HSBC Global Research

15 November 2023

India's fiscal future

Lots done, much pending

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Economics - India

- India's consolidated fiscal deficit remains above pre-pandemic levels even though growth is back on track
- The centre may have to take charge of lowering the deficit, but without cutting back on capex
- We discuss why the various pathways are not straightforward; eventually high GDP growth and a strong commitment to consolidation will be necessary

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India's fiscal finances are in better shape today than in the past in terms of quality of spend. But a lot more needs to be done on fiscal consolidation. After all, public sector gross borrowing is in double-digits.

Let's start with the current year. There are several pressures, for instance high capex growth in 1H and pre-election spending needs. But, the surprisingly high direct tax collection, and some cut back in capex in 2H could help achieve the 5.9% central fiscal deficit target. Alongside this, the spending quality of states has improved markedly this year. Sounds good, so what's the problem?

GDP growth seems to be back at pre-pandemic levels of 6.5% but the fiscal deficit remains much higher (see Chart 1). The need to lower the deficit is well known. India runs public debt, deficit and interest bill ratios that are higher than the world average, despite growth being strong. More importantly, even though bank investment in g-secs has fallen, non-bank investment has risen by a similar clip. This substantial quantum of investment in g-secs may become more obvious when funds to start a new private sector capex cycle are needed. What's caused the excesses?

We find that compared with the last pre-pandemic 'normal' year (FY19), the *central fiscal deficit* is higher (by 2.5% of GDP) and, while the capex budget is encouragingly bigger now (by 1.1% of GDP), current expenditure is even higher (by 2.1% of GDP). Meanwhile, the *state fiscal deficit* is only 0.3% higher over this period. Thus, for now, the centre may have to play a bigger role in getting back to pre-pandemic levels.

How does the central government go about lowering the deficit from 5.9% of GDP (FY24 Budget Estimates (BE)) to 3.4% of GDP (in FY19)? Can gross taxes be raised? Falling commodity prices have boosted corporate profitability and direct taxes, but can't be relied upon indefinitely. Can net taxes be raised? Transfers to states have fallen already and can't be relied upon for more consolidation. Can privatisation receipts be raised? For sure, but there have been misses in the past. Can the subsidy bill be cut? Yes, but recent trends show an increase in both price and income support. Can other expenditure be cut? Yes, but centrally-sponsored schemes are on the rise, and may not be cut immediately. So what could be a sure shot way for the needed fiscal consolidation? We believe strong GDP growth is important. In recent history, India consolidated most in periods of high growth (i.e. 7%). And, of course, a strong commitment for consolidation will be critical.

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What's done? What's pending?

The number of questions we get asked on India's fiscal finances have clearly fallen in number, and that's a good thing. There is a perception that India's fiscal finances, while having worsened in the pandemic period, are more under control now compared with the past.

And there is merit to this positive perception. After rising sharply in the pandemic period, the central government's fiscal deficit has fallen each year since (from 9.2% of GDP in FY21 to 6.4% in FY23), and is likely to fall further, given the government's various targets (e.g. under 4.5% by FY26). Gross tax revenue growth so far this year has been strong, in fact stronger than widely expected (growing 16.3% y-o-y ytd versus budget estimate of 10.1% y-o-y for the full year).

The quality of spending has improved through the pandemic period. Capital spending by the central government has risen appreciably (from 1.6% of GDP in FY19 to 2.7% in FY23). And this has followed on the heels of the central government's efforts to make the fiscal accounts cleaner and more transparent by moving the below-the-line expenses above the line.

At the same time, we note the states' fiscal deficit is also broadly in line with pre-pandemic levels (of 2.5-3% of GDP).

And yet, some worries remain. Public sector borrowing is in double digits (see Chart 1). Much of the planned fiscal consolidation of the central government is pending (from 6.4% of GDP in FY23 to the 4.5% target in FY26, and eventually to the long-standing Finance Commission target of 3%). Past experience shows that consolidation gets harder in the outer years, as tough decisions need to be made. For instance, should capex be cut in order to lower the fiscal deficit?

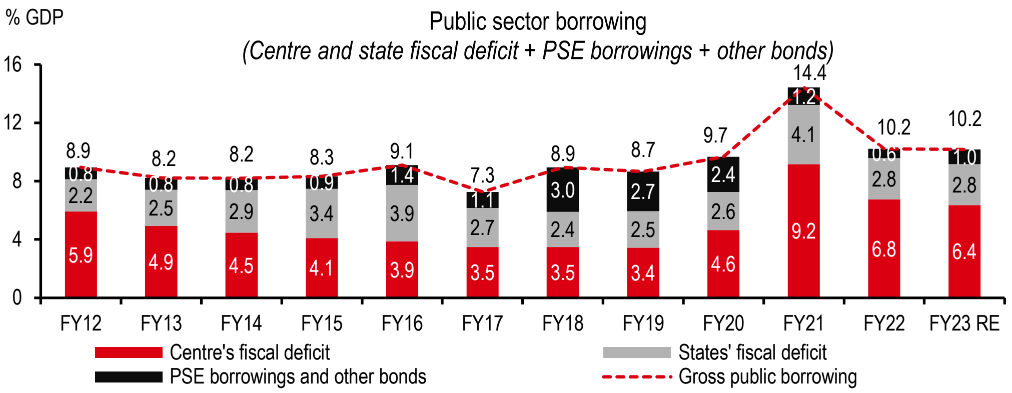
Some spending commitments have risen. For instance, the extension of the free food scheme for the next five years could cost the exchequer about INR150bn per year in the form of revenue foregone. And the cost of running the scheme will likely only rise from here, in line with higher food grain procurement costs, for example led by a rise in MSPs[1].

