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Budget will try to ease the demonetisation pain

CRISIL Economy Quick Byte

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When the Finance Minister Arun Jaitley rises to present the Union Budget for 2017-2018, he faces pretty much the same task for the third time: to ensure the economy pulls ahead on the crutches of budgetary support.

But for entirely different reasons, this time. The first two budgets of the Narendra Modi government were overcast by the shadow of poor monsoons. This year's 'drought', on the contrary, was brought about by the adverse effects of demonetisation. The fiscal, in fact, saw normal and well-distributed monsoon, across geography and time.

Yet, Budget 2018 will have to play a greater effort in buttressing the economy compared with the previous two Budgets. Despite deficient rains in fiscals 2015 and 2016, growth was gradually inching up. But this fiscal, the Central Statistical Organisation has pegged GDP growth at 7.1%, knocking 50 basis points off last fiscal's 7.6%.

To the government's credit, the policy focus so far has been towards raising growth potential rather than stepping up the cycle. It has avoided using monetary and fiscal steroids to deflect global headwinds and absorb the adverse impact of two consecutive failed monsoons. Policy actions were focused on putting the house in order and initiating structural reforms- notably, the passage of Bankruptcy and Insolvency Act, and the push-through of the Goods and Services Tax (GST) closer to reality. These reforms may not have created an immediate upside to growth but have raised the potential and trend rate of growth.

The Budget therefore will focus on stemming the downturn.

First, in addition to the fall in overall growth, private consumption growth, one of the bulwarks of the economy, too, has fallen.

The ability of the Budget to kick start the economy depends on the 'fiscal space' it has to manoeuvre. The debt/GDP ratio for the Centre as well as the Centre and states together has been stubbornly sticky in the past few years, despite a conservative fiscal stance. Bringing this down is a key policy objective, as India has the highest debt ratio among similarly rated sovereigns. The second factor that constrains the ability of the government to spend aggressively is the commitment to reduce fiscal deficit to 3% of GDP in fiscal 2018 from 3.5% in the current fiscal.

Some fiscal space for fiscal 2018 can be created through (1) relaxation of pre-committed fiscal deficit target of 3% of GDP (if the Fiscal Responsibility and Budget Management Committee recommends so) and (2) dividend payment to the government (from the Reserve Bank of India) equivalent to the value of the Rs 500 and Rs 1000 currency notes extinguished.

This space can be used to push private consumption by relaxing personal income tax limits, support to housing, and increased budgetary allocations to the rural economy.

Second, revival of the investment cycle remains a key challenge. Even without demonetisation, private investment was falling and could have taken a year to show signs of revival. On its part, the government has been trying to lift public investments so as to crowd-in private investments. In addition to budgetary allocation, bolstering the execution capability of ministries is also critical to ensure that the government's investment plans see light at the end of the day. So far, the government's efforts to push public investments have been more than offset by weakness in private corporate investment, leading to overall decline in investments in fiscal 2017. Within public investments, the government is likely to continue its focus on building roads and incentivising low cost housing, as the construction sector has high labour intensity, and this will generate employment as well.

Unless the private sector returns with bigger investment plans, sustainable recovery will remain elusive. Budget 2018 will have to be fairly creative in the use of limited fiscal space to support growth and cheer the private sector.

Third, budget thrust on sectors that can immediately push job creation is critical, more so in rural areas which is likely to be hit hardest due to the demonetisation drive.

Testing times for fiscal consolidation

Budget 2017 comes against the backdrop of a slowing economy. The Central Statistical Organisation (CSO) has estimated the economy's gross domestic product (GDP) growth to slow to 7.1% in fiscal 2017 from 7.6% in fiscal 2016. This estimate does not factor in the impact of demonetisation. The Budget has two immediate tasks cut out: assuage the shock received by private consumption from demonetisation, and bolster faltering investment demand. The advancement of the Budget presentation by a month gives the government that much more time to plan and implement its spending programmes before the beginning of fiscal 2018.

So far so good.

Can the government do it *and* meet the FRBM target of 3% fiscal deficit target?

Short of a miracle, "no". India will have to prune its fiscal deficit by Rs 280-350 billion from the level in the previous fiscal[1] in order to reduce the fiscal deficit ratio (fiscal deficit/GDP, or FDR) to 3% in fiscal 2018, as per the Fiscal Responsibility and Budgetary Management (FRBM) commitment.

