Modi Government’s Budget 2023: A Peek into the Past, Present and (Likely) Future

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analysis

Economy

The political economy of the Modi government’s budget policies signal a centralisation of political power, but an adjunct outsourcing and coercive privatisation of public responsibility/ownership to the private space.

Deepanshu Mohan, Soumya Marri, Bilquis Calcuttawala, Malhaar Kasodekar, Aniruddh Bhaskaran and Hemang Sharma

Economy

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This is the first article in a two-part series produced by the CNES InfoSphere team analysing past budget trends, the current state of the economy, and the possible scenarios of actions considered for Budget FY2023

As finance minister Nirmala Sitharaman prepares to present the next Union budget in a few weeks, a closer review of the attempted precedents set by previous budgets becomes a valuable exercise – not just from an academic lens, but also from a policy review perspective.

The Centre for New Economics Studies' *InfoSphere* team undertook a comprehensive exercise to analyse the outlay of macro-trends from previous Budgets and weave these in context to the current macro state of the Indian economy (for this we are grateful to the team at Systematix Institutional Equities who have undertaken a thorough macroeconomic review of the Indian economy here).

The last few Budgets were in principle 'pandemic budgets', all set in extraordinary polycrisis situations. The government needed to spend more on immediate spending needs like healthcare (to enable COVID-19 infrastructure, buy vaccines etc.) and boost social sector funding to support the most vulnerable. What it did was: increase public sector capex to take care of growth (seeing most of the private sector was investing/spending less during a pandemic phase).

From post 2016 (twin shocks of demonetisation and hurried GST implementation), India has witnessed a slowing down of growth. During the pandemic, and in months post the lockdown restrictions were lifted, the nation was not just battling a deep economic contraction in its growth trajectory but was also facing chronic issues stemming from high unemployment, a decimation of its unorganised informal sector, a poor performance in the macro-social security landscape (with all schemes focusing on women, children and the malnourished seeing dwindling outlays).

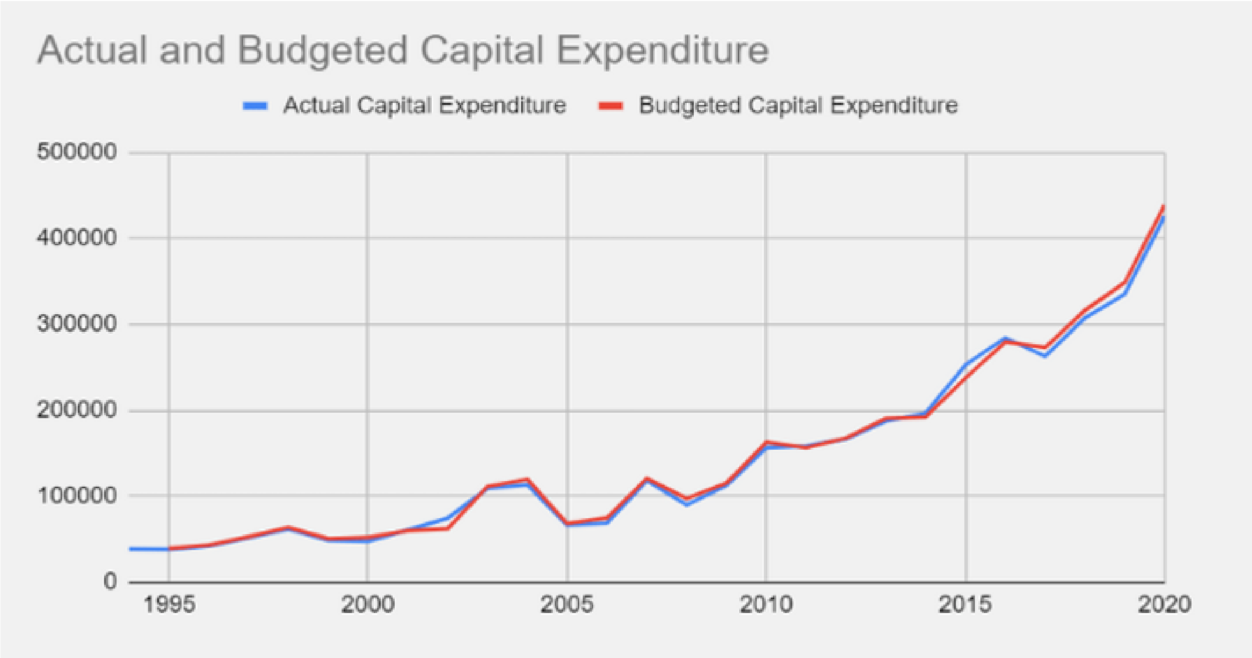
Also read: A Decline in Inflation Is No Comfort for the Majority