Furthermore, as we discuss later, the number of centrally sponsored schemes have also been on the rise, where the central government puts up the initial outlay and the state governments add to it and implement the programme.

Will it be easy to consolidate the fiscal deficit from here while preserving the much-improved quality? We answer some key questions on this front.

1 In the pre-pandemic period, the central government distributed subsidised food grains to about 813 million beneficiaries, at Rs 3 per kg for rice, Rs 2 per kg for wheat and Rs 1 per kg coarse grains. During the pandemic, *additional* 5 kg of food grains per person per month, free of cost, was made available to all the beneficiaries under the Pradhan Mantri Garib Kalyan Anna Yajana (PMGKAY). This scheme was operational till December 2022. In 2023, the central government replaced the pandemic-era food distribution scheme with a new integrated food security scheme which provides 5 kg food grains, free of cost, per person, per month. This new scheme was meant to last until the end of 2023. However, in a state election rally recently, PM Modi extended this scheme by five years.
The fiscal impact of this extension will likely be seen in the food subsidy bill over the years. To meet the food security scheme needs, the government Minimum Support Price (MSP) will likely be raised, thereby raising fiscal costs. Doing away with the INR 1-3 per kg cost will likely result in a revenue loss of about INR150bn (0.05% of GDP) to the central government. Also, once food grain is made free of cost, it might be difficult to start charging a nominal price in the future.

Chart 1: Public sector borrowing is elevated



Source: Budget documents, RBI, HSBC. RE: Revised government estimates. Notes: 1) State fiscal deficit includes the impact of UDAY bonds. 2) PSE borrowings is calculated as total resources (actuals) - internal resources (revised budget estimates). 3) Other bonds include oil bonds, fertiliser bonds and FCI bonds issued by the government, and bank recapitalisation bonds. Government's fully serviced bonds are included in PSE borrowings.

A pulse-check on the fiscal situation in the current year

Let's start with the current year. Earlier in the year, the central government announced a fiscal deficit target of 5.9% of GDP for FY24 (from 6.4% in FY23). But pressures have mounted since.

One, commodity prices have fallen and, led by a sharply lower deflator, nominal GDP growth may come in much lower than forecast (8.7% HSBC vs 10.5% BE).

Two, it doesn't help that this is a pre-election year when pressure on current expenditure traditionally tend to mount. Current expenditure grew by 10% y-o-y in 1H versus a full year target of 1.4%.

Three, capital expenditure has risen rapidly (by 43% y-o-y in 1H versus a full year target of 36%), led in particular by interest-free long-term loans to states.

And yet, we believe the fiscal deficit target will broadly be met (see Table 1). Gross tax revenues have been rising much faster than expected (16.3% y-o-y ytd versus 10.1% budgeted for the full year).

The fall in commodity prices, which lowered nominal GDP growth making fiscal consolidation harder, is also lowering the cost of production of firms, leading to better profitability and tax revenue growth. No wonder that direct taxes are growing more impressively (25.4% y-o-y ytd versus 11.6% budgeted for the full year) than indirect taxes (6.6% y-o-y ytd versus 8.3% budgeted for the full year).

But for the challenging 5.9% fiscal deficit target to be met, capex will have to be lowered sharply in 2H. In fact, we believe the central government may have encouraged a larger-than-normal push to capex in 1H (see Chart 2), so it can focus on other election priorities in 2H.

We believe that the overall capex will come in around INR8.1tr in FY24, much higher than in FY2023 (INR7.4tr), but a shade lower than the INR10tr target. And of this, 60% has already been spent in 1H[2].

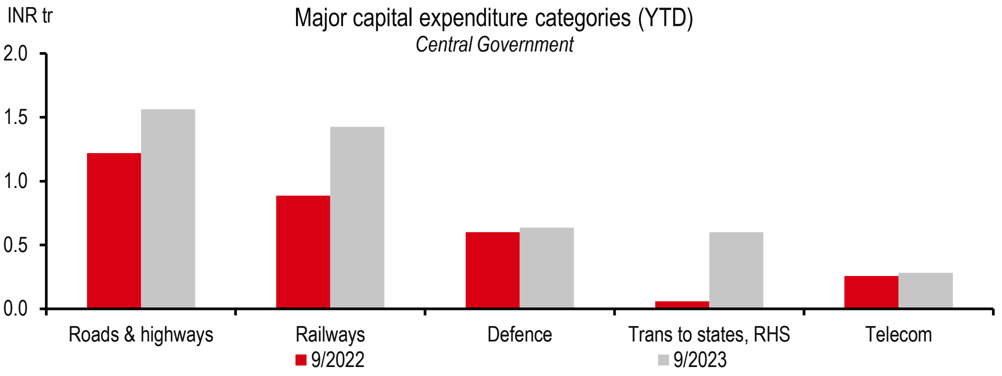
2 This means than capex growth could soften from 43%y-o-y in 1H to -19%y-o-y in 2H

