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Public Finance: A Rocky Road Ahead

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Impact of COVID-19 on Public Finance

India introduced lockdown in late March as its response to COVID-19, which was subsequently followed with multiple extensions and modifications in the months to come. The government had instituted stringent regulations, which had caused most of the economic activities to come to a standstill. This affected millions of people, devastatingly affecting their incomes and revenue sources.

The implications of the pandemic have been far-reaching, with the government revenue and expenditure policy also moving in unprecedented and dangerous territories. Various state governments have also pointed at how they have had to face revenue shocks owing to the slowdown in the economy. The top five states with the greatest number of cases are likely to report losses to the tune of ₹14.4 lakh crore in 2020-2021[i], indicating the seriousness of the financial constraints that the states are grappling with.

Different state governments have reacted to the crisis in their own ways. For example, Andhra Pradesh, Rajasthan, Telangana amongst others, on one hand have postponed the payment of salaries to the government staff and ministers. Karnataka, on the other hand, has organized sales of its corner plots to raise funds to meet the state's needs[ii].

Executive Summary

In today's turbulent times, citizens are looking up to the government for ensuring their social welfare. Governments, however, can do this only when they are backed with strong & well thought financial mechanisms. Public Finance policies thus, become the backbone for other social welfare policies.

The pandemic has brought the intricately woven policies of public finance to limelight. Revenue generation has taken a hit & is far below the projected levels. Sufficient funds are required to fund medical care, infrastructure & other supporting mechanisms which now have become a priority. To compensate for this shortage, finances are being arranged from various sources which are indirectly causing public distress. This is detrimentally affecting the Indian Macroeconomic Circle of Life.

Our recommendations are in line with generating revenue from alternate resources & its optimal distribution to resources in need. They include:

1. Leveraging foreign investments in existing domestic SEZs,
2. Speeding up disinvestment deals from Non-Profit ventures and,
3. Investing in state-level development projects to create new revenue centres.

The encapsulating point is to emphasise the importance of spending adequately to grease the wheels of the economy. Fiscal deficit, though a pressing concern, should not outweigh the need for reviving the economy.

Most of the states have reoriented themselves to realise the harsh realities and stepped-up humanitarian spending. The crisis has brought about a twofold setback, where rescuing lives from unemployment has become as important as from the disease. In this light, rehabilitating migrant labourers, distributing subsidised food packages and doling out cash to the needy have become top priority.

The income generation and growth of an economy is self-fulfilling insofar the expenditure fuels demand, which will encourage more expenditure. This circular flow of income has been hampered because even the basic expenditure carried out by the government is endangered.

Thus, the economy is in a precarious situation with the government's revenues diminishing, accentuated with its inability to carry out developmental expenditures. This view has been further supported by research and ratings agencies that have provided bleak forecasts about India's economic future. One such agency, India Ratings, estimates India's GDP to contract ~5.3% in FY21, recording the country's lowest growth rate since GDP calculations began in 1951[iii].

Revenue Crunch

The federal structure of India is such that the revenues and expenditures of the Union and the state governments are jointly shared. Given the budget estimates of FY20, 52.5% of the revenue for the states were supposed to be generated on its own, with the remaining 47.5% being attributed to central transfers. The crisis would have a two-fold impact on the revenues of the state, as not only would the self-generated revenues suffer but also the central devolution.

On a closer look at revenue sources generated by the states, about 85% of it is tax revenue. Within tax revenue, GST contributes the major share—however, determination of the GST rates does not fall under the ambit of states and hence, cannot be used to influence revenue generation directly. Another 10% of state-generated revenues is collection of stamp duty—levied on property transfers, which have slowed down amidst the lockdown. These have further landed a blow to states' revenues.

However, within tax revenues, the state governments are trying to extract additional revenues by increasing levies on alcohol and fuel. Even though their own tax revenues have risen from April 2020 to May 2020 on this account, they still fall short of the normal amount collected. Even the contributions received by the states from the centre seem suspect, given the economic slowdown. Research and ratings agency ICRA estimate the tax devolution from Centre to go down by 30% this year, highlighting the significant budget crunch the states are facing[iv].