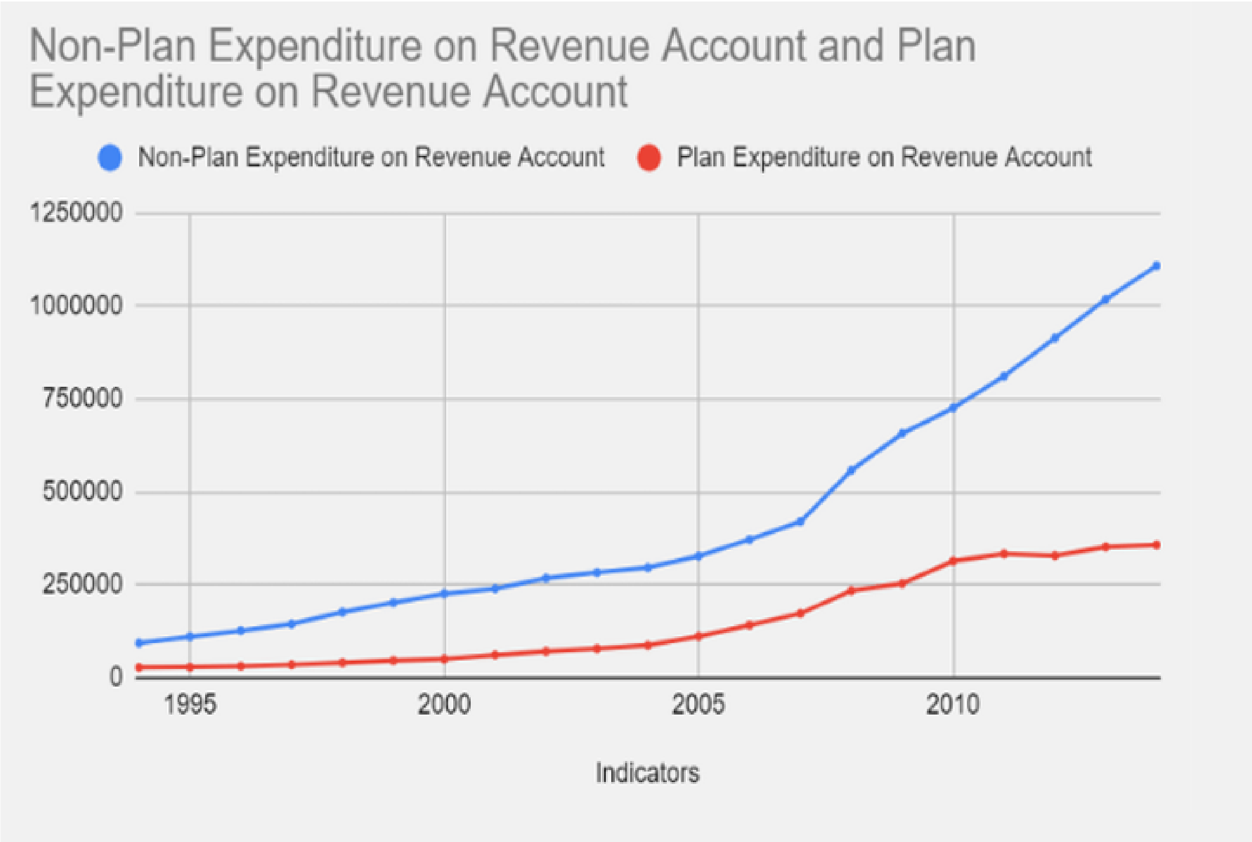
The Narendra Modi government's fiscal outlook has failed to strike a reasonably good balance between supporting public-funded social welfare schemes for developmental goals to be sustainably realised, and the need to drive growth by creating enough opportunities for the private sector to invest across sectors-and subsequently create good jobs. None of the two have happened in congruence with one other. Supply side-economic interventions (via increased government capex outlays at cost of social security) have outweighed demand-side economic policy needs.

Let's review this one step at a time.

