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STCI
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Government Spending: An Analysis

The Government's spending behavior in the face of the pandemic has drawn much attention from the financial markets and policymakers. The Government's spending pattern appears to be puzzling as it has been frugal in its spending in April- July FY22 so far. Our observations point to a change in the spending pattern since the onset of the COVID-19 pandemic. Usually, there is a well-established divide between government behavior in the developed nations and the developing nations in terms of cyclicality of fiscal policy. It is found that developed nations opt for a counter-cyclical fiscal policy and the developing nations exhibit a pro-cyclical spending pattern. This behavior probably stems from the resource constraints faced by a developing country in terms of borrowing and a weak revenue base.

Moreover, the social costs that are often touted as being ominous, in case the government does not spend in times of crises, have been secondary in the priority of developing nations which run the risk of falling into a debt trap in case growth does not pick up to the expected levels even after excessive spending by the government. The ability to pay off debt matters more to developing nations than the developed nations. In the case of India, the adoption of Expenditure Rules (ER) has led to, at least partially, the pro-cyclicality in Government's fiscal policy stance. Expenditure Rules formulate expenditure targets in various ways, for example under the FRBM Act Indian Government is committed to reach a gross fiscal deficit target of 3.5% of GDP by FY2025-26 in case economic recovery is faster than expected. To remove this pro-cyclicality caused by confirming to a glide path resulting in fiscal consolidation, the revised FRBM act was augmented with an escape clause and a buoyancy clause to provide more flexibility to the government to adopt a counter cyclical policy stance in times of crisis.

The Counter-Cyclical and Pro-Cyclical Debate:

The growth in spending levels over the years since FY2014-15, have been as high as slightly above 20% and as low as contracting by 5%. The fulcrum of spending has mostly been revenue expenditure and growth in capital expenditure has been more of an exception. Through during this time period, there are more instances of capital expenditure being curbed and can be seen in the Chart 1 that capital expenditure has been in the contraction mode at least thrice since FY2014-15, especially in the calendar months between April-July. The adoption of ER rules like the Fiscal Responsibility and Budget Management Act (FRBM) in 2003 have led to this unfortunate outcome of curbing capital expenditure and increasing revenue expenditure in bad times, whereas the beneficial effects of the fiscal multiplier would be more pronounced if the Government would incur increased capital expenditure as compared to revenue expenditure.

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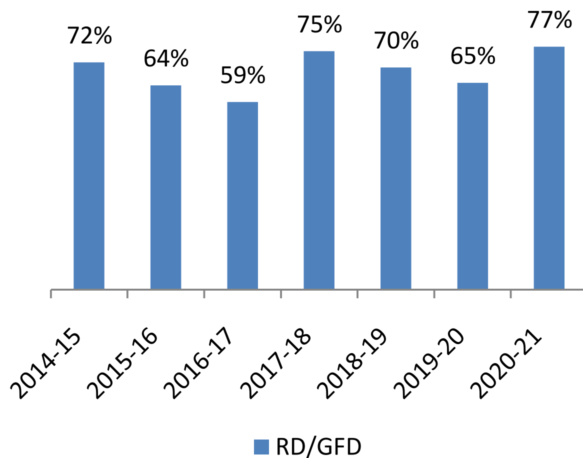
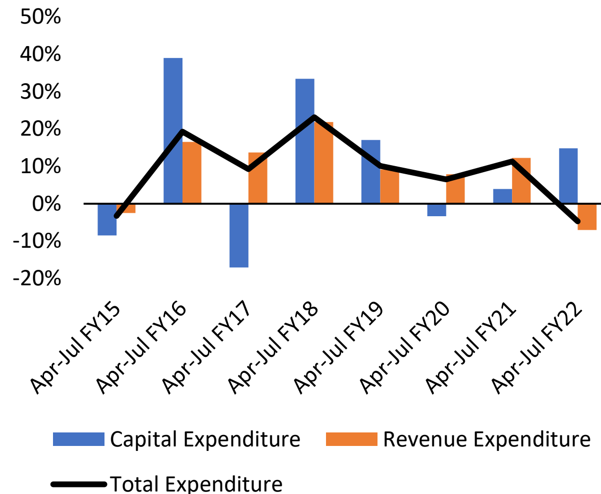
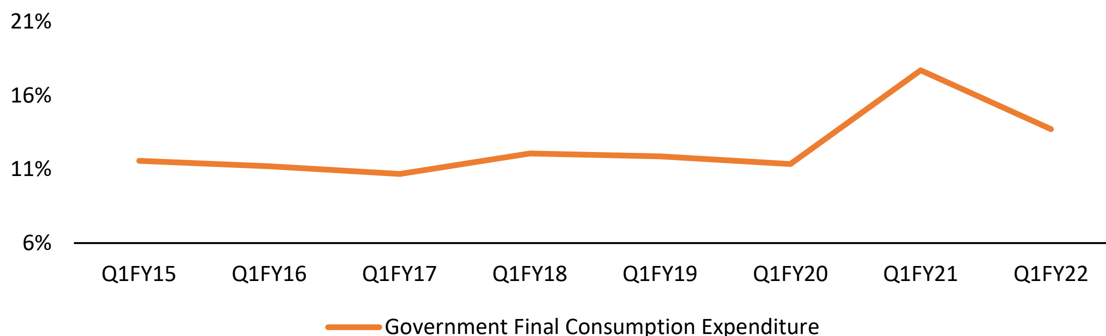
In the debate whether the Government should adopt a pro-cyclical or a counter-cyclical fiscal policy stance, the crucial factor remains the quality of expenditure which has to be monitored by the relevant fiscal institutions. An indicator to provide clarity and track the quality of fiscal expenditure is the ratio of the revenue deficit to the gross fiscal deficit. This has a threshold level of 32% in the FRBM act[1] and has been ~70% on average since FY2014-15 in India.