Desperate times call for desperate actions—states are resorting to unprecedented moves to mop up the losses in the generated revenue. As mentioned earlier, Karnataka is trying to monetise its corner plots and make money via its sales. However, these measures were ad-hoc at best and could not possibly curtail the destructive forces endangering the fiscal health of the states. Healthcare, being a state subject, took away a significant portion of their already meagre revenues. The revenues fell further, and expenses rose sharply, as the states tried to regain normalcy.

Expansion of Borrowing Limits

The Union government has relaxed the borrowing limits for the states, to partly relieve them from their financial stress. The earlier limit of 3% of GSDP now stands revised at 5%. The extra 0.5% would be unconditional; however, securing further access to credit would be contingent on reforms in areas like digitisation of ration cards, ease of doing business etc[v].

Though this initiative prima facie supports the states insofar allowing them more elbow space, it is also accompanied with a lot of conditions, making the access to such additional credit tougher.

Varied effect on states:

The revenue shocks have also been differentiated across the states, with some of them having to bear the brunt more. Unfortunately, the states with the maximum number of cases are also the more developed ones—mainly on account of influx of migrant workers, who can inadvertently act as virus carriers.

Another source of disparity emanates from analysing the split of revenues as either on own account or received from the Centre. The self-reliant states were impacted more directly but the overall scenario seemed to be disappointing, as far as revenue collections are concerned.

External assistance:

Given the suspension of normal state of affairs, there is a greater inclination towards generating revenue from external sources. The Prime Minister has asked the states to interact with foreign companies and attract investment to revive the plummeting economy. For instance, Gujarat has written to the Japanese government inviting them to open businesses. Even the Uttar Pradesh government has constituted a task force to showcase the state's primary attractions to appeal investment.

Even Invest India, the Centre's investment promotion agency, has been proactive in facilitating meetings between the states and foreign companies. Thus, the states are attempting hard to develop alternative sources of revenues to reform their fiscal health.

Alternative options:

At this juncture, the states are clinging to any option that can assist them in easing their revenue problems. One of the main avenues is the GST compensation that is due to them. According to the GST Compensation Act, 2017, the states are assured a 14% annual growth in tax revenues for five years till 2022. Any shortfall arising in this matter would be borne by the Centre. However, given the unprecedented situation, it is difficult to understand how much this commitment would be acted upon at the moment.

The states are looking to maximise revenues from sources that fall directly under their control. Higher rates of taxes and fuel, as mentioned earlier, are examples.

Expenditure: The Economic Package

The government announced an economic package worth ₹20 lac crores on 12th May 2020 to help revive the economy. In terms of the percentage of the economy, it was stated to be around 10% of the GDP, but a closer look reveals that the additional fiscal stimulus by the government is not enough, leaving room for more spending in the future. We have analysed the package from various angles and made some policy recommendations.

Drivers of Growth:

The primary drivers of growth are either the supply side or the demand side. Supply-side constitutes primarily the credit support provided by banks and other financial institutions, and the demand side includes the demand generated from the GDP and income of the population. India was facing demand-side shock even before the COVID-19 crisis hit us. The GDP had seen negative growth for the previous 7 quarters as shown below.

The pandemic has only worsened the situation with analysts expecting a GDP decline to the tune of 5%. Moody's even downgraded India's sovereign rating by one notch to Baa3 negative[vi]. Due to the prevalent poor infrastructure and low social sector spending, the IMD world competitiveness index has placed India at 43rd position in the list of 63 nations[vii].

The Package:

Given the state our country currently is in, it needed an above-average demand-side stimulus. However, we feel that this stimulus was missing in the package that was announced on the 12th of May. Most of the provisions were to strengthen the supply side.

Banks have been flushed with liquidity, there are loans available in abundance for businesses to borrow. However, as Mr. Rajnsh Kumar, Chairman of the State Bank of India, pointed out in an interview, there are no takers of such loans[viii].