Revenue vs capital expenditure

The focus on capital expenditure has been large and ever-expanding with a growth of 33% in spending outlays seen for every year. Modi government's hope has been that this would help generate long term assets and crowd-in private investment for driving growth.

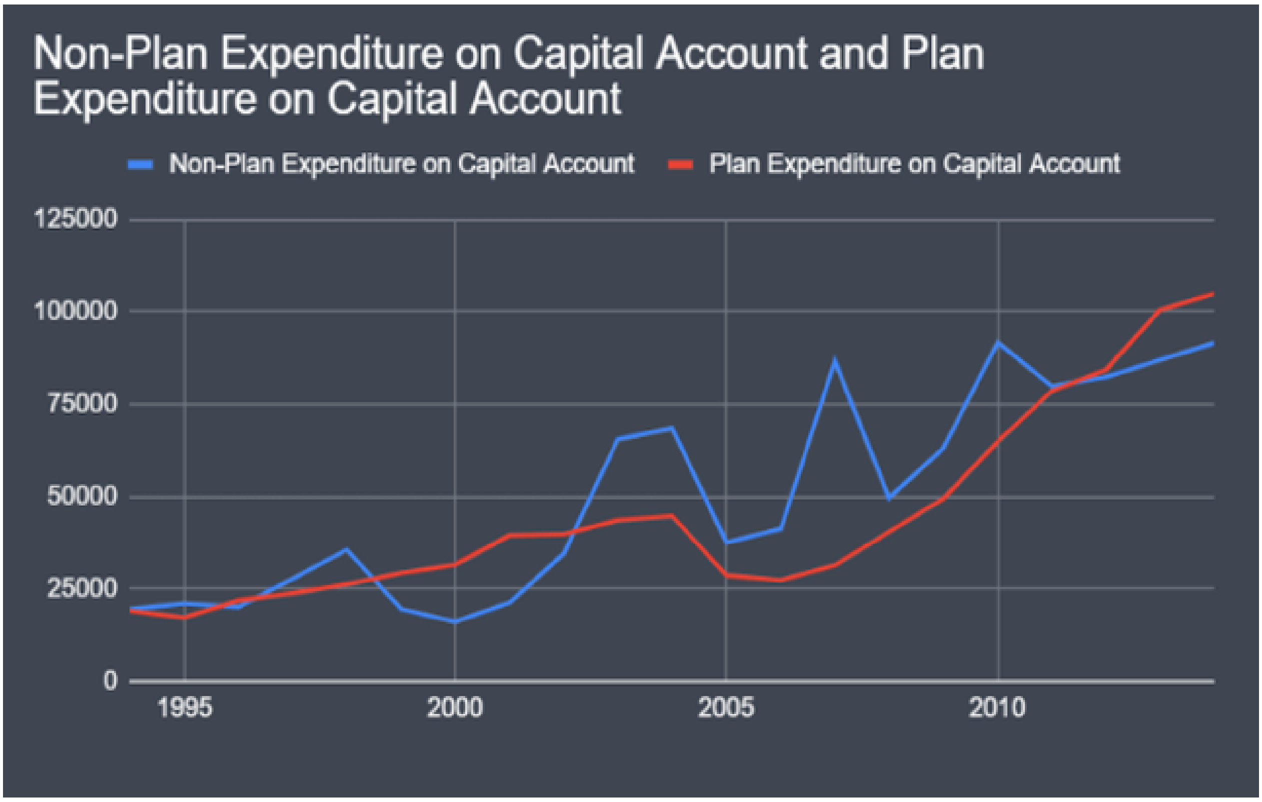




Source: InfoSphere Team

We observe an increasing discrepancy in the planned expenditure and the unplanned one (on revenue vs. capital expenditure accounts). There has been no revision in budgets to accommodate this gap and we cannot expect the same to happen in FY2023 as well.

Capital expenditure (plan vs. non plan) follows a different pattern with actual and budgeted expenditure matching throughout the years, but, for revenue accounts, when we look at which of it was planned and unplanned, there is wide divergence in trend across the years-indicating a large increase in non-plan expenditure overheads (especially prior to 2015).



Source: InfoSphere Team

On capital account, the rate in progress for both non-plan and plan expenditure has gone up. Under the Modi government, the push to planned capex has been more. But, to what extent this increase in government support capex spending yield any positive results?