Some transient factors - such as excise hike on petroleum products and spectrum revenue - that helped improve the government's revenue in the past two years, may be missing in fiscal 2018. For instance, of Rs 2,300 billion that the government is expected to earn as excise revenue from petrol and diesel in fiscal 2017, Rs 790 billion would be on account of excise rate hikes alone. With rising oil prices[2], this window could narrow, as the government might have to rescind the hike that was brought into force when oil prices were sliding. Besides, CRISIL Research predicts revenue from spectrum sales (past and present) in fiscal 2018 to shrink to Rs 550 billion, from Rs 700 billion in fiscal 2017. To be sure, the structural benefits of higher tax net and increased compliance on account of both demonetisation and GST implementation will accrue gradually. In the short run, however, the latter may even be disruptive from the tax collection point of view.

How much fiscal room does the government have?

Not much under the current fiscal consolidation framework, particularly if it sticks to the pre- committed FDR target of 3%. And there are three compelling reasons as to why it should.

First, India has already postponed achieving the FRBM target in the past. Originally, the 3% target was to be achieved by fiscal 2009, but the FRBM Act was amended twice - in 2012 and 2015. According to the Finance Act 2015, the target dates were further extended by three years to March 2018. Postponing it further could dent credibility.

Second, the government's debt dynamics suggest a constrained fiscal space. Over the last few years, the government did manage to rein in the debt/GDP ratio, or debt ratio, from over 56% in fiscal 2005 to 45.4% in fiscal 2011. But since then, the debt ratio has moved up, despite attempts at fiscal consolidation. It stood at 48.6% in fiscal 2016. This is true of the debt indicators of the central as well as the state governments.

Third, a slippage in FDR target does not send a right signal to monetary authorities, which now follow inflation targeting framework to engender a low and stable inflation regime in India.

[1] Under an optimistic scenario (where the government's estimate of 11.9% nominal GDP for fiscal 2017 comes true, and growth for fiscal 2018 is targeted at 11%), the centre's fiscal deficit will have to shrink Rs 280 billion from the previous year to get to 3% FDR in fiscal 2018. This number would increase to Rs 351 billion, should nominal GDP growth in fiscal 2017 fall to 10.4% (a more likely scenario). In either case, bringing down fiscal deficit would be challenging if the government has to increase its capital expenditure.

[2] CRISIL forecasts oil prices to be in the range of $50-55/barrel in fiscal 2018, up from $42-47/barrel in fiscal 2017

That said, an additional spending window can be created if the target is relaxed to 3.5% (provided the FRBM committee recommends it). In that case, the government will have to demonstrate credible steps to lift the tax/GDP ratio in the coming years to ensure medium term fiscal sustainability, and reduce debt/GDP ratio (See Box 1).

Box 1: The nuts and bolts of debt/GDP

Centre	**FY13**	**FY14**	**FY15**	**FY16**	**FY17 BE**
Debt/GDP (%)	47.3	47.4	47.0	48.0	46.4
Average interest Cost ‘i’	6.4	6.7	6.6	6.6	--
Nominal GDP growth (%) g	13.91	13.28	10.78	8.71	11.9@
Primary deficit/GDP (%)	1.78	1.14	0.87	0.68	0.27

Centre + State	**FY13**	**FY14**	**FY15**	**FY16***
Debt/GDP (%)	66.6	66.8	67.1	68.6
Average interest cost ‘i’	7.3	7.5	7.5	7.4
Nominal GDP growth (%) ‘g’	13.91	13.28	10.78	8.71
Primary deficit/GDP (%)	2.31	1.91	2.23	1.60

*Source: Finance Ministry, RBI, Crisil Research, *state numbers are budget estimates, @CSO estimate*

The debt dynamics equation suggests that for bringing down the debt/GDP ratio: a) GDP growth must be higher than interest rates and b) primary account should be in surplus.

It is clear from the above table that the stickiness of debt ratio was owing to narrowing gap between growth and interest rates (nominal GDP growth rate came down sharply but average cost of debt remained sticky) and inability of the government to run a primary surplus.

In the evolving scenario, the central government will have to run a surplus on the primary account (obtained after netting interest payments from fiscal deficit) to bring down the debt ratio. Viewed from this lens, the government has limited fiscal space.

The good news, perhaps is, the bad news has already hit. Sagging areas of the economy have been identified, and the fiscal constraints, clearly drawn. Sure, the Budget has to perform a tight rope walk between kick starting the consumption-investment cycle and maintaining fiscal discipline. In the best-case scenario, some windfall from demonetisation can provide one time fiscal space in fiscal 2018. Over the medium run, GST and steps to improve compliance will help raise tax/GDP ratio. But as we speak, expenditure will have to precede collection and compliance to spur growth, so some transitory relaxation of fiscal target may be inevitable in the coming fiscal.

