MOTILAL OSWAL

ECOSCOPE
The Economy Observer

Pre-Budget II: One thing to be done and another avoided

Limited space must be exclusively utilized for investment spending

- **The Union Budget 2020-21 will be announced amidst a very unfavorable background, leaving the government with difficult choices. With real GDP growth weakening to sub-5%, expectations run very high at a time when the fiscal space to stimulate the economy is very limited.**
- **Two major expectations from the budget are: (i) investment push by relaxing the fiscal deficit targets and (ii) boost to personal consumption by cutting personal income taxes. In our view, the former must be attained but with strict conditionality and only after the true economic and fiscal narrative is placed before the country, while the latter must be avoided despite the very strong urge.**
- **The most important announcement in the budget could be to make the event relevant by inducting 'public sector borrowing requirement (PSBR)' along with the central government's deficit/borrowing data. It is essential to inform the nation that PSBR is almost double of the reported deficit of ~3.5% of GDP, which has put serious stress on the domestic financial markets. Still, a very low current account deficit at this stage allows the government to expand its deficit by up to 0.5% of GDP (or up to INR1t), provided it is spent entirely and exclusively on investments. The additional deficit should be financed by foreign savings to avoid any further stress on the domestic financial markets.**
- **Nevertheless, the strong urge to boost personal consumption spending by cutting taxes or discouraging savings must be avoided because the problem lies in subdued personal income growth. If personal consumption is incentivized but income growth remains weak (as has been the case over the past 6-7 years), the economy will remain structurally vulnerable – and in fact worsen faster.**
- **On the contrary, deliberations should happen on whether or not personal savings should be incentivized by increasing the deduction limit under various sections (80C, 80E, 80EE etc.). Although it will entail small fiscal costs and may hurt personal consumption growth over the short term, it could potentially address the most serious structural issue and help ease the domestic financial markets, which would help lower the interest rates.**

Union Budget 2020-21 – a challenging task:

As we have discussed several times earlier, there is very limited fiscal space to stimulate the economy. With real GDP growth weakening to sub-5%, expectations, however, have increased exponentially. This is what makes the Union Budget 2020-21 extremely challenging. In our view, broadly, there are two major expectations from the budget:

a) to relax the fiscal deficit targets and attempt to crowd-in the private sector by pushing fiscal investments higher and
b) boost personal consumption spending by cutting personal income taxes or incentivizing higher consumption by other means.

While the limited fiscal room must be utilized with some strict conditionality, the strong urge to push personal consumption must be avoided.

We believe that while the limited fiscal room must be utilized with some strict conditionality to make the first expectation turn into a reality, the second one must be avoided despite the very strong urge. In this part (II) of our 'pre-budget' series, we hope that the government places the true economic and fiscal narrative before the nation, which will help understand the real opportunities and challenges.

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One thing to be done in the budget – present the true fiscal narrative and utilize the limited fiscal space with strict conditionality

Markets appear to have mixed views about fiscal stress. One section believes that there is sufficient fiscal room to provide a significant stimulus to the economy, while the other section (including us) has been arguing about the very limited fiscal space. Irrespective of whether or not the government decides to follow fiscal consolidation or relax deficit targets, a clear reasoning for its decision would help a long way to clear the air on this confusion.

The government should include 'public sector borrowing requirement (PSBR)' along with the fiscal deficit/borrowing data.

In our view, the easiest way to achieve this objective is by inducting 'public sector borrowing requirement (PSBR)' along with the central government's deficit/borrowing data. As our calculations **suggest**, it is essential to inform the nation that PSBR is almost double of the reported deficit of ~3.5% of GDP *(Exhibit 1)*. This has put serious stress on the domestic financial markets because PSBR now absorbs >130% of household financial savings – the highest at least in the past two decades *(Exhibit 2)*.