Table 1: Central Government's fiscal finances – FY24 vs FY23

% GDP	FY23	FY24 BE	FY24 HSBC
Gross tax revenue	**11.2%**	**11.1%**	**12.1%**
Direct tax	6.0%	6.0%	7.0%
Corporate	3.0%	3.1%	3.4%
Income	3.0%	3.0%	3.6%
Indirect tax	5.2%	5.1%	5.1%
GST	3.1%	3.2%	3.3%
Customs	0.8%	0.8%	0.8%
Excise	1.2%	1.1%	1.0%
Net tax receipts	**7.7%**	**7.7%**	**8.4%**
Non-tax revenue receipts	1.1%	1.0%	1.1%
Capital receipts	0.3%	0.3%	0.2%
Privatisation receipts	0.1%	0.2%	0.1%
A. Total Receipts	**9.0%**	**9.0%**	**9.6%**
Current Expenditure	**12.7%**	**11.6%**	**12.8%**
Interest expenses	3.4%	3.6%	3.7%
Subsidies	1.6%	1.3%	1.5%
Other current expenditure	7.6%	6.7%	7.6%
Capital expenditure	**2.7%**	**3.3%**	**2.8%**
B. Total Expenditure	**15.4%**	**14.9%**	**15.5%**
Fiscal deficit	**6.4%**	**5.9%**	**5.9%**

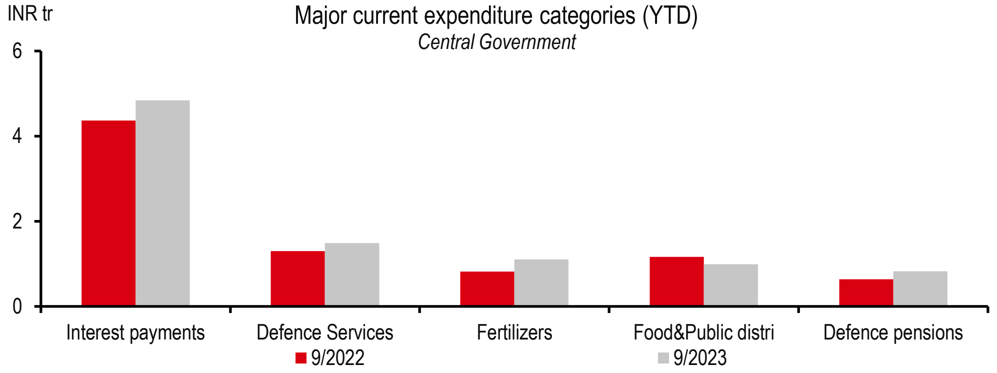
Source: Budget documents, CGA, CEIC, HSBC estimates

Chart 2: The central government has given a large push to capex in 1H…



Source: CEIC, HSBC

Chart 3: … which may enable it to focus more on current expenditure in 2H, in areas where we can already see some pressure mount



Source: CEIC, HSBC

Current expenditure has risen sharply (10% y-o-y ytd versus 1.4% budgeted for the full year, see Chart 3), and the space for it to rise at an even faster clip in 2H will not be there, unless capex is slashed even more than we anticipate, or the fiscal deficit target is relaxed[3].

And then there are the states. Following a 'spending strike' last year, the states have raised spending in FY24 and could post a fiscal deficit of closer to 3% of GDP from 2.8% in FY23. But we are not too worried. Much of their spend has been capex focused so far, and they are normally bound by the 3% fiscal deficit rule and cannot borrow from the market if the deficit crosses 3% (unless it is a special case, for instance, higher borrowing allowed during the pandemic if the states did certain reforms).

All said, with some good luck (falling commodity prices) and hard work (keeping a tighter rein on expenditure in 2H), we believe the centre's FY24 fiscal deficit target could just about be met. Meanwhile, the states have ramped up on 'good' quality spend.

But does that mean India doesn't have a fiscal problem? Even if the current year's fiscal deficit comes in lower than the previous year, is that good enough? How much more does the deficit need to be lowered in order to become sustainable, and how do we get there?

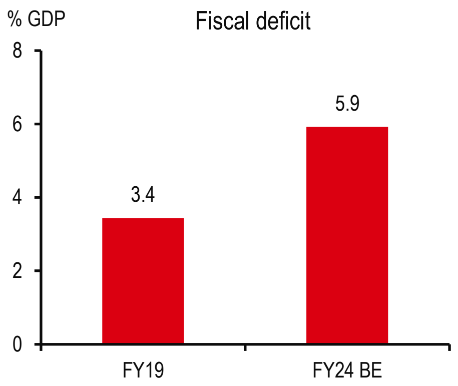
Why lower the fiscal deficit further?

