THROUGH THE LOOKING GLASS

RELAXATION IN FISCAL DEFICIT TARGETS CREATES ENHANCED FISCAL SPACE; THIS OFFERS AN OPPORTUNITY TO BUILD INDIA

India's $550 billion stimulus

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LAST MONTH WAS abuzz with many commentaries on the FY22 Budget—the document was dissected for its numbers and narrative. Many new and bold ideas such as privatisation of public sector undertakings (as the government confines itself largely to the strategic sectors), asset monetisation and its public register, a new development financial institution, and an asset reconstruction company to address non-performing assets of the banking sector have been introduced. As we settle into the many new paradigms introduced in the Budget, it is time to look at the longer-term impact of some of these new paradigms: in this article, we will focus on the enhanced fiscal space that India has created for itself with the relaxation in the fiscal deficit glide path.

Putting the numbers in place

Given the pandemic in the last financial year, governments worldwide implemented expansionary fiscal policies to help support lives and livelihoods. Many sectors and large sections of populations were cushioned from the sudden and dramatic impact of Covid-19. Increase in fiscal deficits were hence a natural corollary of the increased role that the governments had to play.

India estimated that the fiscal deficit of its central government for FY21 will be 9.5% of its ₹196.2 trillion GDP. The central fiscal deficit is budgeted to be 6.8% of its GDP in FY22, a year in which the economy is expected to grow 15.4% in nominal terms. This number will trend down to 4.5% of GDP by FY26—the glide path has not been formally specified, so a reasonable assumption is a linear decline of ~0.6% of GDP per year over the next four years.

States in India have also been at the forefront of the response to Covid-19: they have been permitted to have a higher fiscal-deficit-to-GDP limit for FY21—this is pegged at 4.5%. It is expected that the states will come back to their fiscal deficit limit of 3% of the respective GDP by FY24. Again, a linear trend of a 50 bps annual reduction over the next three years is assumed.

To estimate what the expected amounts of the fiscal deficits can be over the next few years, we need to build an estimate of what the nominal GDP in the respective years can be. We have an estimate for FY21 and FY22 from the Budget documents. For the next four years, we assume a 12% per annum nominal growth: this can be decomposed in various combinations between real growth and inflation. We note that the inflation band of 4% +/- 2% is up for review in March; the Reserve Bank of India has indicated maintaining the band in the current range.

The above trajectories of central and state deficits are then compared to what the earlier Fiscal Responsibility and Budget Management (FRBM) Act mandated: a 3% limit for both Centre and the states. The difference between the erstwhile FRBM mandate and the current expected trajectory gives us an estimate of the increased fiscal space. The accompanying table attempts to quantify the magnitude of the change.

We estimate that India has created ~₹40 trillion (or ~$550 billion) of increased fiscal space over the next five years. Adding nominal numbers is not entirely appropriate from an economic perspective: however, given a low and stable inflation target, this calculation gives a reasonable estimate of the enhanced fiscal space available to both the central and the state governments cumulatively. This estimate depends both on the fiscal deficit trajectory that emerges and the nominal GDP. With these caveats, we note that the size and scale of fiscal stimulus that India has set itself up for is around 20% of its current annual GDP.

Build India better

The central government has indicated in the Budget that it has a special focus on capital investment. The world over, governments are being prodded to "crowd-in" private sector investments by leading with their own investment plans and projects. There has been a marked increase in allocation to capital expenditure this year—the large fiscal space allows governments to continue along the investment path over the medium-term.

India has already articulated the ₹111 trillion ($1.5 trillion) of National Investment Pipeline (NIP) some time ago. Coupled with proceeds from asset monetisation and privatisation, this enhanced purse for the government can lead to significant government financing for infrastructure. The Economic Survey estimated that the multiplier effect of capex investments is around 2.5x. This offers an opportunity not just to build India better but also set in motion a virtuous cycle of increased jobs, incomes, and consumption expenditure.

The virtuous cycle of growth is also required. Higher fiscal deficits naturally cumulate into higher debt for the government. From a macroeconomic stability perspective, a reasonable debt-to-GDP ratio is important: various economists have estimated what a sustainable ratio could be. In any case, what helps bring down the ratio is high growth. The debt sustainability equation notes that when 'g' (the nominal growth in the economy) is higher than 'r' (the nominal interest rate paid by the government on its borrowings), the debt-to-GDP ratio will trend down.

Investment-driven strategy is not just expected to drive higher economic growth, it needs to necessarily deliver on growth. Investments that offer high economic and social returns need to be judiciously planned and executed. With the 'animal spirits' having been unleashed, it is expected that the private sector (both domestic and foreign) will join the government in building India better.

India opened up ~₹40 trillion of extra fiscal space for Centre and states

Calculations showing estimate of increase fiscal space over FY2022-26
(₹ tn, March fiscal year ends)

	GDP		Fiscal deficit/GDP (%) Post Budget '21			FRBM from FY22			Increased fiscal space	
	₹ tn	Growth	Centre	States	Total	Centre	States	Total	(%)	₹ tn
2021	196.2	-4.0	9.5	4.5	14.0					
2022	226.5	15.4	6.8	4.0	10.8	3.0	3.0	6.0	4.8	10.9
2023	253.6	12.0	6.2	3.5	9.7	3.0	3.0	6.0	3.7	9.4
2024	284.1	12.0	5.7	3.0	8.7	3.0	3.0	6.0	2.7	7.5
2025	318.2	12.0	5.1	3.0	8.1	3.0	3.0	6.0	2.1	6.6
2026	356.3	12.0	4.5	3.0	7.5	3.0	3.0	6.0	1.5	5.3
Total										39.8

Notes: (1) Assumes a linear fall in fiscal deficit/GDP ratio between FY2022-26; (2) Nominal growth assumed at 12% annually; Source: India Budget, calculations.