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GUEST VIEW

The sentiment boost that India's economy is in need of

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With many Indian states having commenced a phased unlocking, a sequential improvement in economic momentum set in last month, as confirmed by high-frequency indicators such as goods and services tax (GST) e-way bills, vehicle registrations, electricity demand, rail freight and petrol consumption.

At odds with this picture of an economy on the mend, the purchasing managers' index for manufacturing and services printed in the contraction zone in June. This suggests that businesses remain cautious regarding the near-term outlook after the bruising second wave of covid.

Amid the uncertainty, enhancing sentiment takes on a crucial role to strengthen the economic recovery. Central to this is the pace at which covid vaccination can be accelerated. India's daily average doses nearly doubled from 3.2 million in the week ended 20 June to 6 million in the following week, before easing to 4.1 million in the week ended 4 July.

If the pace of vaccination can be maintained at 6 million per day in the second quarter of 2021-22 and increased to 8 million from the third, we estimate that all adults would receive both the doses of the vaccine by early February 2022. This will cover over two-thirds of India's population, bringing us closer to herd immunity and lifting the haze surrounding the economic outlook.

Another factor that could imminently imbue enthusiasm and activate 'animal spirits' is the pace of government spending. The fiscal cues, however, are somewhat confounding.

The Indian government's fiscal deficit was limited to ₹1.2 trillion in April-May 2021, less than 30% of the ₹4.7 trillion recorded during last year's nationwide lockdown. To an extent, it benefitted from the likely upfront surplus transfer of nearly ₹1 trillion by the Reserve Bank of India, following a change in its accounting year.

More importantly, gross tax revenue stood at ₹3.1 trillion in April-May 2021, well above even the pre-covid levels of ₹2.1 trillion each in the comparable periods of 2018 and 2019. Subsequent data suggests that direct taxes collected till mid-June were twice as high as their year-ago level.

Despite a comfortable receipts position, revenue expenditure in April-May 2021 was lower than the level recorded in the last two years. After a sharp growth in April 2021, capital spending contracted by a considerable 41% in May, suggesting that widened state-level restrictions arrested activity. At end-May, the government's total expenditure had contracted 7% from the year-ago level. Unless expenditure jumped in June, this segment may end up exerting a drag on gross domestic product (GDP) growth for the first quarter of 2021-22.

An economic relief package was unveiled on 28 June, with a substantial total value of ₹6.3 trillion, although its fiscal imprint in 2021-22 is much smaller. Soon after, expenditure management measures were reintroduced. If a lack of conviction in the revenue outlook holds government spending back, the recovery in economic activity and sentiment would likely be needlessly subdued.

In addition to a faster pace of central government spending, business sentiment is likely to benefit from the visibility of a pickup in capital expenditure by state governments. One way to nudge this along is by stepping up the monthly amount of devolution of central taxes to states, instead of back-ending a large amount to March 2022.

So far, the Centre has devolved ₹392 billion each in April and May to state governments. If this monthly amount is retained in June-February, the release of ₹2.4 trillion of tax devolution could get back-ended to March 2022 (presuming that the devolution amount for 2021-22 is not revised below the budgeted level). This would be inefficient from a cash-flow perspective for states. If the monthly devolution is upped, it may embolden states to accelerate capital expenditure; this would be growth-supportive.

QUICK READ

India's economic recovery has run into signals of weakness that suggest caution-constrained demand and a need to uplift sentiment via public spending that may help stir 'animal spirits'.

The Centre should front-load its tax devolution to states for them to spend at the earliest and also lower levies on fuels to spur consumption while easing cost-push inflation pressures.

Another factor that could boost sentiment is a cut in excise duties on fuels. Given an anticipated rise in mobility to accompany an economic recovery, ICRA projects year-on-year growth in the consumption of petrol and diesel in 2021-22 at about 14% and 10%, respectively, on the low base of 2020-21. Higher fuel consumption should raise indirect taxes levied on them, affording a window for a partial reversal in the cess hikes that were imposed last year.

Our calculations suggest that cesses levied on petrol and diesel could be reduced by ₹4.5 per litre each, while maintaining the central government's total cess revenues in 2021-22 at their 2020-21 level. Such a revenue-neutral cut in cess would shave off 10 basis points from ICRA's forecast of consumer inflation for July, in terms of its first-round impact, with a similar second-round impact likely with a moderate lag.

In its last three policy reviews, the Monetary Policy Committee highlighted inflationary pressures created by last year's increases in cess and value-added tax rates by the central and state governments, and the need to unwind them to ease cost-push pressures. A reduction in fuel cesses would afford monetary policy continued space to support a growth revival. Lower fuel prices would also ease pressure on disposable incomes, allowing for a faster revival in consumer sentiment and spending.

These are the author's personal views