Source: RBI, CGA, STCI PD Research

The ratio of Revenue Deficit to Gross Fiscal Deficit (RD/GFD) indicates the quality of expenditure by indicating what amount of the financing has gone towards revenue expenditure and how much has been allocated towards capital expenditure. The COVID-19 crisis has provided a unique opportunity for the Government to divert more resources towards capital spending. FY22 has been an exception as on a year-on-year basis, capital expenditure has grown by 15%, while revenue expenditure has declined by 7%.



Source: RBI, MoSPI, STCI PD Research

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[1] Fiscal Framework and Quality of Expenditure in India –Sangita Mishra et al, RBI Bulletin June 2021.

The overall share of the Government Final Consumption expenditure (GFCE) in GDP has been on an average at ~13% in Q1 over the years since FY2014-15, which jumped close to 18% during the peak of the pandemic in FY2020-21, giving credence to the fact that the government had indeed adopted a counter-cyclical fiscal policy stance. Although, this pattern was not repeated in the current financial year and GFCE has again reverted to the old normal at 14%. This would be attributable to the return of the risk aversion as the economic aftermath of the second wave and the possibility of third wave loom large on the horizon. Although, as pointed above, the silver lining remains that the curb was exercised on revenue expenditure rather than capital expenditure which is a step in the right direction as far as improving the quality of fiscal spending is concerned.

Analysis of Government Expenditure:

While there is an ongoing debate about the Central Government not spending enough during the current financial year, the spending patterns indicate the reasons behind this behavior. As we analyze the distribution pattern of the Government spending during FY15-FY21, we observe that between FY15-FY20, the spending was marginally skewed towards the first half of the financial year, where the Government made an average total expenditure of about 53% in H1. However, this pattern changed notably during the pandemic year i.e., FY2020-21, as distribution of total Government expenditure was 42% in H1FY21 and 58% in H2FY21. If we look at component wise spending, the capital expenditure was 39% in H1FY21 against the average of 53% recorded in H1 of last seven years and revenue expenditure was 43% in H1FY21 against the average of 53% recorded in H1 of last seven years. This trend might be expected to continue in FY22 as well with the government spending being loaded more in the H2 than H1.

