Quickonomics

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Fiscal consolidation path

Three scenarios and the arithmetic thereof

Highlights

1. Staying put on the fiscal deficit glide path will require the government to moderate its capex momentum seen in recent years
2. Even if the capex momentum is reduced, our scenario analysis shows that capex share in gross domestic product (GDP) remains higher than the pre-pandemic level
3. A mix of revenue-enhancing measures (disinvestment and asset monetisation) and further rationalisation of revenue expenditure might be needed to reduce the capex sacrifice

Among the several boxes that this year's union budget ticked, fiscal rectitude was a critical one.

The fiscal deficit target of 5.9% of GDP for the next fiscal signals a return to this path, after the pandemic bloated it from 4.6% in fiscal 2020 to 9.2% in fiscal 2021. To be sure, it was reined in at 6.4% this fiscal, as some spends during the pandemic were moderated and economic recovery, along with inflation, lifted revenue collections. The goal remains reducing it to below 4.5% by fiscal 2026.

Less favourable debt dynamics[1] in the coming fiscal vis-à-vis the past two years make the pursuit of fiscal prudence even more imperative, with just two more years to go to strike 4.5%.

The 5.9% target set for the coming fiscal appears doable. The underlying assumptions of growth and revenue buoyancy are fairly realistic. The risk to budget math is from a gloomier-than-expected global environment hurting domestic growth via exports and messy geopolitics keeping crude and commodity prices high.

But to meet the 4.5% target, the government will have to cut fiscal deficit by 70 basis points in fiscals 2025 and 2026 each.

We believe this can be challenging and will require continuous fiscal vigil.

Here, we look at some scenarios to assess the likely path of fiscal consolidation the government might adopt in the run up to fiscal 2026. A key conclusion emerges, regardless of the path adopted:

The extent of government capex thrust seen in the past 2-3 years is unlikely to sustain beyond fiscal 2024, if trimming the fiscal deficit is indeed a priority. In other words, our scenario analysis suggests that the government will have to moderate capex growth to meet the deficit target.

We demonstrate this using three scenarios.

But first, the assumptions made on the following three variables:

- Effective revenue expenditure = revenue expenditure – grants-in-aid for creation of capital assets
- Effective capital expenditure = capital expenditure + grants-in-aid for creation of capital assets
- Receipts = net tax revenue + non-tax revenue + non-debt capital receipts

Assumption on revenue spends: Share of effective revenue expenditure in GDP in all the three scenarios is assumed constant at pre-pandemic five-year average

In each of the three scenarios, we assume effective revenue expenditure (ERE) at 10.1% of GDP. This is marginally lower than fiscal 2024 budget (10.4%) but is at the same rate as the pre-pandemic average (fiscals 2016-2020). This translates to an ERE growth of 7.6% in fiscal 2025 and 10.8% in fiscal 2026, after seeing no growth in fiscal 2024. The rationales for this assumption are as follows:

- The fuel subsidy burden on kerosene and liquefied

[1] Debt dynamics: The sustainability of debt is be guided by how primary deficit (i.e. fiscal deficit excluding interest payments) behaves and how the difference between nominal growth and interest cost moves. For instance, if the growth -interest rate differential (g-i) is negative, a primary fiscal surplus is needed to reduce or stabilize the debt-to-GDP ratio. Conversely, a positive (g-i) would imply that debt ratios could be reduced even in the presence of primary deficits

petroleum gas (LPG) has been lowered from pre-pandemic levels as retail prices have been deregulated. But there is higher pressure from interest payments on central government debt (currently 3.6% of GDP). Plus, other mandatory expenses on salaries, pensions and defence (4.0-4.5% of GDP) make it difficult to bring down revenue spends further

- Higher revenue expenses on welfare schemes during the pandemic are now normalised, which alleviates some pressure

It is, therefore, broadly assumed that the government will not deviate from consolidation on ERE but focus on balancing the mix between capex and receipts.

Growth assumption: Nominal GDP grows 10.5-11.0% during fiscals 2024 and 2026 each

Scenarios to achieve a fiscal deficit to GDP target of 4.5% by fiscal 2026

I. Effective capex share in GDP is maintained at fiscal 2024 levels. This would require a sharp increase in receipts to reach the 4.5% fiscal deficit target

This is the most optimistic scenario which entails a sharp increase in receipts to fund capex.

