021–22 implicit in budget projections seem reasonable considering the economy is expected ^[5] to rebound on the back of sharp contraction.

The tax-to-GDP ratio is projected to jump, from 9.9 and 9.8 per cent during the two years prior to the pandemic, to 10.9 per cent in 2021–22, despite the declining trend preceding the pandemic. Disinvestment revenues are far out of proportion to realisations in previous years. If

revenue mobilisation is maintained at 9.9 per cent of GDP, and divestment collections taken at the average of the three years prior to the crisis, the fiscal deficit in 2021–22 would be 8.2 per cent of GDP. Once adjustments are made for the surprising decline in pension payments (projected to decline by 8.2 per cent despite double digit growth in recent years), this would boost the deficit to 8.4 per cent (or 8.6 including off-budget items).

In both 2019–20 and 2020–21, the centre absorbed the revenue shock from a contraction in growth by disproportionately shifting the burden of adjustment to the states. This involved delayed GST transfers and increasing reliance on cesses outside the shared pool.

Tax transfers to the states fell from 4 per cent of GDP in 2017–19 to 3.2 per cent in 2019–20, and further to 2.8 per cent in 2020–21. The decline is absolute in nominal terms, with negative growth of 14.5 and 15.5 per cent over the last two years.

Meanwhile, net tax revenue to the centre remained stable at 6.7–6.9 per cent of GDP. This runs counter to fiscal federalism ^[6], with the centre weakening rather than strengthening state finances that bear the major burden of social sectors like health and education.

The budget estimated a central fiscal deficit of 9.5 per cent (10.2 including off-budget borrowing) of GDP in 2020–21, and 6.8 per cent (7 including off-budget) for 2021–22. The nominal deficit comprises two components, structural and cyclical. The structural deficit is what remains once the revenue shortfall and expenditure increase on account of sharp deviations in trend growth are stripped away. In a boom year, the cyclical deficit is lower than the structural; during a slump, it is the opposite. The cyclical deficit disappears with a return to trend growth as revenues revive and the stimulus is withdrawn.

Revenues were growing at 8.5 per cent before the collapse in 2020–21. Expenditure grew at 8 per cent in 2018–19 and 16 per cent in 2019–20. Since the slump preceded the sharp COVID-19-induced contraction ^[7], the latter figure includes a stimulus component. Normal expenditure growth is taken at the 12 per cent midpoint, giving a structural deficit of 5.8 and 5.2 per cent of GDP in 2020–21 and 2021–22, respectively. The difference between the nominal deficit and the structural is the cyclical component: 3.7 and 1.6 per cent in the two years, respectively.

The fiscal stimulus deficit can be assumed to be the difference between the pre-crisis expenditure growth of 12 per cent and the actual increase. This works out to 2.3 per cent in 2020–21 (against the 2.7 per cent estimated by the IMF ^[8]) and 1.5 per cent in 2021–22. The cumulative stimulus for the two years is therefore estimated to be just 3.8 per cent of GDP, compared to the 8.8 per cent loss of potential output over these two years estimated by IMF based on its pre-pandemic January 2020 World Economic Outlook projections ^[9], among the highest globally ^[10].

On the expenditure side, outlays on health, agriculture, food and fertiliser subsidies that increased sharply in 2020–21 will see a rollback in 2021–22. Overall health expenditure is stuck

at the medium-term average of 0.3 per cent of GDP. The slide in education and defence outlays in real terms also continues. Enhanced allocations for the rural employment guarantee (MNREGA) and other social security (NSAP) schemes in 2020–21 taken together have halved back to pre-crisis levels.

The stimulus in the budget focusses on boosting public infrastructure and capital expenditure whose share in GDP has increased from 1.5 per cent in 2017–18 to 2.5 per cent in the 2021–22 estimates. Public investment in infrastructure can crowd in private investment to accelerate growth. It is arguable whether this is better than putting more income in the hands of people suffering from job or income loss, and struggling small businesses.

India has seen a sharper contraction in growth than several Western economies where COVID-19 mortality is over 10 times higher. It is also sharper than all other major developing countries. Western countries cushioned the shock to their economies with aggressive income support stimulus. India's stimulus is minimal in comparison.

The question remains whether the budget could have done more to bolster the economy through income support rather than enhanced outlays on infrastructure and capital investment. In view of the outsized structural budget deficit, it might have been difficult to do both.

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