India's GDP growth has been robust, if we look at PMI domestic orders and tax collection. GDP growth is forecast at 6.5% for the current year (FY24) by the RBI, which is exactly where it was in the last 'normal' year before the pandemic (i.e. FY19). This begs the question that **if GDP growth is back at pre-pandemic levels, why is the central government fiscal deficit much higher** (see Chart 4).

The question that follows is **why does the fiscal deficit even have to fall down?** We address this in the following section.

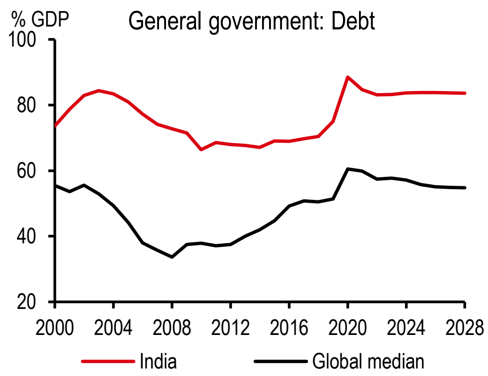
India stands out on the global stage for its high debt and deficit (see Charts 5-6). And this is despite having annual growth which is much higher than the world average (see Chart 7).

Chart 4: GDP growth is back at pre-pandemic levels, but not the fiscal deficit



Source: Budget documents, HSBC. BE: Budget estimates

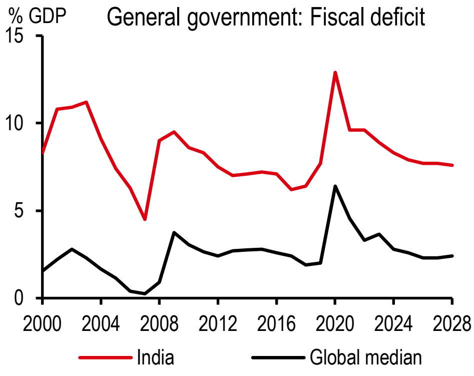
Chart 5: India stands out on the global stage for its high debt…



Source: IMF, HSBC

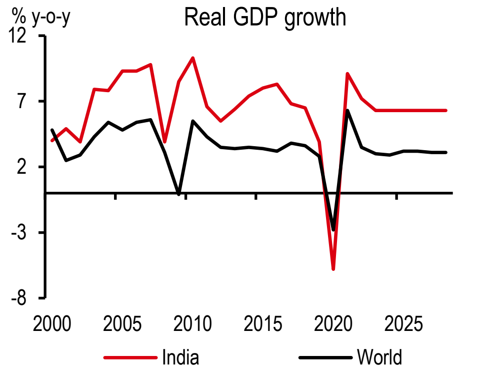
3 We expect current expenditure growth to soften from 10% y-o-y in 1H to 8.5% y-o-y in 2H

Chart 6: …and its fiscal deficit…



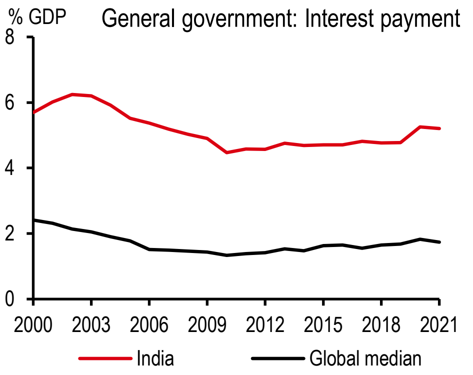
Source: IMF, HSBC

Chart 7: … despite having growth which is much higher than the world average



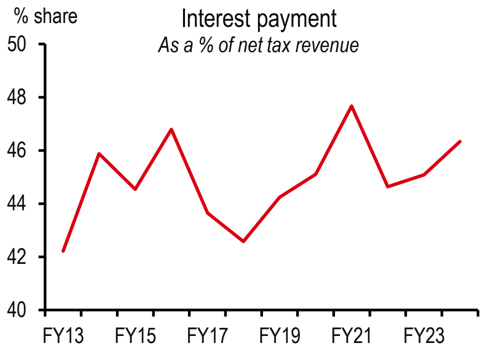
Source: IMF, HSBC

Chart 8: India's interest bill is not just higher than the world average…



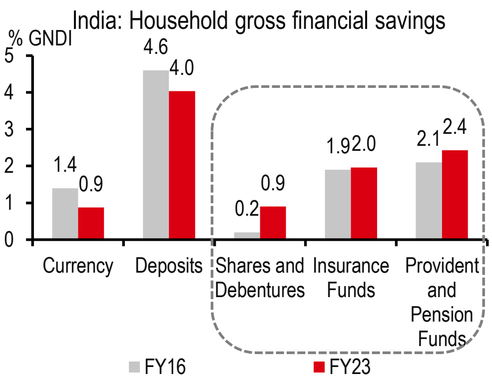
Source: IMF, HSBC

Chart 9: … but it also exhausts 45-50% of the net tax revenues



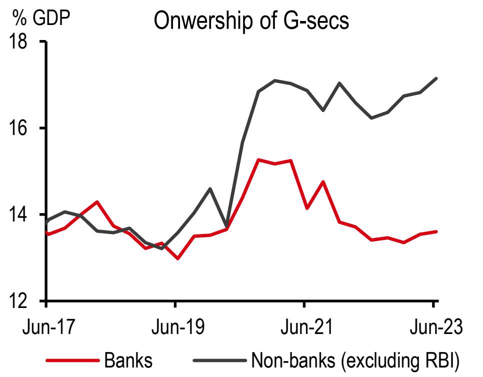
Source: CEIC, Budget documents, HSBC

Chart 10: Household savings have been rising for non-bank categories like insurance and pension funds



