The Inflation-Growth Dilemma: Walking the Tight Rope*

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Let me wish all our readers a very Peaceful, Prosperous and Productive New Year!

This is budget time again and speculations are rife and expectations galore. Although the economy is in a recovery phase, the global headwinds of slowdown, inflation and recession, and continued risks of the virus in countries like China, pose serious policy challenges. In India, the government is faced with the dilemma of having to loosen the purse to fast-paced infrastructure spending to aid growth recovery while containing the fiscal deficit to return to the fiscal consolidation path. This is the last full year before the general elections to the Lok Sabha. Although as many as nine states will go for elections this year, they are unlikely to influence the budget process much.

The Finance Minister has the difficult task of preparing the budget at a time when both global and domestic economic environment is far from being congenial. According to the IMF, the world economy is projected to grow at just about 2.7% in 2023 as compared to 3.2% in 2022 and 6% in 2021. One third of the world and a half of Europe is expected to slip into recession and the US is at the cusp. With major production centres in the grip of the pandemic in China, the country is also expected to face a phenomenal slowdown. The sharp rise in interest rates following raging inflation in most developed countries of the west has only added fuel to the fire.

India's growth performance in FY23 estimated at 7% looks impressive as compared to other large countries, but this is mainly due to economic recovery from the low base in the first two quarters of FY22. The RBI projects that in the second half (H2) of FY23, the growth rate in GDP will be just about 4.3% and the next year's growth rate is pegged at 6%. The crucial element to accelerate growth is increase in investment, and the public sector will have to take a lead role in this in the prevailing circumstances. Although the indicators like PMI index for manufacturing at 57.8 in December was the highest in 27 months and services at 58.3 was a significant improvement over the previous month (56.4), and bank credit to commercial sectors have been impressive, it is too early to characterise these as a trend.

Thus, growth acceleration will require significant increase in infrastructure spending by the government, but that will be constrained by the need to comply with the fiscal consolidation path. The framework of consolidation recommended by the Finance Commission is to compress the fiscal deficit to 4.5% of GDP by 2025-26, if the recovery is lower than expected by the Commission, 4% if the recovery is according to the expectation and 3.5% if the recovery is faster. The Finance Minister in her 2021-22 budget Speech has committed that the fiscal deficit will be compressed to 4.5% of GDP by 2025-26. Assuming that the government will contain the deficit at the budgeted 6.4% in

FY23, there will have to be a reduction of 1.9 percentage point in the next three years and quite a considerable part of that has to be done in the forthcoming budget as the compulsions of electoral politics could constrain much compression next year. To keep pace with the required compression, the budget would have to reduce the fiscal deficit to 5.8% in FY24.

The nominal estimate of GDP put out by the first advanced estimate, provides some cushion. The budget had assumed the nominal GDP of Rs. 258 trillion and the advance estimate puts it at Rs. 273.08 trillion. If the nominal value of the fiscal deficit is limited to the budget estimate of Rs. 16.6 trillion, the fiscal deficit will work out to 6.08%. In other words, the new GDP estimate provides a cushion of Rs. 865 billion. However, there have been overshooting of expenditures from the budgeted and that is estimated at Rs. 3.36 trillion. This includes increased allocation to food and fertilizer subsidies, additional dearness allowance payments and additional allocation to MGNREGA as the beneficiary numbers have swelled from 50 million before the pandemic to 70 million now. Swelling of food subsidy was due to the additional allocation of foodgrains under Pradhan Mantri Garib Kalyan Anna Yojana (PMGKAY) and increase in fertilizer subsidy was on account of inputs. However, increased tax collections over the budget estimate on account of higher buoyancy in both income taxes and GST should be enough to meet these additional expenditure requirements. Thus, there may not be much increase in the fiscal deficit in nominal terms and as a percentage of GDP, there could actually be a marginal decline.

The Finance Minister would be hoping that the buoyancy in tax revenue seen this year will continue into the next year and in addition, the government would garner more through monetisation of assets and disinvestment. GST, in particular, has shown higher revenue productivity and with better application of technology and administration, compliance should increase. With the crude oil hovering around USD80 per barrel, the fertilizer and transport bill too could settle at a lower level. Rationalization of subsidies is important, and this is the time to do that. The discontinuation of additional allocation of foodgrains under PMGKAY would save at least Rs.500 million. Introduction of Single National Agency in the administration of Centrally Sponsored Schemes (CSS) seem to have helped the government to effect significant volume of savings and the benefit of that will accrue in the coming years as well. There is a much larger issue of consolidation and design reform in the CSS, but it is unlikely to be initiated this year. With pick up in employment opportunities in urban areas, migration of labour from rural areas will increase and the requirement for MGNREGA allocation would be less.

On the reform front, some important measures are expected in this budget. The last couple of years have seen much greater transparency as off-budget liabilities have been phased out. The 15th Finance Commission has made a number of recommendations to under the rubric, “Fiscal architecture for 21st century” (i) to have credible fiscal rules; (ii) initiate a public finance management system to provide comprehensive, consistent , reliable and timely reporting of fiscal indicators as a part of the fiscal rule based policy and (iii) creation of an independent fiscal assessment mechanism

to provide assistance and advice on the working of fiscal rules and public finance management system. Also, it is hoped that the attempts to make the tax system simple and transparent by phasing out deductions and concessions and reducing the rates will continue. In doing this, it is not necessary to increase the number of brackets. Most importantly, keeping the long-term perspective on competitiveness and growth it is hoped that the protectionist policy followed since 2017 will be reversed.

* Views are personal.

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