Exhibit 1: Public sector borrowings requirements (PSBR) are much higher than the reported fiscal deficit…

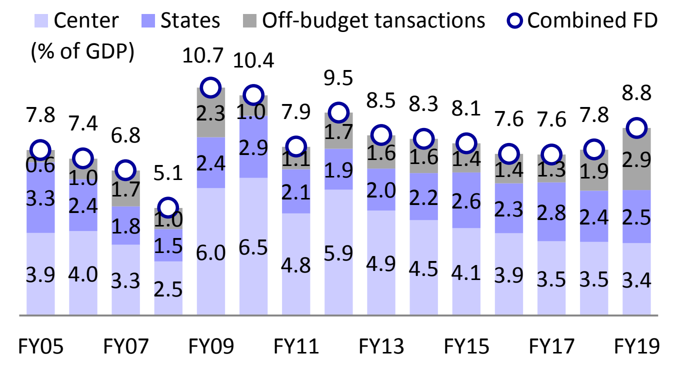
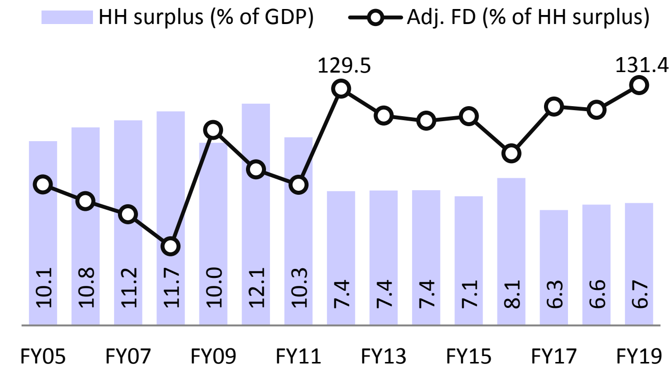


Exhibit 2: …and they absorb more than 130% of household financial savings – the highest in almost two decades

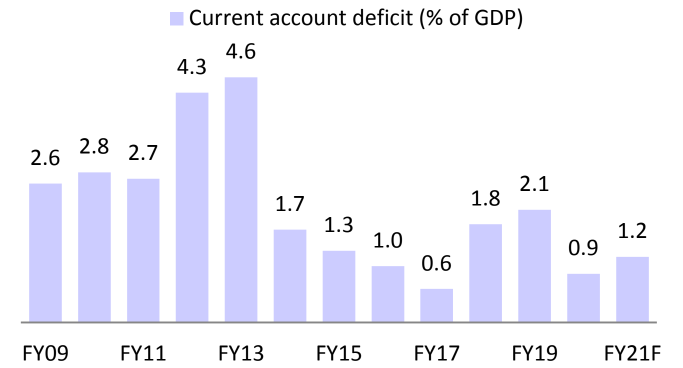


Source: RBI, Bloomberg, MoFSL

The additional deficit of up to 0.5% of GDP should be financed by foreign savings to avoid any further stress on domestic markets.

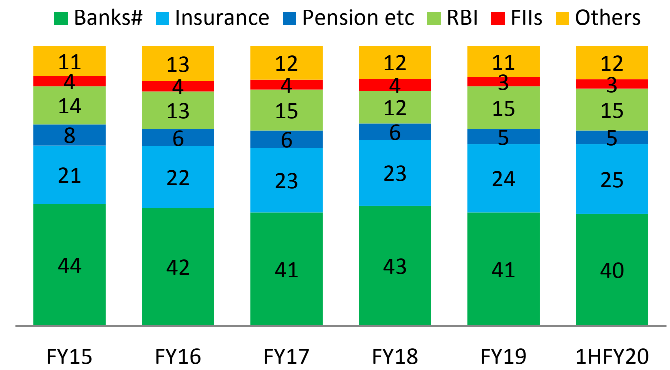
Still, very low CAD at this stage – we expect CAD to narrow from 2.1% in FY19 to ~1% of GDP in FY21 – allows the government to expand its deficit by up to 0.5% of GDP (or up to INR1t). The additional deficit, it implies, should be financed by foreign savings to avoid any further stress on domestic financial markets *(Exhibit 3-4)*.

