IMPACT OF FISCAL SITUATION OF INDIA DURING COVID-19

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ABSTRACT

COVID-19 pandemic, a health crisis, has rattled the global economy. In this situation, the Indian government has announced a fiscal package worth INR 1.7 trillion, but there are arguments for even more spending. Using data from a cross-section of countries, we first estimate the relationship between fiscal spending and COVID-19 spread, economic stringency, and macroeconomic factors. Our estimates suggest that India can spend 2.2-4.8 percent of its Gross Domestic Product (GDP), based on the global benchmark. Accounting for tax and output shortfall due to the pandemic, we project the fiscal deficit of the central government can be as high as 8.4 percent, in the most pessimistic case, while 3.7 percent in a relatively optimistic case. We finally argue that subsidy rationalization is the way forward to fund the much-needed health expenditures and transfers while maintaining the fiscal discipline.

Keywords: Fiscal Deficit, Debt, COVID-19, GDP

INTRODUCTION

We are in the core of a worldwide Covid-19 pandemic, which is delivering two sorts of stuns on nations: a wellbeing stun and a monetary stun. Passed on the idea of the illness which is exceptionally transmittable, the approaches to contain the spread incorporate arrangement activities, for example, inconvenience of social separating, self-seclusion at home, conclusion of organizations, and open offices, limitations on versatility and even lockdown of a whole country. These exercises can conceivably go to horrible ramifications for financial frameworks around the world. In other language, successful control of the infection includes the economy of a nation to keep down its ordinary activity. This has started fears of a secretive and extended worldwide downturn. On April 9, the head of the International Monetary Fund, Kristalina Georgieva said that the year 2020 could observer the most noticeably terrible worldwide financial aftermath since the Great Depression during the 1930s, with more than 170 nations prone to encounter negative per capita GDP development because of the seething coronavirus pandemic.

The global economy has come to a near standstill because of the COVID-19 pandemic. The enforced economic shutdowns, implemented around the world, are unprecedented and will entail large economic costs.1.Under this scenario, fiscal policy can provide temporary relief to those most impacted by the shutdown. With the widespread disruption in economic activity, carefully designed government expenditure could help ease the pain as well as nourish the economy back to its full potential. However, the policy action has to be guided by the available fiscal space and cannot operate in a vacuum. In this context, our paper looks at the current fiscal situation in India and how it will be affected by the pandemic. India's fiscal spending can be described as fiscal populism (see Alesina et al. [1997], Brender and Drazen

[2005] and Nandy et al. [2020]). The government undertakes spending on social security through cash transfer or food programs, boosting employment, maintain airlines, and engage in many other activities. The cumulative result of all this expenditure is high fiscal deficit. Many studies (see ShankarAcharya [2016]), have pointed out that the fiscal situation in India over the last few decades has been one of profligacy when compared to similar economies around the world. In the last two years, the combined deficit of the central and state governments has been around 6.5 percent.

It is expected that the contraction in foreign demand and domestic consumption will lead to significant job losses in both the formal and informal sectors in India. Even if the health crisis is averted, there are concerns regarding the longer-term impact on the economy. For example- whether there will be a long term fall in the consumption, what will be the impact on the firm and bank balance sheet, whether the migrant labor will return to work soon, are questions that cannot be answered at this point. In these uncertain times, the fiscal push thus seems to be the natural policy lever. However, the current spending should be managed in a way that the fiscal health remains good, and India does not suffer from credit flight due to a credit rating downgrade. This is a real concern since another rating downgrade will put India's sovereign rating in the non-investment grade. we expect the central government deficits to reach 7.7% and 8.4% of GDP respectively. The real impact on the GDP is still uncertain; however, if India's containment strategy works like China and the economy returns to normal, 10 percent GDP Finally, we argue that the additional fiscal spending is the need of the hour; however, India should also take the current crisis as an opportunity for preparing a roadmap for fiscal prudence. Globally as well as in the Indian context, it has been argued that the fiscal deficit has an impact on economic growth (see Rangarajan and Srivastava (2005). The current crisis is an opportunity for implementing subsidy rationalization, and a careful 360 degree look at the expenditure profile. If the government can prune one-third of the current fertilizer, food, and petroleum subsidy, it will immediately release INR 0.75 trillion (around 0.35 percent of the GDP). Not only will this substitution allow India to raise health and social security spending immediately, but also allow us to solve long-standing issues of market distortion due to these subsidies.