On the contrary, if it turns out that the government has been betting on the wrong horses, we might be bracing ourselves for an even tougher winter by the end of this year. We bet on the former playing out.

Can the budget revive investments?

In the previous two Union Budgets, the government took steps to improve the investment climate in India, but this turned out to be an exercise in futility because share of capital investments in GDP continued to fall. Investments as a percentage of GDP have fallen from 34% in fiscal 2012 to 29% in fiscal 2017. The Central Statistical Organisation estimates that fixed investment has declined 0.2% in this fiscal. As for the private sector, the appetite to invest is just not there amid high leverage and impaired balance sheets.

Private investment was expected to take another year to recover – even before demonetisation. According to the Reserve Bank of India's OBICUS survey, capacity utilisation in manufacturing was 73% in the quarter ended June 2016, or well below the threshold required to trigger fresh investments. Things haven't changed materially since.

Capacity utilisation could have improved had domestic consumption been higher, as was expected in the second half of this fiscal. However, the cash crunch following demonetisation curbed demand. That, in turn, could delay revival in private investments.

CRISIL's surveys show automobiles, cement, steel, paper, aluminium and fertilisers had the lowest capacity utilisation – and many of these have been the ones hardest hit by demonetisation. For instance, domestic sales of auto industry slumped 18.7% in December. Short-term demand for cement and steel will also be affected, since 60-65% demand for cement, and 30-35% demand for steel comes from the cash dependent real estate sector.

Demonetisation hit sectors already reeling under low capacity utilisation

Sector	Capacity utilisation prior to demonetization*	Effect of demonetisation
Tractors		Negative
Cars and UVs		Negative
Commercial vehicles		Negative
Two wheelers		Negative
Cement		Negative
Steel		Marginally negative
Paper		Neutral
Aluminium		Neutral

Source: CRISIL Research

While demonetisation may not have impacted ongoing investments, fresh ones would have been kept in abeyance. That, in turn, would further delay recovery in the private investments, so critical for sustained pick-up in investments.

What can this Budget do for reviving investments?

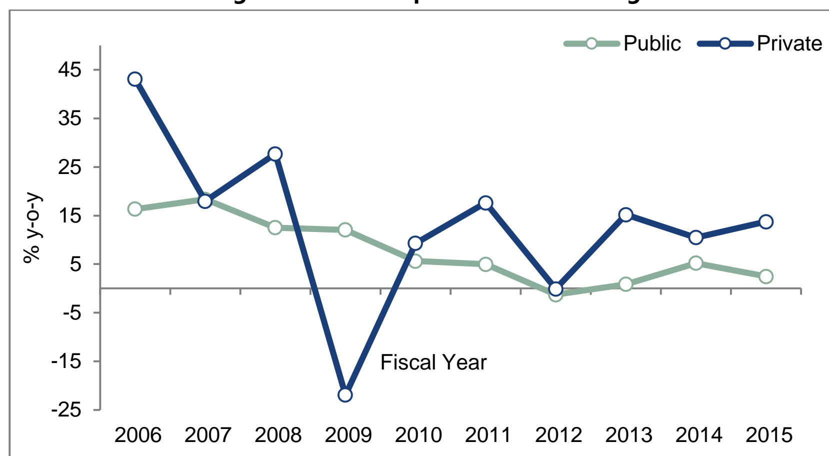
Lift up the consumption cycle

The immediate priority of the government should be to revive consumption demand. Private consumption growth slowed to 5.9% in the second half of fiscal 2017 from 7.1% in the first half (CSO, advance estimates). Domestic consumption must be boosted by improving purchasing power, especially among the rural population and workers in the unorganised sector, and smoothening transaction process in cash-driven sectors. This will help remove the short-term constraint of low capacity utilisation in the industry and pave the way for investment recovery.

Continued push to infrastructure

Historically, increase in public investment growth in India has been followed by increase in private investment growth with a lag. This indicates that public investment does help in crowding in private investment.

Private investment growth follows public investment growth[3]



Source: Central Statistical Organisation

The government can support investment directly by spending more on infrastructure, particularly roads and affordable housing. This will also help raise demand for core industry sectors such as steel, cement etc. In addition, construction of roads and low-cost housing is highly labour intensive in India, which will help generate employment in the economy.

The Budget can help by stepping up public investments and supporting private consumption demand. But given the government's limited fiscal space, this may not be sufficient. Therefore, revival of private corporate investment appetite is critical to the revival in the investment cycle.

3 Investment here refers to gross fixed capital formation as per national accounts. Data till fiscal 2012 is according to old GDP series. From 2013 onwards, both public and private investment include respective financial and non-financial investment.