Chart 4 :Capital Expenditure

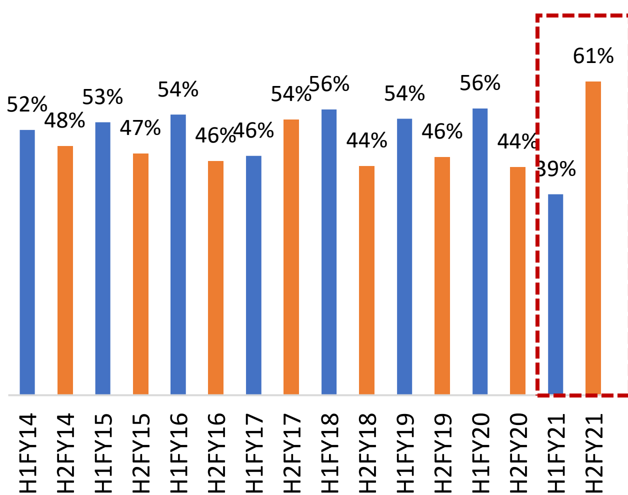
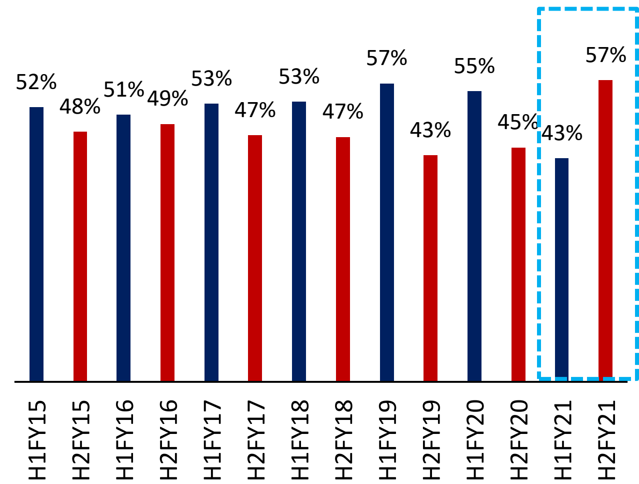


Chart 5: Revenue Expenditure



Source: RBI, CGA, STCI PD Research

The shift in spending can be explained, as the Government was dealing with unprecedented times which prompted cautious spending initially during the year. Though the COVID-19 situation has begun to stabilize currently, the uncertainty of the third wave, multiple virus mutations, and doubts on the efficacy of the vaccines to new variants, still looms large. According to us, it is quite likely that the Central Government would defer its spending for this financial year to H2 also, considering the possible risks, as any unprecedented additional spending would have an adverse impact on the costs of borrowing. Our analysis of the monthly pattern of spending suggests that the Government might be able to achieve the budgeted expenditure numbers for FY2021-22 with a risk of marginal undershooting in capital expenditure and overshooting revenue expenditure respectively, depending on the manifestation of the third wave and pace of vaccinations.

Systemic Liquidity and Government Expenditure:

Since the onset of the pandemic, the RBI has taken various conventional and unconventional measures to ensure abundant surplus liquidity in the system. However, in response to stabilizing COVID-19 situation and evolving financial conditions, on January 8, 2021, the RBI announced the resumption of normal liquidity management operations by conducting 14-day variable rate reverse repo (VRRR) auctions. Further, during the first Bi-monthly MPC Policy Review in April 2021, the Governor announced longer term variable rate reverse repo (VRRR) auctions citing the increased surplus liquidity. However, as the second wave struck the economy, beginning from mid-April 2021, the RBI decided not to conduct longer tenor VRRRs. Improving liquidity conditions has prompted the RBI to gradually increase VRRR amount up to Rs.4 Lakh Crore till September end which was announced in the August 2021 MPC Policy Review.

One of the major components that impact systemic liquidity is the amount spent by the Government, where higher spending leads to increased liquidity and lower spending leads to decreased liquidity. In the current scenario, the slower pace of Government spending and management of systemic liquidity appears to be a coordinated act by the RBI and the Central Government. As the Government increases its spending, RBI would be forced to absorb some of the excess liquidity from the system, in order to stabilize overnight money market rates.

Conclusion:

The pattern of Government spending indicates that the risk aversion prevalent for the other economic agents has also affected the sovereign and there is a marked change in the spending pattern from the first half of the year to the second half of the year since the onset of the pandemic in FY2020-21. This has led to the Government spending being low and the building up of huge cash balances ranging from Rs.3-4 Lakh Crore in the recent times. Depending on the manifestation of the third wave of the COVID-19 in the

medium term, we expect the Government to incur the better part of its expenditure in the second half of the year. Notably, with the buildup of huge cash balances and existing borrowing programme, it would be likely that there would be no fiscal slippage, which should prove beneficial for both RBI and the bond markets and should help in lowering the borrowing costs for the Centre, States and corporates.

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