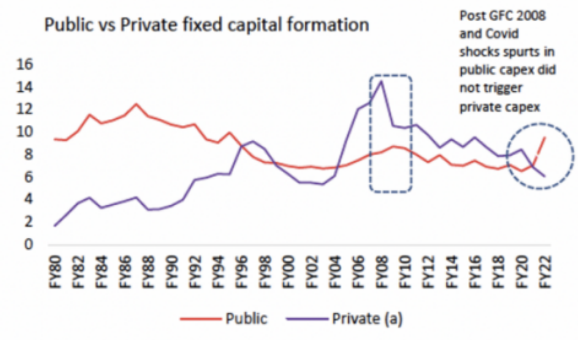
Adjudicating by the evidence shared by the Systematix team in one of their latest policy briefs, the answer would be: Not really. Quoting from their brief here: *"The lack of private capex despite the policy support and conducive environment indicates that the crowding-in impact of government capital spending and tax cuts is not working."*

In fact, reviewing a broader range of indicators may convince most that the inflection point for India's capex cycle has drifted further.

"Market euphoria reflected in peak-time valuations for the capital goods sector mimics overtly optimistic firm level expectations even as near-term momentum is losing steam; Index for Industrial Production (IIP) for capital goods has declined by 23% over the recent peak," reports the study here.

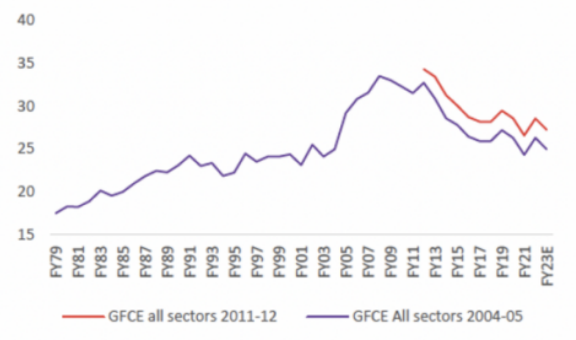
The data points shared below narrate a telling picture.

Exhibit 1: After 1980s crowding-in effect of public capex has not worked, private capex drifted lower since FY08 (% GDP)



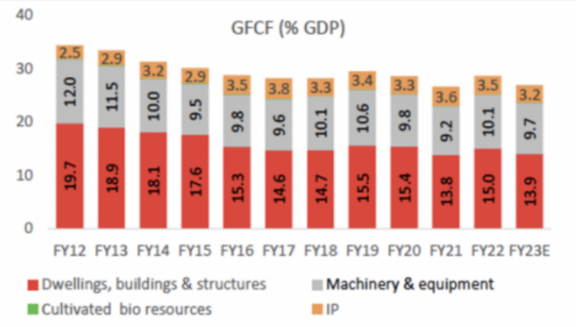
Source: CMIE, Systematix Research; private GFCF long-time series estimated based on splicing back 2011-12 data series into the 2004-2005 series

Exhibit 2: GFCF/GDP (%) declined to 28% in FY22, vs pre-covid peak of 29% in FY19 buoyed by US rebound, FY23E at 27.3%



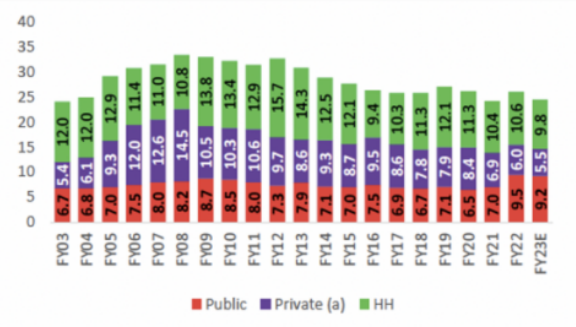
Source: CMIE, Systematix Research, 2004-05 series extended till FY23 using the overlapping difference for FY12-FY14 with the 2011-12 series

Exhibit 3: Investments in machinery & equipment have declined, govt capex supported employment-intensive construction



Source: CMIE, Systematix Research, 2011-12 series

Exhibit 4: Share of private investments is now lower than household and public sectors



Source: CMIE, Systematix Research, based on spliced 2004-05 series, In the 2011-12 series, private capital formation is higher by 235bp during the overlapping period of FY12-14 but its declining trend is intact

As per the brief: *"The crowding-in effect of government capex on private was relevant during the 1980s when its contribution to overall GFCF was 55% and when its role in industrial production was high (Exhibit 1). In the current situation, while its contribution is again on the rise (34%), it is mainly concentrated on construction activities, which does not have a wide-scale multiplier effect on the industrial sector.*

Contrastingly, with private capex getting increasingly guided by the cycles of household consumption, global trade, and market situation, the combination of rising demand uncertainty, contracting exports, early withdrawal of fiscal support (incidence of net indirect tax rising from the covid lows 9% to 11% of GDP), and contracting operating profits has resulted in continued shrinkage in the share of private GFCF to 29% of the total in FY23E from a pre-covid average of 37% (See Exhibit 4).