Source: RBI, HSBC

Chart 11: Where banks have pulled back, non-banks have raised investment in g-secs



Source: CEIC, HSBC

What stands out most is India's interest bill, which is not just higher than the world average, but also exhausts 45-50% of the net tax revenues (see Charts 8-9). And while India's government debt is much lower than the advanced economies' debt, **its interest servicing cost is far higher than the advanced economies**, making the elevated debt a problem.

It is worth highlighting that after years of careful effort, the Statutory Liquidity Ratio has been cut (from 24% in the early 2000s to 18% now), and the bank holding of government bonds has fallen. This is useful because more resources are available for funding the private sector.

But this is just part of the story. Household savings have been rising for non-bank categories like insurance and pension funds (see Chart 10), and the bulk of their savings are going into funding the fiscal deficit. In other words, where banks are cutting back on investing in government bonds, non-banks are raising their investment. **Looking at banks and non-banks together, no more funds are becoming available for the private sector** (see Chart 11). For more funds to become available, the fiscal deficit and thereby market borrowing needs to fall.

This may not seem to be a pressing issue right now, but could become important when the private sector capex cycle rises and demands the funding.

What's caused the fiscal excesses?

Was it the states leading the fiscal excesses? **We look at state finances, and interestingly their deficit hasn't widened very much since the pandemic** (see Table 2). Their revenues fell sharply, but they cut expenditure and thereby limited the fiscal slippage, at least until last year (FY23).

In fact, some effort had to be made to end the states' 'spending strike' earlier this year. With the help of the centre's capex loans to states (budgeted at INR1.3tn for FY24), and upfront finance commission tax revenue transfers to states, states have started to increase capex this year (see Chart 12) and their overall expenditure growth, which was well below nominal GDP growth last year, has moved above those levels this year (see Chart 13).

The challenge for the states from here is to ensure that they stick to good quality spending amid controlled fiscal borrowing.

So if it's not the states leading the fiscal excesses since the pandemic, it must be the centre. To understand better, **we compare the centre's finances in FY24 (HSBC forecast) with FY19, the last 'normal' year before the pandemic.**

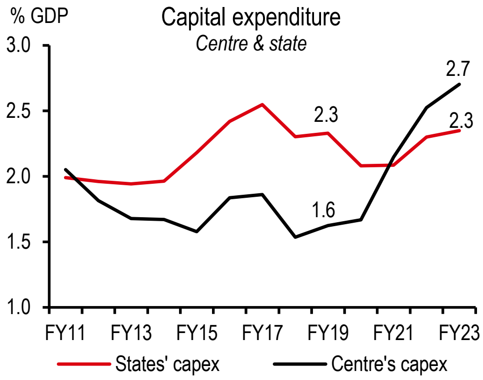
What we find is rather unexpected. While the capex bill has risen by 1.1% of GDP, current expenditure has increased by almost double that during that period (see Charts 14-15). And perhaps, the drive for fiscal consolidation should be focused there.

Table 2: State governments – not in significant breach of fiscal targets thus far

% GDP	FY19	FY23	FY23 - FY19
Revenue receipts	**13.0**	**12.6**	**-0.4**
Tax revenue	9.9	9.5	-0.3
Non-tax revenue receipts	1.0	1.0	-0.1
Grant in Aid and Contribution	2.1	2.1	0.0
Capital receipts (excl. state borrowings)	0.2	0.0	-0.2
Borrowings and other liabilities	2.4	2.7	0.3
A. Total Receipts	**13.2**	**12.6**	**-0.6**
Current Expenditure	13.1	13.0	-0.1
Capital expenditure (incl. loans & advances)	2.5	2.4	-0.1
Loans and advances disbursed	0.2	0.3	0.0
B. Total Expenditure	**15.6**	**15.4**	**-0.2**
Fiscal deficit	**-2.4**	**-2.8**	**-0.3**