POLICY CHALLENGES

While some strategy activities have just been declared by the legislature and the RBI, they are for the most part interval gauges and won't be satisfactory to help the economy. Given the current macroeconomic and money related condition in India, there are noteworthy difficulties in monetary, fiscal and budgetary arrangements which must be mulled over by the policymakers. Significantly increasingly significant, there are some approach traps that must be stayed away from so as to forestall a drawn out financial debacle. The target must be to guarantee a V-formed financial recuperation once the wellbeing emergency lessens. In the event of financial arrangement, in any event, expecting a preservationist situation where the legislature doesn't bring about any extra costs due to Covid-19, the shortfall will be more prominent than anticipated an incentive in the FY2021 spending plan. During the ongoing 3-week long lockdown, practically all financial exercises have been suspended and the greater part of these are probably not going to continue in not so distant future given the idea of the

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wellbeing stun. Therefore government incomes will fall definitely. Given the discouraged value economic situation and worldwide financial vulnerability, the disinvestment targets are probably not going to be met. Well beyond this, a great part of the arrangement activities required to limit the financial aftermath of the stun will include government spending. It is practically sure that the administration won't have the option to stick to its monetary objective for 2020-21 and will in all likelihood penetrate it by a major edge.

In India monetary shortfall is upheld by money related suppression wherein government gets from a hostage market of banks and other institutional purchasers. In the pre-Covid-19 period, absolute government getting (focal and state) had just surpassed all out family unit reserve funds. Further acquiring will hone the yields in the security market and group out private capital when countless firms and families should get to remain above water. In addition, net household sparing rate diminished to 30.1% of GDP in 2018-19 from 32.4%in 2017-18 (RBI, 2020). The sparing pace of the family part, which is a net provider of assets to the economy, declined from 23.6% of GDP in 2011-12 to 18.2% in 2018-19. To the degree that legislature depended vigorously on families for financing its shortfall, this decrease in reserve funds doesn't look good. The huge scope salary misfortunes of numerous organizations and family units that are unavoidable during this emergency infer that the investment funds rate is probably going to fall much further. These components practically rule out the administration to build its residential acquiring.

FISCAL POLICY:

A large portion of the arrangement activities to help the economy during such extraconventional occasions will involve an ascent in financial shortage., the legislature as of now has next to no financial space to suit a generous improvement. There is a great deal of weight from various quarters to relinquish the financial combination rules, broaden the monetary deficiency and let the obligation/GDP proportion go up. This might be unavoidable given the conditions however ought to be done dependent upon satisfactory governing rules with the goal that the drawn out outcomes of a monetary extension don't endanger the financial recuperation.

THE CURRENT FISCAL SITUATION

India adopted the Fiscal Responsibility and Budget Management (FRBM) Act in 2003 in to improve fiscal discipline and bring down the fiscal deficit under pre-defined limits Buiter and Patel (2010). There has been some progress on this front; however, the target has eluded the central government till now. Given this background, we look at the fiscal deficit situation in India for both the central and state governments. Under the latest revision to the target under FRBM, the central government was aiming to achieve 3.0 percent deficit latest by FY 2020-21. The fiscal deficit in the most recent FY 2019-20, stood at 3.7 percent, significantly above the 3 percent target. Thus the targeted fiscal deficit for the current financial year was revised to 3.5 percent in the recent budget. As a benchmark for the current scenario, we can look at the fiscal deficit of India in the period immediately following the Global Financial Crisis (GFC). The fiscal deficit peaked at 6.6 percent during this period. Then it almost took a decade to bring the fiscal deficit to the current levels. However, the trend of a sharp improvement in the fiscal deficit numbers slowed down in the last few years due to the additional funds that the central government had to allocate to the banking sector to improve liquidity and tide over the NPA condition. This slow improvement can also be partially attributed to the less than expected disinvestment receipts. But the focus on the fiscal deficit of central government masks the overall level of deficit in India. To complete the discussion, we present the state-level deficit below.

The fiscal deficit in FY 2018-19 for all states and unions territories (UTs) in India.5 The combined state level fiscal deficit stood at 2.9 percent of GDP in in FY 2018-19. It is argued that such levels of deficits at the sub-national level are very high and shown to be unsustainable as in Roy and Kotia [2018]. We can notice that a lower fiscal deficit is mostly associated with states having a relatively higher Gross State DomesticProduct (GSDP) and vice-versa. Ideally, fiscal deficit should be reduced in each successive year until the revenue deficit and government dissavings have been eliminated (Rangarajan and Srivastava [2005]). Given these high deficit numbers at the state level, it is not surprising that most states have not come out with their stimulus package in the aftermath of COVID-19 induced lockdowns. To summarize, the current collective fiscal deficit for both the center and state governments in India stands above 6.5 percent of GDP. Given this baseline scenario, we can now discuss the evolution of the fiscal deficit in the near future. However, before we do that, we look at the level of fiscal stimulus package declared by countries around the world and compare it to India.