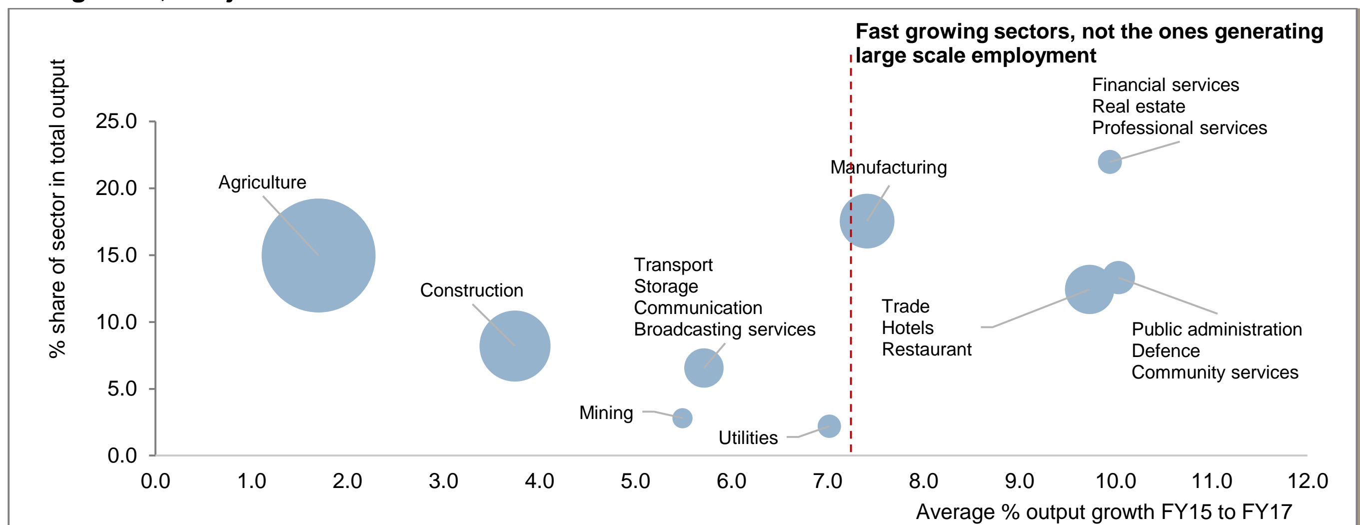
Budget thrust needed on sectors that can immediately push job creation

Sectors growing fast are not the ones generating large-scale employment

The last three years have seen a slow-but-steady uptick in economic growth, but it is likely that this hasn't been accompanied by commensurate job increase in employment. The sectors that grew fast have low labour intensity and share in overall output.

That's the predicament at a time when ~1.5 million people are entering the labour force every month, with most of them seeking jobs. Trouble is also brewing on another flank: the rapid adoption of technology, especially automation, which is reducing the labour-intensity of many an industry. Policies will, therefore, have to support sectors with large job growth potential such that, despite slipping labour intensity, absolute employment continues to increase. Additionally, the policy focus should also be in preparing the youth for new job opportunities.

Fast growth, few jobs



Note: Size of bubble represents labour intensity of the sector, Red dotted vertical line represents average GVA growth during these years

Source: CSO, NSSO, CRISIL Research

Sectors with high potential to absorb labour have grown at a slower pace

In the past three years, three sectors have grown way faster than GDP: 1) financial services, real estate and professional services; 2) public administration, defence, and community services, and, 3) trade, hotels and restaurants. Of these, only the trade, hotels and restaurants sector is labour intensive, requiring about 6 workers to produce Rs 1 million worth of output. But its share in total output is low at ~12%. In contrast, other fast-growing sectors, despite having a larger share in output, have low labour intensity of 2-3. And sectors that have higher labour intensity – such as agriculture with 30, construction 13 and manufacturing 7 – have been undershooting overall GDP growth. Growing at 3-3.5% per year, agriculture is unlikely to become India's growth engine. In fact, people need to be moved out of overcrowded agriculture to high growth and high productivity sectors.

Reasons why despite a pick-up in GDP growth, fewer employment opportunities are likely to have been created in the past three years. The gorilla in the room can be quelled only through policies that support sectors with large employment potential -- despite falling labour intensity. Policy support can also can be in the form of easier labour laws, providing physical infrastructure, mitigating power shortages, and facilitating reasonable terms of credit and taxation laws.