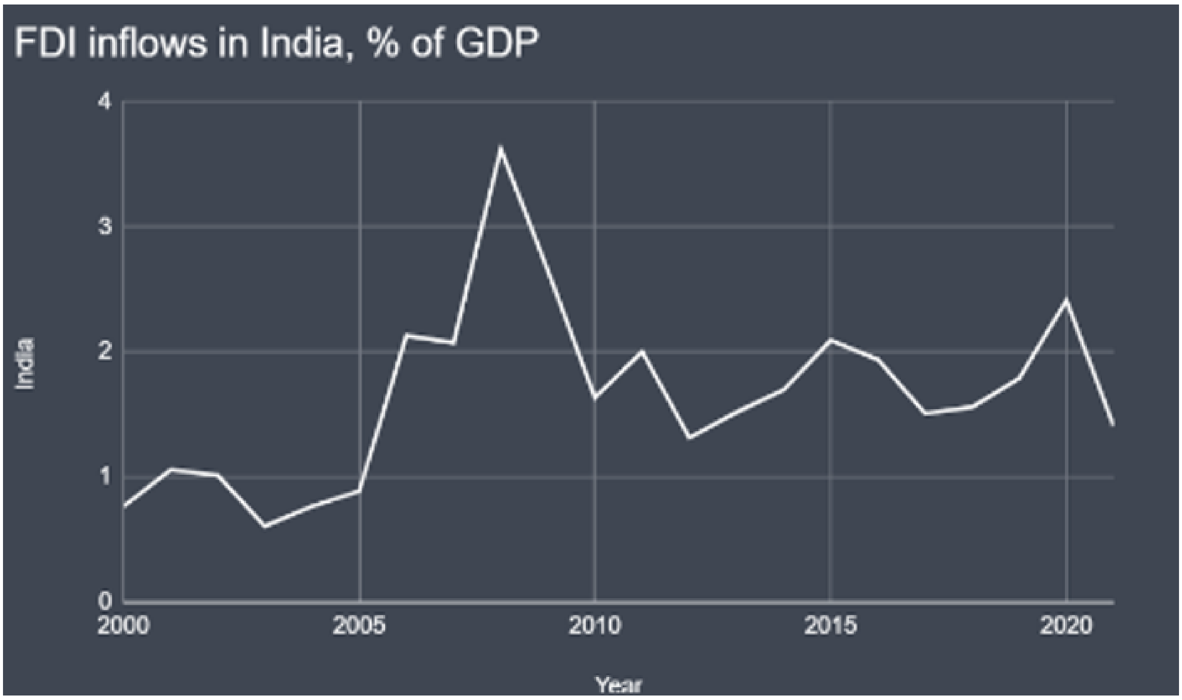
Household PFCE in housing construction is now contributing 37% of the total. Thus, resulting from the continued downdraft in private capex, its share is now lower than both the household and the government."

How about foreign direct investment?

FDI as a percentage of the GDP has been overall quite volatile.

Post 2010, the flow has been hovering around 2-2.5% of GDP (as seen below), which is hardly sufficient from a desired foreign investment level in India (high FPIs are part of hot money and are much more volatile than any other form of investment).

Still, attracting foreign direct investment on a sustained basis has been vital to the government's efforts to driving higher growth. Fiscal interventions like cutting corporate tax rates or the use of PLI (Performance Linked Incentive) scheme hasn't helped in driving FDI upwards too.

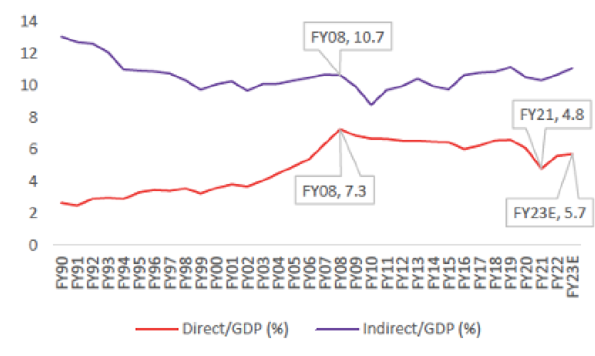


Source: InfoSphere Team

The revenue situation for the government is also a concern.