FISCAL DEFICIT SITUATION POST COVID-19

The spread of the pandemic will impact the fiscal deficit situation in India through two channels. First, the governments have to allocate a sizable portion of their budget to fight the pandemic. This includes expenditure on health as well as social security and other payments needed to control the economic fallout due to this event. Second, the enforced lock-down and containment measures will lead to a fall in economic activity. It will lead to a fall in the GDP as well as tax collections. So not only will the expenditure go up, but the tax receipts will also go down. However, the question is by how much? Given the nature of the pandemic and the general uncertainty right now, it is a challenging exercise to forecast the exact impact on the GDP. We thus take the current level of expenditure commitment by the central government and calculate the impact on the fiscal deficit under various GDP realizations. The baseline case corresponds to the fiscal deficit numbers projected in the budget for the FY 2020-21. The budget projected a fiscal deficit of 3.5 percent for the current financial year. Given COVID-19, the central government then announced a slew of measures to contain the economic fallout due to the pandemic in mid-March. The fiscal package announced by the government amounted to Rs Rs 1.7 lakh crores or 0.8 percent of the GDP. Throughout our calculations, we also assume that domestic five-year sovereign bonds at 6% interest per annum are used to fund the entire additional expenditures. We look at three counterfactual scenarios for the central government fiscal deficit, given this additional fiscal commitment. We also assume that the rest of the budget allocations remain the same. If the government reduces other allocations under the budget, it can keep the overall expenditure lower, leading to a lower deficit. However, the overall revenues may also fall due to difficulty in disinvestment during such periods. So, we assume all other expenditures and revenue stay at the level announced in the budget, except the additional fiscal expenditure declared under the stimulus package. We consider three main scenarios for FY 2020-21 GDP, 1) no fall in GDP, 2) 10 percent fall in GDP, and 3) 20 percent fall in GDP. Under each of these, the government can provide an extra stimulus of 0.8 (low), 2.2 (medium), or 4.8 (high) percent of GDP. We also assume that the deficit is funded by issuing 5-year G-Sec bonds, which increases the interest burden for FY 2020-21. We report the estimated fiscal deficit in table ??. Scenario 1 corresponds to the case where we see no fall in the GDP relative to the projected numbers in the budget. It is the most optimistic scenario, under which the expense goes up in line with the stimulus package, but there is no impact on the GDP. Also, the fiscal boost successfully counteracts the fall in economic activity, both during and after the lockdown. It assumes that the effects on the household, firm, and bank balance sheets are minimal. If this turns out to be the case, the deficit should rise by an amount equal to the INR 0.38 trillion for the current stimulus. The estimated fiscal deficit under Scenario 1 and 0.8 percent stimulus is then 3.7 percent. Scenarios 2 and 3 paint a more grim picture for both the economy and the fiscal balance sheet. We consider, under scenario 2, a case where GDP shortfall is 10 percent compared to the estimates in the budget. This drop is in line with what one observed in China, a country with a large population like India and a similar healthcare infrastructure. Under a case with zero feedback into tax revenues, we expect the deficit to rise to 5.3 percent of GDP under the the low fiscal stimulus case. Of course, tax revenues will also fall when households' and businesses' earnings fall. As per our estimates, the elasticity between GDP and tax revenues (direct + indirect) is 1.05.8 So a 10 percent fall in GDP is associated with a 10.5 percent reduction in tax revenues. For the medium and high stimulus cases, the fiscal deficit will climb to 5.7 and 6.3 percent, respectively.