Policy support will need a mix of both, short-term and long-term focus

Push to road sector and low cost housing has always helped in times of crisis

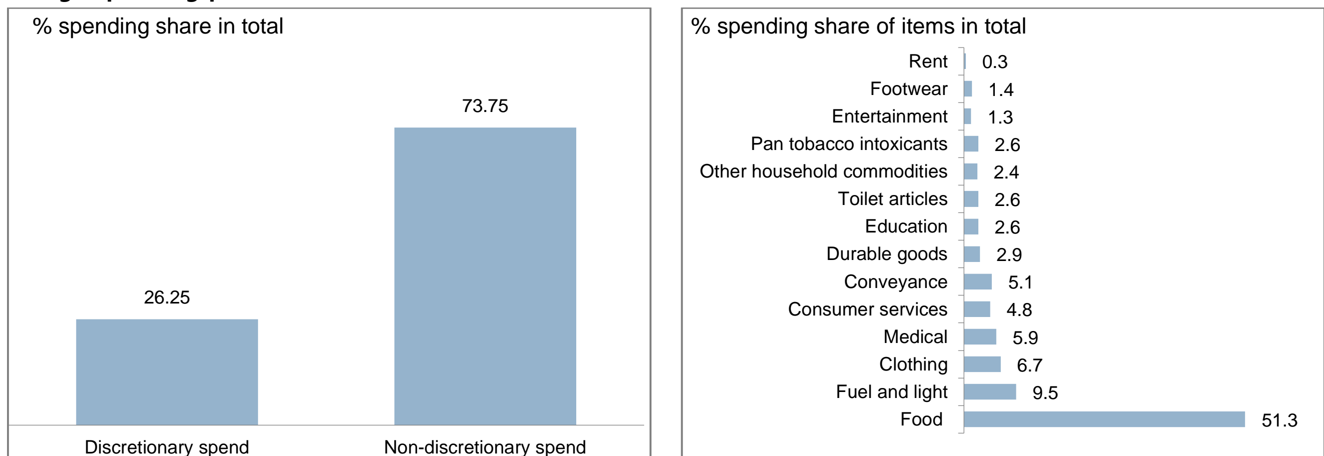
For immediate benefits, the forthcoming Union Budget should chose to support sectors hit hardest by demonetisation, and those that are more labour intensive, such as the small and medium enterprises segment, and also construction.

For the government, pushing the roads sector has always helped in times of crisis. When monsoon failed in 2002, the thrust on National Highway Development Project helped create rural jobs. And in drought-hit 2009, the expansion of the National Rural Employment Guarantee Scheme (NREGA) ensured rural jobs were aplenty. In 2012, too, when rains were inadequate and poorly distributed causing drought-like situation in certain states, NREGA came to the rescue. In the last two years, too, the current government has sharpened focus on rural road construction through the Pradhan Mantri Gram Sadak Yojana (PMJSY). The last Budget saw a 25% on-year increase in allocation, over and above a 52% increase in the fiscal before, and also fast-tracking completion of road projects. Continued increase in government spending on rural roads, given its high employment intensity, can be a consumption kicker.

In the similar vein, thrust on low cost housing will also help create jobs.

We studied the consumption patterns of workers benefiting from the government's rural roads program and found that about 26% of average spend is on discretionary items. This assumes that other than food, rent and clothing, spending on medical expenses and fuel and light is also relatively inelastic and therefore termed non-discretionary in nature. Of the discretionary spends, workers tend to allocate a larger portion of their spending for consumer services such as communication, tailoring and conveyance. Significant spending is also reported on durable goods (new and second hand), education, paan, tobacco, intoxicants, toiletries and household commodities. The sectors producing them, therefore, can expect some boost from the Budget if it gives a push to construction activity.

Average spending pattern of a rural roads worker



Note: Average income of worker of a NREGA worker is taken and assuming that is the floor for a PMGSY worker's wages, the corresponding consumption pattern of that fractile group is analysed using NSSO data for 2011-12

But long-term focus must be on alleviating structural constraints to employment creation

For longer-term benefits, though, policies should have a three-pronged approach;

i. Reduce overemployment in agriculture by providing opportunities outside of the farm sector

ii. Push the manufacturing sector by emphasising on ‘Make for India’, along with improving export competitiveness, and,

iii. Design policies to push growth in labour-intensive services sectors such as trade, medical and education services, community and social and personal services.

These efforts will have to be complemented with education and skill development of youth. A CRISIL study had found that four manufacturing sectors – textiles, food products, non-metallic mineral products and transport equipment – can drive employment creation over time, provided structural issues facing them are resolved. Meanwhile, the services sector can also contribute to the employment drive. The nature of activity in a large part of the services sector is such that it makes technology substitution for productivity gains is either difficult or will take time. Specifically, sectors such as education and health, trade, hotels and restaurants, and community, social and personal services could potentially be large employers. But here, the supportive role played by education and skill development will be critical

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