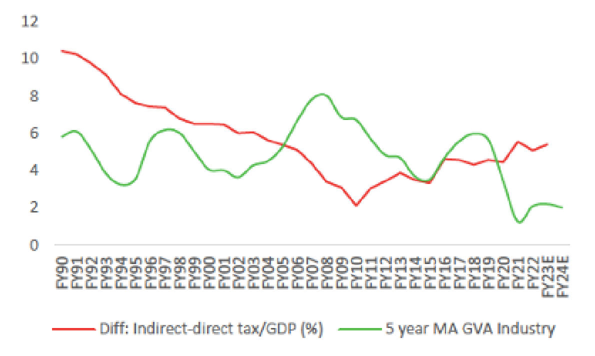
A structural part of the issue is also related to the skewed nature of India's indirect-direct tax base. Convergence of indirect-direct tax incidence prior to the financial crisis of 2008 had seen a structural uptrend in growth despite the cycles (see the reference exhibits below).

Exhibit 43: India has increasingly relied on indirect than direct taxes since the post GFC recovery, indicate reduced tax buoyancy



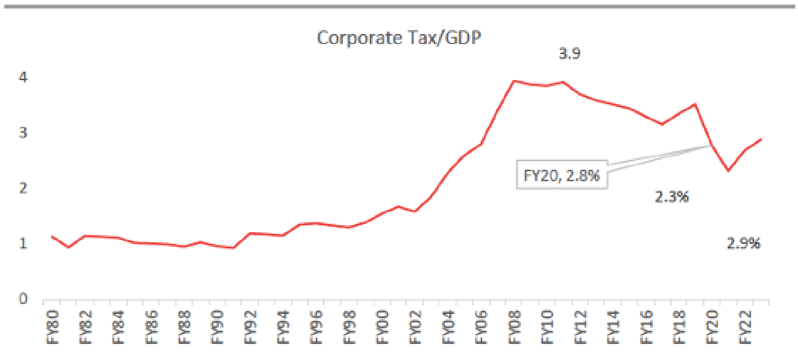
Source: CMIE, Systematix Research

Exhibit 44: Convergence of indirect-direct tax incidence prior to GFC 2008 saw a structural uptrend in growth despite the cycles



Source: CMIE, Systematix Research

Exhibit 45: Incidence of corporate tax at 2.9% of GDP equals pre-covid, the declining trend since FY10



Source: CMIE, Systematix Research

Still, despite GST's introduction (to simply the pre-existing complex indirect tax system) last few budgets have failed to push the envelope further in increasing the 'direct' tax base.

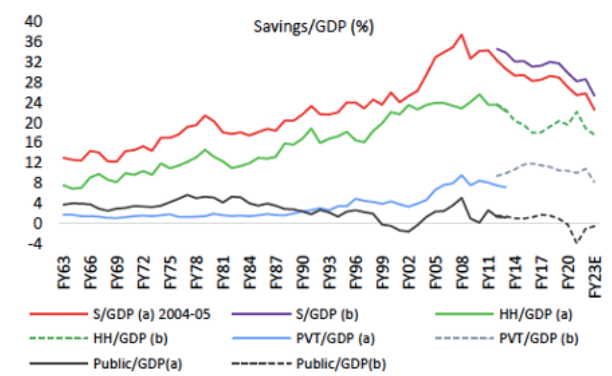
The lead author has argued earlier for the need of a wealth-induced consumption direct tax for over three years now that can be one of the steps in this regard. On the contrary, the incidence of corporate tax remains at 2.9% of GDP -equaling pre-covid levels, as part of a declining trend seen since FY2010.

Ineffective capex, falling investments, decreasing savings and their macro-effects

The continued decline in investment rate and potential growth has slowed down employment creation, income generation, and a rising proportion of consumption expenditure from disposable income.