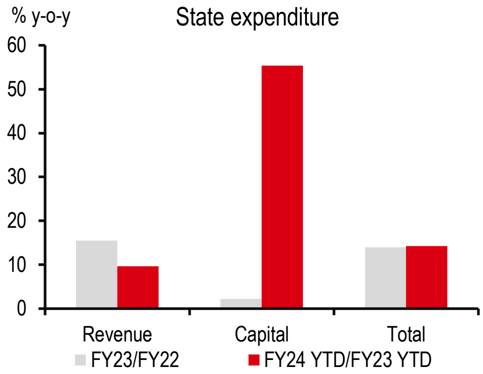
Source: CEIC, HSBC

Chart 12: States have started to increase their capex this year…



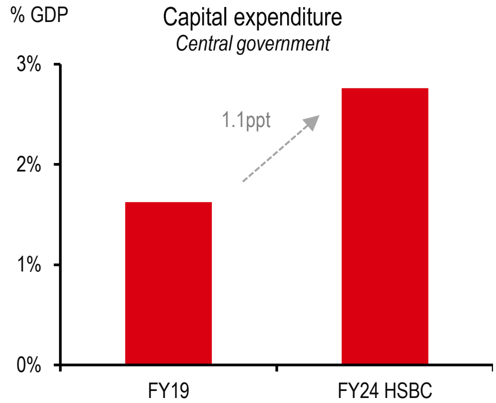
Source: RBI, HSBC

Chart 13: …with capex growing at a higher clip that nominal GDP



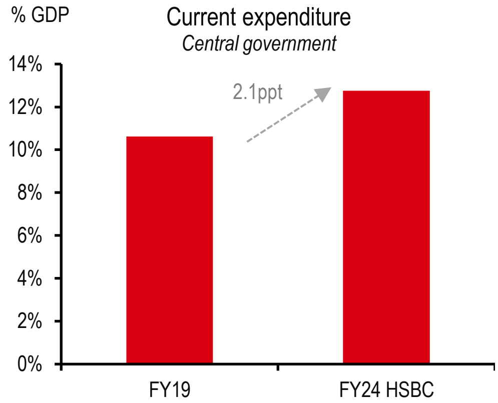
Source: CEIC, RBI, HSBC

Chart 14: Centre's capex is set to rise by 1.1% of GDP from pre-pandemic levels…



Source: CEIC, Budget documents, HSBC

Chart 15: … and current expenditure will likely rise by double that



Source: CEIC, Budget documents, HSBC

How to lower the central fiscal deficit?

First off, what does the central fiscal deficit need to be lowered to? There are three different targets depending on the horizon. First, the Finance Ministry has a 5.9% of GDP target for FY24 (from 6.4% in FY23). Second, it has a FY26 target of under 4.5% of GDP. Third, the finance commission has a medium-term target of 3% of GDP.

What we prefer instead, as a useful goal, is to get **the fiscal deficit back to the last normal pre-pandemic year's level of 3.4% of GDP** (this was where it was in FY19). This would mean an almost 2.5% of GDP consolidation from FY24 levels (see Table 3)

How do we go about lowering the central government fiscal deficit without cutting back on capex?

1. **Can central government gross taxes be raised?** Tax buoyancy has risen between FY19 and FY24 (ytd), but the drivers of this rise may not continue to yield year after year. A closer look suggests that the rise has come from direct taxes (see Chart 16), not indirect taxes. And this rise has come primarily over the last few quarters (see Chart 17). We believe a lot has to do with commodity prices falling, lowering production costs and raising profits of the corporates. But this boost may not last. For instance, oil prices fell 40% in the March quarter and 14% in the June quarter, and fell 3% in October. As such, higher taxes can't be the only tool for consolidation.

2. **Can central government net taxes be raised?** Tax devolution to the states has already fallen, leaving limited room for a further fall (see Charts 18-19).

3. **Can disinvestment receipts be raised?** Disinvestment receipts have disappointed over the last several years (see Chart 20). True, the Air India disinvestment (which was completed in January 2022) was notable, but barring that, disinvestments have been slower than budgeted.

4. **Can the subsidy bill be cut?** India traditionally provided price subsidies for food, fertiliser and oil (e.g. kerosene oil). In more recent years, it ventured into direct cash transfers (e.g. PM Kisan) but the income support was added on to the price support. It did not replace price support. Across the various definitions, overall subsidies are higher today than in FY19 (see Charts 21-22). And steps such as the extension of the free food scheme for the next five years do not give a sense than the bill will be bought down rapidly.

5. **Can 'other current expenditure' be cut?** Current expenditure is not just about subsidies. There are many centrally-sponsored schemes that the central government runs, in which it gives some upfront funding (about 60%). States provide the remaining funding (of about 40%) and implement the scheme. After a careful process of lowering the number of schemes, these have been raised again in recent years. In fact, the central government has recently made a rule that if the states do not spend the money quickly, they will have to pay an interest cost to the centre on the unspent amount[4]. So if these schemes are being raised and encouraged, it seems unlikely that cutting back on them will be a tool for fiscal consolidation.

