Populism – a bane for India?

Abstract

The demographics and growth of India have made it an epicentre in emerging world economics. In the face of prevailing geopolitics, trade frictions and race for technology dominance, India’s trajectory has a meaningful impact - not only on global commerce, but also emerging world pre-eminence. This paper examines the direction of India's current fiscal course, socio-economic impact of resource alignments, and the potential fallouts of any misdirected priorities. It concludes that India’s tilting balance towards politically benefiting populism constricts the fiscal space for priming the economy to growth, thereby increasing downside risks to revenues and deficits. The only solution is better targeting of populist expenditure, to allow much needed capital infusion into development sectors.

Keywords: fiscal deficit, monetary policy, inflation

Introduction

Despite a resilient global economic growth projected in 2025, uncertainty looms large on multiple fronts. Easing inflation and buoyant labour markets are being negated by discordant localized phenomena, from fiscal tightening, weak productivity growth, and an aging population in Europe, to rising debt servicing costs, lack of employment opportunities and an increasing severity of climate change in Africa. Global trade outlook faces significant headwinds from trade tensions, protectionist policies and geopolitical uncertainties. Furthermore, the growing clout of services as a potential growth engine vis-a-vis merchandise trade carries risk of exacerbating global inequalities, especially in the creative service sector of brands, software, data and patents. High interest rates in advanced economies and depreciating currencies in developed countries redirect resources away from development, productivity growth and social empowerment, towards debt payments. Realigning global commerce towards a strong multipolar world through regional trade and integration is essential to build a resilient, equitable and sustainable global growth. As the world's fastest growing large economy and the fourth largest consumer market in the world, India’s economic and policy directions will have a direct bearing on the above.

Methodology

This study is based on the quantitative interpretation of secondary data published in the public domain by responsible, recognized authorities in the field. All data, tables, and figures presented to support the inferences and observations have been labelled with the source and appropriate captions. The article has focused on a limited period owing to the availability of relevant credible data of reference.

Results and Discussion

India has been running a comparably large fiscal deficit for a long time.

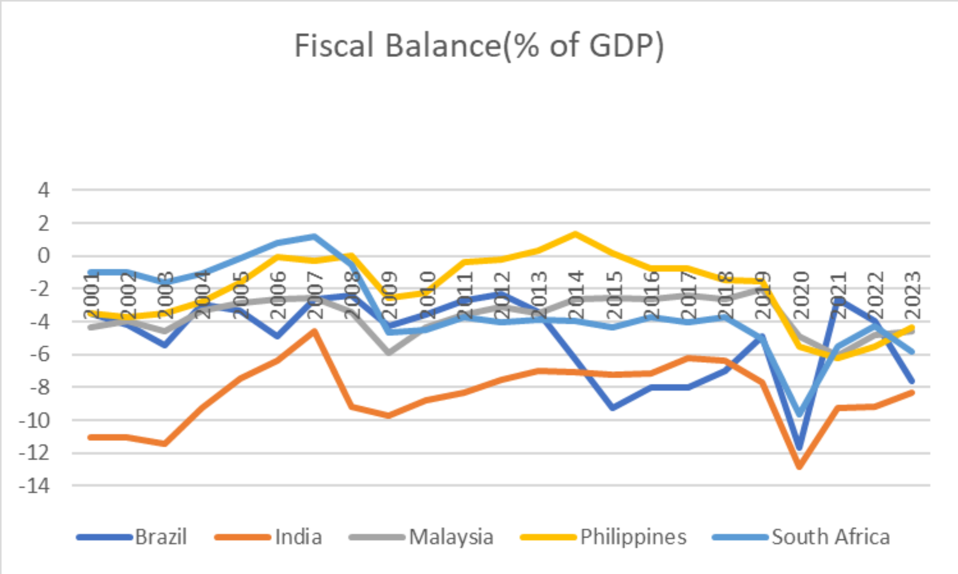

Fig 1) Source – World Bank, 2024

The Fiscal Responsibility and Budget Management Act, 2003 (FRBMA) aimed to bring the fiscal deficit to a manageable 3% of GDP and eliminate the revenue deficit. The zero-revenue deficit target was intended to prevent use of borrowed resources for the purpose of consumption/revenue expenditure such as wages and salaries, interest payment, pension, payment of subsidies, etc. However, in the 2018 FRBMA amendment, revenue account balance as an objective was given up.

Notably - it is the revenue deficit of the union government that has driven the fiscal deficit over the last two decades.