Finally, we consider the scenario of a 20 percent fall in GDP for India. The numbers from China that motivated Scenario 2 may be optimistic from a democratic country's perspective. China implemented extreme lockdown measures and used invasive tracking methods to control the pandemic. Probably, India will not be able to implement measures as strict as China, and the economic lockdown can last longer. In a worse scenario, the aggregate GDP shortfall can be 20 percent compared to the budget estimate. If so, under the low stimulus case, the fiscal deficit would jump by 2.0 percentage points compared to budget estimates to 7.3 percent of GDP. Similarly, for high stimulus case, it can reach up to 8.4 percent. As briefly mentioned above, the actual shortfall in GDP will depend on how the crisis evolves, but our numbers give a sense of the likely future outcomes. One crucial point that we glossed over in the above calculations relates to the discussion on the fiscal multiplier. The current fiscal stimulus package announced by the central government is 0.8 percent of GDP, and they will probably announce another package soon. It can directly add another 1-2 percentage points to the stimulus. Based on the past studies (see Dave et al. [2018]) the fiscal multiplier for India is low. So, the fiscal stimulus will, at best, lead to a one-to-one increase in the GDP, i.e., 1-2 percent. It is thus unlikely to cover for the entire loss in economic activity. Furthermore, we think that the boost to consumer spending under this stimulus package can be much lower than what is suggested by the estimates based on past data. The fiscal stimulus might not work in the standard fashion if the markets are closed and consumers confined to their homes. To complete the discussion, we also perform a similar analysis with state-level fiscal deficits, using the FY 2018-19 information.9 Since the states have not announced any massive stimulus package like the central government, we calculate the increase in aggregate statelevel fiscal deficit only on account of a reduction in GDP. Under Scenario 2, the state-level fiscal deficit will climb to 3.2 percent, and under Scenario 3, i.e., 20 percent GDP shortfall, it will increase to 3.6 percent.

DISCUSSION

This paper is motivated by the belief that while the COVID-19 pandemic remains a health crisis primarily, its effects on the economy must be closely monitored. Also prompt corrective actions are necessary to ensure that both the effects and after-effects of the crisis are minimized. In this line, several commentators and experts have argued for massive fiscal boosts. When the uncertainty is high, private markets break down, and fiscal boosts are essential to ensure financial stability. We agree with these observations. However, we argue that even the existing fiscal boost of INR 1.7 trillion, which at 0.8 percent of the estimated GDP is small, can have significant effects on the fiscal deficit.

We have shown that unlike the GFC, the fiscal deficit under COVID-19 crisis might end up much larger if not carefully monitored. The higher the fiscal deficit now, the slower will be the recovery path to FRBM mandated target. It will not only lead to crowding out of private

investments in the current fiscal year, but also in the foreseeable future. Additionally, as seen under GFC, emerging market economies also face a larger risk of credit rating downgrade (Amstad and Packer [2015]). If that happens, the borrowing by Indian firms will suffer even in the international market. The events of rating downgrade are associated not only with an increase in credit spread (Cantor and Packer [1996]), but also a flight of capital as many institutional investors are not allowed to invest in non-investment grade securities (Becker and Milbourn [2011]).

Notwithstanding these issues, fighting COVID-19 requires a massive mobilization of resources. While monetary policy can provide liquidity support, the role of fiscal policy cannot be ignored. It goes without saying that if the slowdown persists for a while, disinvestment will not be a very lucrative option to compensate for lower tax receipts. An immediate subsidy rationalization and higher disinvestment once the economic conditions improve, will help to bring down the fiscal deficit at a much faster rate. This will prevent a recurrence of the fiscal deficit overhang, as seen in the period after the GFC. So, where should the government find the much-needed funds? By our estimates, another Rs. 4.5-10 trillion (i.e., up to 4.4 percent of GDP in expenditures above the budget estimates) may be needed depending on how long the harsh social distancing measures persist. There are three main ways to do it. First, borrow domestically or abroad (including from the Indian diaspora), print money, or cut expenditure, i.e., rationalize subsidy or postpone non-essential expenditure. We exclude the option of raising taxes at the current juncture because it will undermine domestic demand which is essential for a quick rebound. Dave et al. [2018] show that consolidating fiscal balance sheet with additional taxation is associated with a negative fiscal multiplier. While the first two options are viable, we think there is a good reason to consider the third carefully.

CONCLUSION

Covid-19 has posed an unprecedented challenge for India. Given the large size of the population, the precarious situation of the economy, especially of the financial sector in the pre-Covid-19 period, and the economy‟s dependence on informal labour, lockdowns and other social distancing measures would be hugely disruptive. The central and state governments have recognized the challenge and have responded but this response should be just the beginning. Policy makers need to be prepared to scale up the response as the events unfold so as to minimise the impact of the shock on both the formal and informal sectors and pave the way for a V-shaped recovery. At the same time they must ensure that the responses remain enshrined in a rules-based framework and limit the exercise of discretion in order to avoid long-term damage to the economy. Our paper provides calculations of potential fiscal deficit for India in the FY 2020-21 to support expenditure related to fighting COVID-19 pandemic. We expect that a total fiscal stimulus of 2.2-4.8% of GDP may be necessary based on the global benchmark. However, the risk of a rating downgrade and fiscal deficit spike will make it harder to borrow and spend. The government can, therefore, use this crisis as an opportunity to rationalize existing subsidies to mitigate the economic fallout due to COVID-19 as well as prevent debt overhang in the future.

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