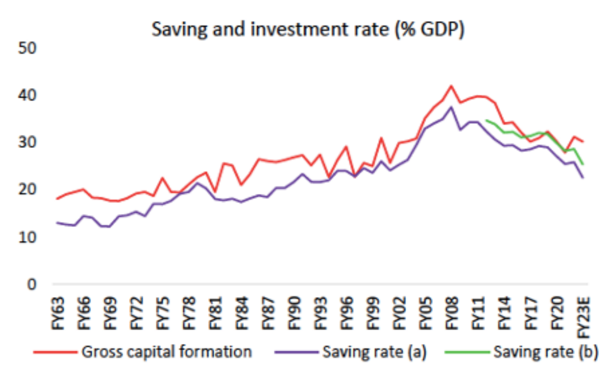
"A decline in the real income of households at the broader level typically leads to a rising proportion of consumer spending, particularly on basic items like food, etc. This has meant an incessant drop in the savings rate of households and the private sector over the past 14 years; the overall savings rate has declined from a peak of 37% of GDP in FY08 to 22.6% in FY23E", as reported.

Exhibit 5: India's saving rate has declined since FY08 at 38%, currently at 22.6% (2005-06 series or 25.6% on 2011-12 series)



Source: CMIE, Systematix Research, Saving rate, household, private and public sectors; a=2004-05 series, b=2011-12 series

Exhibit 6: Long phase of declining investment rate associated with an equally long phase of decline in the domestic saving rate



Source: CMIE, Systematix Research; a= 2004-05 series, b=2011-12 series

Given that domestic savings fund more than 98% of India's capital formation, a revival in (domestic) savings will be extremely crucial for a revival in investments and potential real GDP growth.

The households have drawn down the COVID-19-stimulus-induced accumulated savings and their saving rate is estimated to have declined to 17.6% of GDP in FY23E, lower than pre-COVID-19 at 19.6%. This is a serious concern. Wage growth-low inflation will help in restoring household savings but job creation is equally vital in the process to ensure those entering the organised job market have a reasonable income base to save-spend.

Also, to keep private consumption high, especially across all income groups, sustaining higher wage growth rate along with employment generation – that is both worker-intensive and growth focused – needs to be the most key pillars for any fiscal roadmap set out for the next 3-5 years.

Also read: Is This a Lost Decade for Indian Manufacturing?

Unfortunately, the past few Budgets have failed to even address this concern, leaving most for the private sector to do. The political economy of the Modi government's budget policies signal a centralisation of political power, but an adjunct outsourcing and coercive privatisation of public responsibility/ownership to the private space.

Modi government's 'pro-corporate' capex push hasn't worked

As argued by the data points above and points raised here:

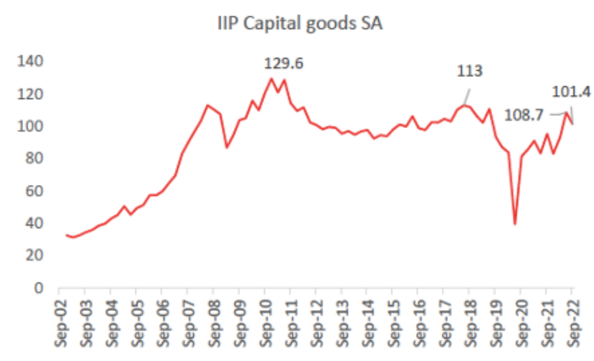
"The policy effort over the past decade to revive private capex and derive a sustainable 7-8% has been futile as evidenced by a) sustained decline in investment and saving rates, b) rising unemployment and c) trend decline in real GDP growth to 2-3% on 3-year CAGR."

India's fiscal policy in the Modi government has centred itself around the need to fiscally conserve by limiting revenue expenditure but increasing capital outlays, while attempting to resurrect the banking system and the corporate balance sheet.

To crowd-in private capital investment, corporate tax rate incidence has been kept low (2.9% of GDP), translating into a decline in the ratio of direct tax/GDP to 5.4% from the post-liberalisation peak of 7.3% in FY08.

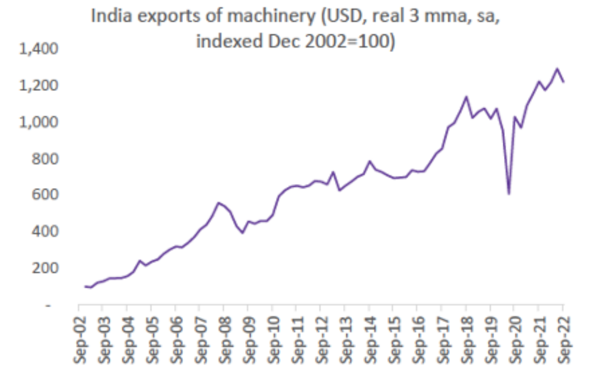
Simultaneously, the indirect taxes/GDP ratio increased to 11% from lows of 8.8% in FY10, more recently through the increase in taxes on fuel and broad basing GST to even basic consumption items.