Exhibit 3: Low current account deficit (CAD) provides limited fiscal space of ~0.5% of GDP (or INR1t)…



F = Our forecasts

Exhibit 4: …which must be financed with foreign savings, which account for ~3% of outstanding G-secs



Including non-bank PDs

Source: RBI, Bloomberg, MoFSL

Other thing to be avoided – further push to personal consumption by discouraging savings

However, the government must also ensure that the additional spending or borrowings are exclusively utilized for investment spending, and any push to personal consumption should be strictly avoided. There are many reasons for this conditionality. *First*, the academic literature sufficiently confirms that the multiplier effect of fiscal investments (or capital spending) is much higher than that of consumption (or revenue spending). According to the RBI's monetary policy report of **April 2019**, *"an increase in capital expenditure by the central and state governments by one rupee each crowds in private investment, induces a more than proportionate increase in investment in the economy, and leads to an increase in output by 3.25 rupees and 2.0 rupees, respectively."* This multiplier was much higher than the revenue expenditure multiplier of below unity. Similar strong results in favor of higher capital spending multiplier were found in an old 2013 study by the **RBI**, and other studies by **National Institute of Public Finance and Policy (NIPFP)** and **Indira Gandhi Institute of Development Research (IGIDR)**.

Second, the share of government (center + states) in total investment spending in the country is still very low at ~13%, which must be raised in order to try to affect the investment cycle in the economy.

For the first time in the post-independence history of India, personal consumption growth has outpaced personal income growth during the past 6-7 years.

Finally, as we have discussed in detail **earlier**, fiscal incentives to push consumption growth discourage personal savings. For the first time in the post-independence history of India, personal consumption growth has outpaced personal income growth during the past 6-7 years *(Exhibit 5)*. Consequently, not only household savings have fallen sharply but also its leverage has increased markedly during the past few years *(Exhibit 6)*.

Exhibit 5: For the first time since independence income growth has lagged consumption growth…

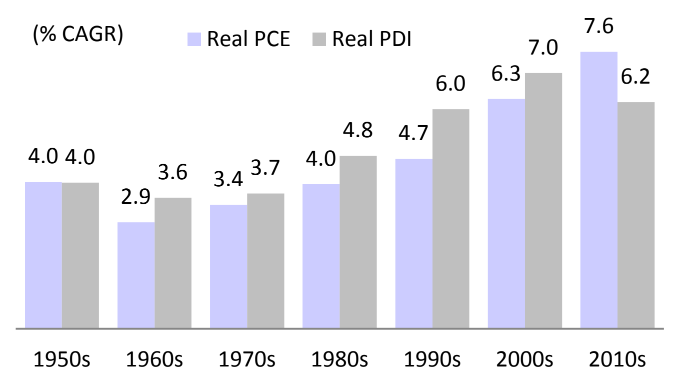
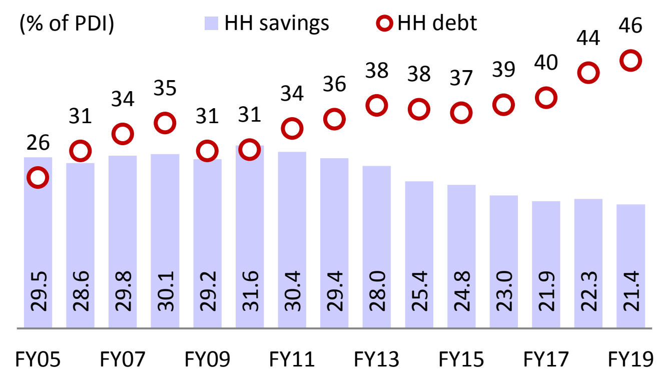


Exhibit 6: …which has led to a marked decline in household savings and a rise in its leverage



Source: RBI, Bloomberg, MoFSL

Therefore, we believe that the strong urge to boost consumption spending by cutting personal income taxes or discouraging savings must be avoided because the problem lies in subdued personal income growth. If personal consumption is incentivized but income growth remains weak (as has been the case over the past 6-7 years), the economy will remain structurally vulnerable – and in fact worsen faster.

One of the policies to boost personal savings and investments could be to increase the deduction on account of interest on loan for residential house property (section 80EE).

On the contrary, deliberations should happen on whether or not personal savings should be incentivized by increasing deductions under various sections. One of the policies to boost personal savings and investments could be to increase the deduction on account of interest on loan for residential house property (section 80EE). Not only could it boost the residential property sector, but the cost to the exchequer will also be very low (only INR2.7b in FY19).

The side-effect of this measure, however, is that it may hurt personal consumption growth over the short term. Nevertheless, it could potentially address the most serious structural issue and also help ease the domestic financial markets, which would eventually help lower the interest rates.

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