Under this, to maintain effective capex to GDP at 4.5% — the same ratio as in fiscal 2024 —receipts must grow ~17% on average during fiscals 2025 and 2026, which is nearly double the pre-pandemic average growth of 8.7%. This is unrealistic, unless there is a windfall from dividends, disinvestment or spectrum sales.

The key takeaway from this scenario is that even if receipts were to surge, effective capex growth will moderate to 10-11% in fiscals 2025 and 2026, down from 27% on average during fiscals 2021-24. This growth rate will be slightly higher than the pre-pandemic average of 9.3%

% of GDP	FY16-20 (average)	FY21	FY22	FY23RE	FY24BE	FY25P	FY26P
Effective capex	2.7	3.3	3.5	3.9	4.5	4.5	4.5
Effective revenue expenditure	10.1	14.4	12.5	11.5	10.4	10.1	10.1
Receipts	9.0	8.5	9.3	8.9	9.0	9.4	10.1
Fiscal deficit	3.8	9.2	6.7	6.4	5.9	5.2	4.5

RE = Revised estimate; BE = Budget estimate; P = Projection

II. Effective capex share in GDP slips as capex is maintained at fiscal 2024 absolute level. This would require reasonable growth in receipts.

% of GDP	FY16-20 (average)	FY21	FY22	FY23RE	FY24BE	FY25P	FY26P
Effective capex	2.7	3.3	3.5	3.9	4.5	4.1	3.7
Effective revenue expenditure	10.1	14.4	12.5	11.5	10.4	10.1	10.1
Receipts	9.0	8.5	9.3	8.9	9.0	9.0	9.3
Fiscal deficit	3.8	9.2	6.7	6.4	5.9	5.2	4.5

RE = Revised estimate, BE = Budget estimate, P = Projection

This is a more reasonable scenario with capex in absolute levels maintained and a smaller nudge to receipts compared to Scenario I.

Here, the absolute level of effective capex of fiscal 2024 is maintained for the following two years due to which its share in GDP declines (given nominal GDP is growing). To fund this capex, receipts are required to grow ~11% in fiscal 2025 and ~15% in fiscal 2026. Though this is more reasonable than in Scenario I, the required growth in receipts is higher than the assumed

GDP growth (of 10.8% average) during the two years and also considerably higher than the pre-pandemic average (of 8.7%). Here, too, receipts might need a nudge from dividends, disinvestments or spectrum sales revenue.

Under this scenario, as the absolute levels of effective capex are maintained, the share in GDP slips, but is higher than the pre-pandemic average.

III. Effective capex falls sharply, as the share of receipts in GDP is maintained at fiscal 2024 and pre-pandemic rates

% of GDP	FY16-20 (average)	FY21	FY22	FY23RE	FY24BE	FY25P	FY26P
Effective capex	2.7	3.3	3.5	3.9	4.5	4.1	3.4
Effective revenue expenditure	10.1	14.4	12.5	11.5	10.4	10.1	10.1
Receipts	9.0	8.5	9.3	8.9	9.0	9.0	9.0
Fiscal deficit	3.8	9.2	6.7	6.4	5.9	5.2	4.5

RE = Revised estimate, BE = Budget estimate, P = Projection

This scenario assumes a realistic growth in receipts but entails a sharp fall in capex.

This assumes receipts will grow at the same pace as GDP (10.8%), which is only slightly higher than the pre-pandemic average growth of 8.7%. Such a growth in receipts is realistic but requires effective capex absolute levels of fiscal 2024 to be maintained in fiscal 2025 and then to fall 8% in fiscal 2026 (from Rs. 12.6 lakh crore).

Here, capex as percentage of GDP sees a sharp fall, but remains above the pre-pandemic average rate.

In conclusion

In each of the three paths that could be pursued to achieve the fiscal deficit target by fiscal 2026, capex growth slows compared with the past few years.

But even in the instance this happens, capex share in GDP would remain marginally over the pre-pandemic rates (scenarios I and II), implying that the capex thrust to the economy remains.

Some of this retreat in government capex might be made up by private capex — but how that could pan out is a topic for another day, another Quickonomics.

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