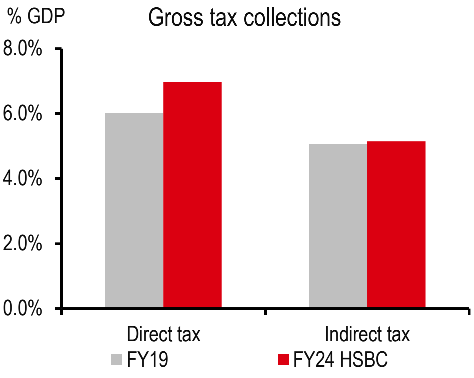
Table 3: Central government's fiscal finances: pre-pandemic vs now

% GDP	FY19	FY24 HSBC	FY24 HSBC - FY19
Gross tax revenue	**11.1%**	**12.1%**	**1.0%**
Direct tax	6.0%	7.0%	1.0%
Corporate	3.5%	3.4%	-0.1%
Income	2.5%	3.6%	1.1%
Indirect tax	5.1%	5.1%	0.1%
GST	3.1%	3.3%	0.3%
Customs	0.6%	0.8%	0.2%
Excise	1.2%	1.0%	-0.3%
Net tax receipts	**7.0%**	**8.4%**	**1.4%**
Non-tax revenue receipts	1.2%	1.1%	-0.2%
Dividends & profits	0.6%	0.4%	-0.2%
Capital receipts	0.6%	0.2%	-0.4%
Privatization receipts	0.5%	0.1%	-0.4%
A. Total Receipts	**8.8%**	**9.6%**	**0.8%**
Current Expenditure	**10.6%**	**12.8%**	**2.1%**
Interest expenses	3.1%	3.7%	0.6%
Subsidies	1.2%	1.5%	0.3%
Fertilizer	0.4%	0.7%	0.3%
Food	0.5%	0.7%	0.1%
Other current expenditure	6.4%	7.6%	1.2%
Capital expenditure	**1.6%**	**2.8%**	**1.1%**
B. Total Expenditure	**12.2%**	**15.5%**	**3.3%**
Fiscal deficit	**3.4%**	**5.9%**	**2.5%**

Source: Budget documents, HSBC

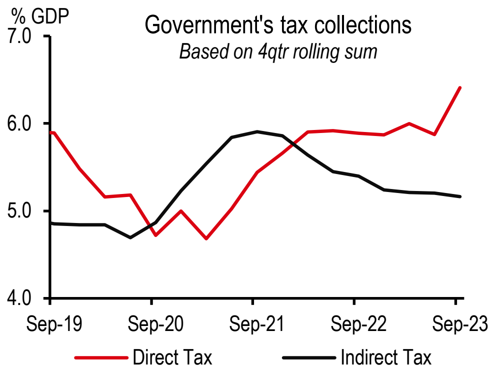
4 Financial Express | Spending under centrally sponsored schemes fell 9% in FY23, 21 July 2023

Chart 16: The rise in tax collections has come more from direct taxes than from indirect taxes



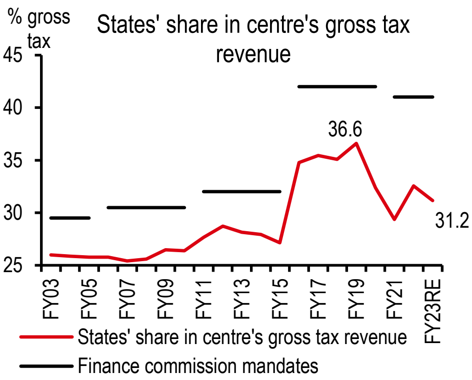
Source: Budget documents, HSBC estimates

Chart 17: This rise in tax collections has been a recent phenomenon



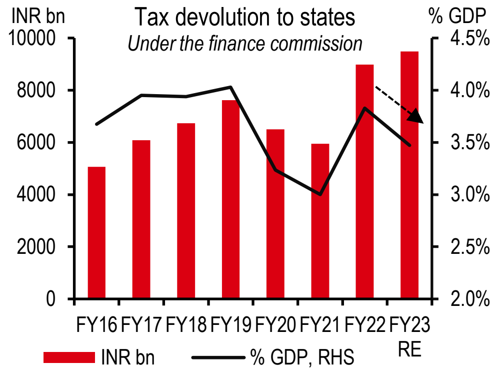
Source: CEIC, HSBC

Chart 18: Centre's transfers to states …



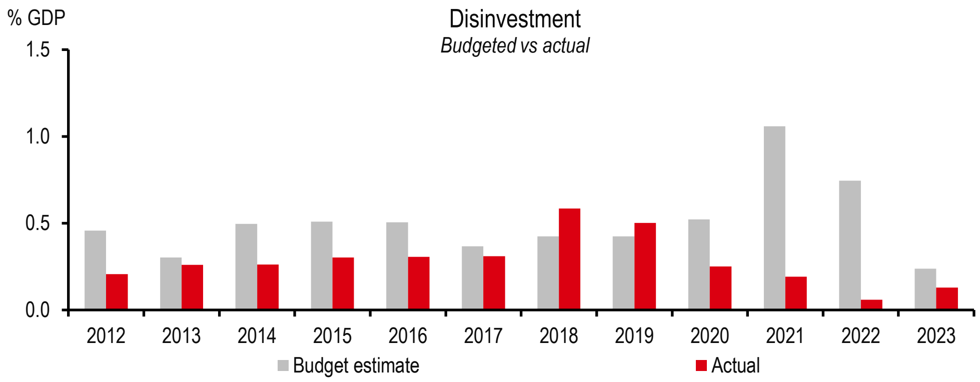
Source: Budget documents, CEIC, HSBC. RE: Revised government estimates