Exhibit 13: Capital goods production is 10% lower than pre-COVID, and 22% lower than the before 2010 peak, 2QFY23 is -7% QoQ



Source: CMIE, Systematix Research, IIP based on 2011-12 series, data prior to Jun 2014 is spliced series of the 2004-05 series

Exhibit 14: Surge in exports of machinery above pre-COVID levels, aided recovery in capital goods production (IIP)



Source: CMIE, Systematix Research

Exhibit 15: Export and import of capital goods at 4% & 5% of GFCF are substantially lower than 2008 averages of 5.3% and 6.5%

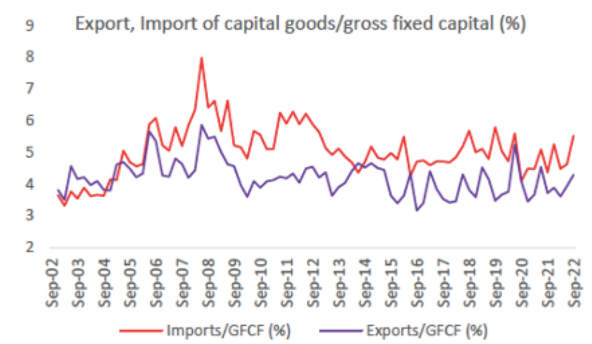
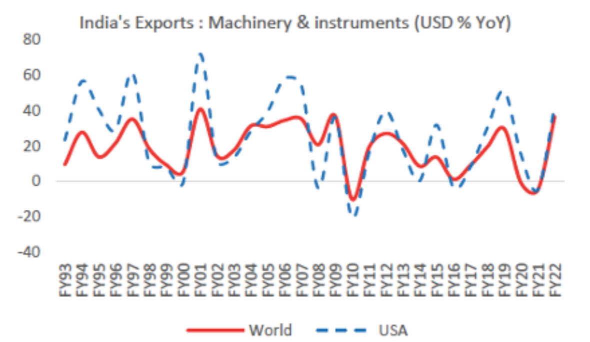


Exhibit 16: Revival in India's capital goods exports to the world largely driven by the US market



So, assuming the government still wants to spend on capex for growth, it will borrow, eitehr internally or externally, to finance its deficit expenditure needs. It may eventually borrow more for capex needs, or for revenue expenditure needs (which is where more than 65% government spending already goes).

Borrowing more to meet either of the needs is likely to worsen the already high inflation problem, given increased supply of money will push prices higher and relatively make the rupee too worse off (it's already been a very bad year for the Indian currency).

So, a higher priced consumption-inflation fuelled cycle will oppress (and financially punish) the poor more, at a time when their needs (through scheme-based transfers) have been compromised.

But we are not sure if the government may go ahead, at least this year, with a plan to spend more (either on capex or on revenue expenditure needs).

An unsolicited two cents on what the Union government may end up doing this budget is:

It will play safe: prioritise fiscal consolidation for this year, try to create more ways for generating revenue (as it seems to be running out of money), keep borrowings as minimal as possible (for keeping both, the deficit-debt and the inflation-exchange rate situation stable), and keep overall capex based spending at par – pushing the domestic private sector to do more on investment and driving consumption demand (which it hasn't done much).

Is that the right step to take?

We respond to this along with a brief analysis of the Modi government's (dismal) outlays on social expenditure schemes and welfare in part rwo of the article series.

*This is an essay extrapolated from*the latest edition of the InfoSphere team*, Centre for New Economics Studies (CNES), Jindal School of Liberal Arts and Humanities, OP Jindal Global University.*

Deepanshu Mohan is associate professor of economics and director, Centre for New Economics Studies (CNES), Jindal School of Liberal Arts and Humanities, OP Jindal Global University. Aniruddh Bhaskaran, Hemang Sharma, Soumya Marri and Malhaar Kasodekar are all members of the CNES InfoSphere team and working as research analysts with CNES.