Businesses and people are risk-averse in the current situation and do not want to invest or spend. It's a classic chicken and egg problem where the supply side push can't be fruitful unless there is demand to support the same.

The four primary pillars on which the package stands are - RBI's liquidity support to banks, banks' credit support to small businesses, building infrastructure using borrowings from institutions like NABARD, and clearing pending bills like DISCOMs' overdue[ix]. 90% of the stimulus uses credit channels to attempt to revive the economy. The fiscal impact is much less than anticipated.

From a temporal perspective, the proposals aimed at expanding infrastructure for agriculture, etc. are very welcome, but their impact may reasonably be expected only in the medium-term, whereas an unprecedented situation calls for unprecedented actions that show its impact in the short term.

Even in the normal situation, the supply-side adjustment is slow because supply responses take time, whereas the demand-side adjustment is fast as incomes spent raise consumption demand without any time-lag.

The MSME sector, which is the focus of the package and the backbone of the economy that provides 25 percent of employment, 32 percent of the GDP and 45 percent of exports, is not very comfortable with the ₹3 trillion line of credit for loans without collateral, since the sector is also dependent on market demand a supply side intervention won’t have the necessary impact.

Policy Recommendations

Leverage SEZs to attract more investment:

It is an opportune time for the government to focus on SEZs and attract FDI. These zones have worked successfully for the IT/ITES industry. To put things into perspective, SEZs have generated employment for about 19 lakh people in 12 years and can further do so for another 19 lakhs in the next 6-8 years. India plays host to a large, educated population, that is extremely skilled in the services sector[x]. Easing procedures and extending benefits to companies in SEZs can prove to be a healthy employment generator.

Speeding up disinvestment deals:

The government should look forward to increasing its income by strategically selling its stakes in public-sector units. In the budget presentation in February 2020, the government had set a disinvestment target of ₹2.1 trillion[xi]. Currently, the government is facing a severe slump in its revenues and hence, should ramp us its disinvestment plans to raise additional revenues.

Investment in development-related expenditure:

The government has been proactive in incurring humanitarian expenditure to ensure survival and addressing basic needs. However, it is pertinent to gradually step-up growth-enhancing expenditure simultaneously in order to generate more income. The circular flow of incomes needs to be kick-started again so that employment can be revived, and the diminishing growth can be arrested.

For this to happen, a fiscal multiple is needed; it is essential to incur expenditure which generates more demand. Most of the development projects are under the foothold of the state list as is defined in the Seventh Schedule of the Indian Constitution.

Distribution of borrowed income amongst states based on factors like, Population Density, Average Daily Rate of COVID-19-19 patients and revenue deficits can ease the burden of state governments in tackling the economic impact of COVID-19-19. Defining KPIs to distribute resources can go a long way in monitoring optimal use of resources and ensuring a smoother recovery from the existing crisis.

Revised budget for 2020-21:

The administration needs to shift focus from fiscal deficit targets and start borrowing more to spend more. The budget for 2020-21 needs to be revised as the assumptions made in Feb 2020 are no longer valid. The current revenue estimate of approximately ₹30 lakh crores needs to be increased in view of the pandemic with an increased focus on the healthcare sector.

Rate cuts:

From a demand-side perspective, reforms like increased GST rebates, tax rate cuts, etc will increase the income of households and in turn increase the consumption. The present sources of revenue (tax, non-tax, capital receipts) are expected to yield only ₹18,00,000 crore. The rest must come from short-term borrowing or in the worst case, printing money[xii]. There is a fear of increasing inflation, but that will be in check given reduced consumer spending and lower interest rates at the moment, providing room for the Reserve Bank of India to increase rates in the medium to long term to control inflation if the need arises.

Policy Implications

The biggest problem with these recommendations is that the government's revenues are a fraction of what it would have been without the pandemic. But even in the current situation, a fiscal stimulus is indispensable. This is based on the expectation that cutting taxes would result in a rising consumption of necessary goods and that could bring in revenues to compensate for the cut.

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