Does Budget 2021 Rest On Robust Macroeconomic Pillars?

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Budget 2021-22 has now been tabled in Parliament and there is no denying that it is an interesting attempt, combining a slew of institutional reforms in various sectors with a fiscally aggressive stance. Coming after a year of deep recession due to the pandemic, as well as a few years of falling growth rates, could this combination be what the economy needs to get back on track? The many institutional changes that have been proposed in the budget—including those in the financial sector—will definitely be studied closely in the coming days and months. In this piece, however, we look at a few macroeconomic issues underlying this exercise.

The Nominal Growth Math

The first issue to be looked at is whether this is a realistic budget. Previous budgets have often been criticised for making over-optimistic assumptions about the nominal growth rate. Correctly anticipated growth rates are essential for a realistic estimation of the total revenue earned by the government as well as an accurate calculation of the various fiscal targets as ratios-to-GDP.

Budget 2021-22 assumes a nominal growth rate of 14.4%. This seems to imply a real growth rate of around 10% and inflation in the GDP deflator of about 4%. Is this a realistic assumption?

Let us start with inflation. By all current indications, after remaining for a few months above the Reserve Bank of India's comfort levels, inflation has now come down. There does not seem to be any reason for it to go up again unless there is another supply shock or the economy reaches a supply constraint. The updated Consumer Price Index inflation forecasting done by one of us for the NCAER mid-year review is also consistent with a 4% inflation in the GDP deflator.

However, in an interesting twist to the usual problem, the assumptions about the real growth rates look unrealistically pessimistic.

A 10% growth on the back of a 7.7% contraction means a 2% growth over 2019-20. For an economy that is already showing signs of positive growth in the current quarter, this seems a very bleak outlook. If we project the four quarterly GDPs in 2021-22 (again using forecasts from the NCAER mid-year review done by one of us) using corresponding growth rates in 2019-20, a very low growth year, we still get about 13.5% real growth and a corresponding 17.5% nominal growth. If one adds the positive impact of pent-up demand and some boost due to the reforms, the nominal growth rate could go even higher.

This underestimation of the nominal growth rate may actually hamper the effectiveness of the budget in two ways.

- First, it leads to an overestimation of all the fiscal ratios. This by itself puts a roadblock on more productive expenditures.
- Moreover, by underestimating how much revenue will be earned, it also results in the allocation of lower amounts in critical expenditures.

Since the economy is in a demand constrained situation, both of these result in a self-fulfilling prophecy that could keep nominal growth rates lower than necessary.

The Fiscal Balance

Next, we look at whether this budget signals a shift from fiscal conservatism to fiscal progressiveness. At first sight, comparing the revenue and expenditure side of the budget, there seems to be some indication of this. The tax-to-GDP ratio is assumed to be close to 10% in 2021-22 with an almost equal contribution of direct and indirect taxes. This is in line with the trend in the past few years. The contribution of direct taxes was somewhat higher earlier but have come down with the reduction in the corporate tax rates.

On the expenditure side, however, the expenditure to GDP ratio is planned to be close to 18% of GDP, much higher than the previous trend that was close to 13%. A part of this increase in expenditure ratios may be due to an attempt at transparency by bringing down extra-budgetary resources and shifting these entries into the central budget. This is, however, only a part-explanation of the increase.

There is definitely an attempt to increase expenditures as well.

As a result of the increase in expenditure, and partly as a result of assuming a relatively low nominal GDP growth rate, the fiscal deficit to GDP ratio remains at a relative high of 6.8% in 2021-22.

Before drawing any conclusion on the fiscal stance of the budget, however, let us remind ourselves of the last few years before the pandemic hit us. The economy then was continuously slowing down with a rapid fall in private investment.

> **A closer look at the budget for those years will show that even then, the fisc was providing a stimulus, although the off-budget expenditures made sure that it was not reflected in the deficit numbers.**

In fact, the extra-budgetary expenditures at that time could be thought of as stimulus-by-stealth, forced on the government by the Fiscal Responsibility and Budget Management Act. The higher fiscal deficit in 2021-22 is in fact a continuation of that effort to pump-prime the economy, albeit in a more transparent manner. The reason that the budget looks more fiscally progressive is due to the fact that for most parts of 2020-21, the Indian fiscal stance was one of the most conservative in the world.

The Immediate And The Future

In one aspect though, the budget has seen a clear break from the past. This pertains to the difficult balance that a budget must strike between short-term and long-term policy objectives. The political economy of India in the last two decades had continuously put pressure on the governments to prioritise short-term objectives. This trade-off had become more acute in the post-Covid period as higher poverty and unemployment following the lockdown lead to increasing demand for transfer payments and social safety nets.

Despite this pressure, this budget has given long-term objectives some priority. The most important manifestation of this has been an increase in the capital expenditure ratio from about 1.8% in 2019-20 to about 2.5% in 2021-22. The other is the increased spending promised to health infrastructure.

What is the underlying vision of the budget?

This is clearly a budget that has largely put the pandemic behind it and focused more on the future.

Overall, it addresses both the demand-side as well as a number of supply-side issues. How far will it be able to help get growth back in the economy? For this, it is useful to consider the effects of budget 2020-21 on the economy as well. While there was a lack of willingness to provide a stimulus during the first part of the year, the approach has been somewhat different for the last few months. The fiscal deficit is now expected to be 9.5% of GDP, with some increase in capital expenditure as well. The two budgets together can definitely incentivise the return of aggregate demand in the economy. However, sustained growth will make a comeback only if private investment feels encouraged to return as well. And that is where, more than the demand creation, it is the success of the many institutional changes that have been introduced in the budget that will become crucial.

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