Chart 19: … have fallen



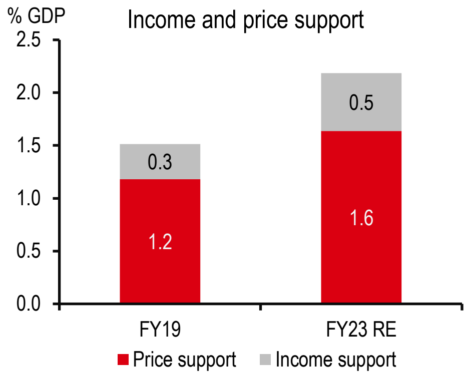
Source: Budget documents, HSBC. RE: Revised government estimates

Chart 20: Privatisation receipts have disappointed over the last several years



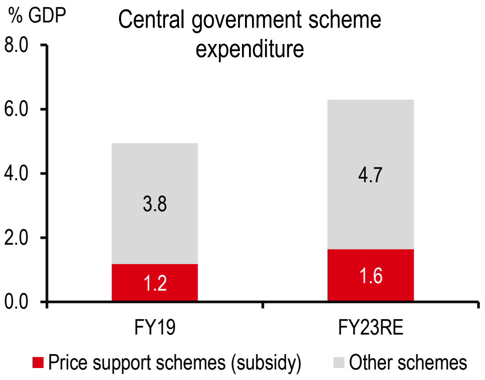
Source: CEIC, budget documents, CGA, HSBC

Chart 21: Overall subsidies are higher today than in FY19…



Source: Budget documents, HSBC. RE: Revised government estimates

Chart 22: … across the various definitions



Source: Budget documents, HSBC. RE: Revised government estimates

So, if going by recent experience, neither higher gross/net taxes and other receipts, nor subsidy and other current spending cuts can be relied upon for fiscal consolidation, what can?

Growth and intent lift all boats

Going back into the history shows that one of India's best periods of fiscal consolidation was between 2001 (FY02) and 2007 (FY08) (see Chart 23). That is also the period when growth averaged a strong 7%. Higher GDP growth helps raise tax revenues faster, while pressure on expenditure doesn't rise at the same clip.

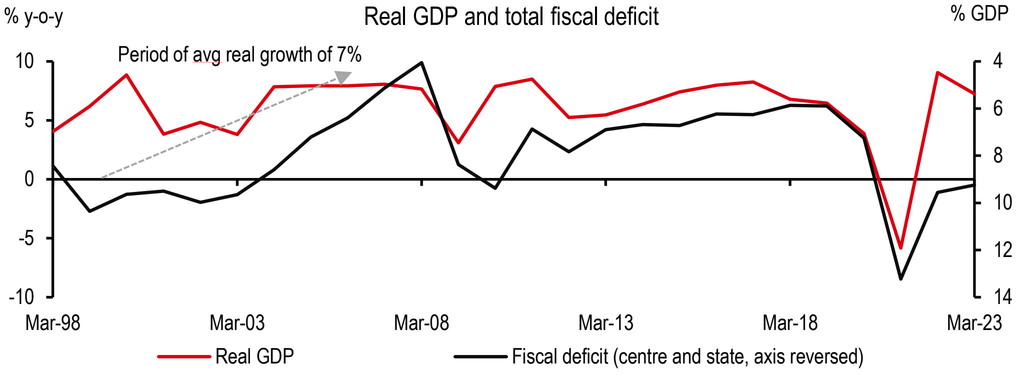
We believe that India will grow faster in the next decade than it grew in the previous decade. On the back of the new high-tech sectors which have sprung up in recent years, we expect GDP to grow at 6.5% pa over the next decade, compared to 6% at the eve of the pandemic.

Can India grow faster, at around 7%, as in the early days of the 2000s? We believe that would be difficult, especially given the current global backdrop, but not impossible. If new India (comprising hi-tech goods and services manufacturing, and tech start-ups plugged into the digital public infrastructure) can energise old India (agriculture and low- and medium-tech manufacturing) via innovations such as fin-tech (enabling small firms to access to credit) e-commerce (helping small firms to access to cheaper raw materials and new markets), and agri-tech, a growth clip of 7.5% is possible. But reforms, for instance in the power sector, direct taxes, skilling and education, will also have to keep pace.

Alongside high growth, a strong political commitment to lower the fiscal deficit will be equally, if not more, important. For instance, most of the five points discussed above need the support of the political economy.

India has made some important strides in improving the quality of spend. But the fiscal deficit must be lowered further to support the funding for a new private sector capex cycle. And both strong GDP growth and political intent will be important for that.

Chart 23: India's largest recent fiscal consolidation has occurred in periods of high growth



Source: CEIC, RBI, Budget documents, HSBC

Disclosure appendix

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Additional disclosures

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2 All market data included in this report are dated as at close 13 November 2023, unless a different date and/or a specific time of day is indicated in the report.

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