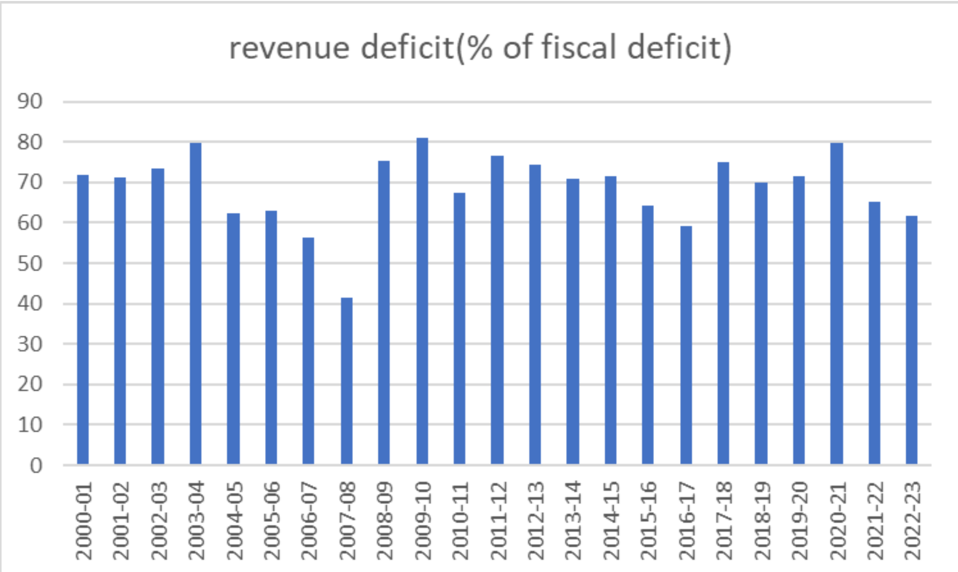

Fig 2) Source - RBI, 2024

The amended Act specified the debt-GDP targets for the union government, states, and their combined accounts at 40%, 20% and 60% respectively by 2024-25, while the fiscal deficit to GDP targets were kept at 3% each.

However, the fiscal course has repeatedly deviated from these targets.

With populism in India increasingly shifting towards rapid economic expansion, from the earlier emphasis on empowering citizens through entitlements to rights like the right to employment through

National Rural Employment Guarantee Scheme and right to education through Sarva Shiksha Abhiyan, it is important to be wary of the perils on this path.

Argentina is an example par excellence of the damage inflicted, when populist politics trumps economics. From being in the top-six largest economies world-wide, Argentina has defaulted on its sovereign debt nine times.

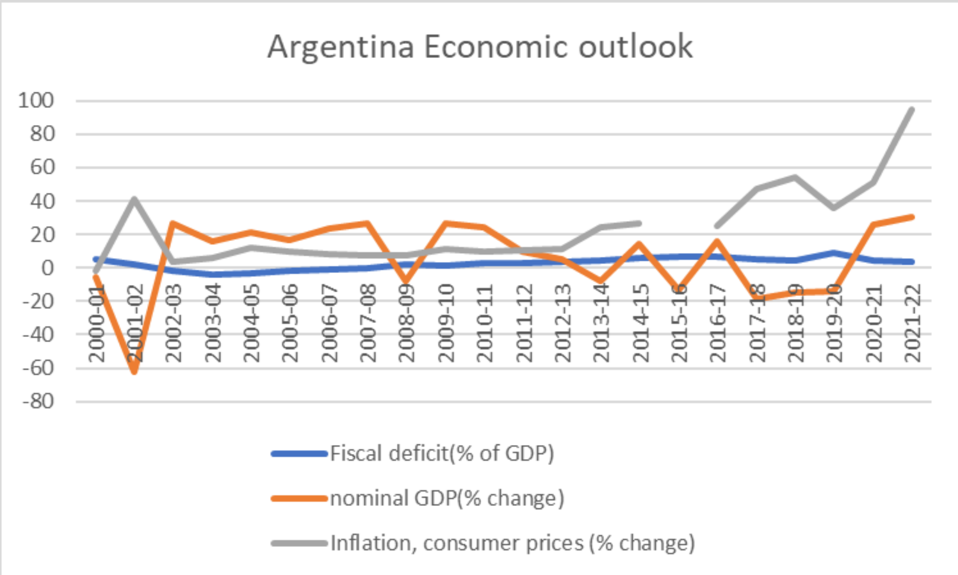

Fig 3) Source – IMF World Economic Outlook, 2023

In the recent transgression cycle in its economic history – a massive debt-fuelled social welfare and subsidy spending undid the healthy stability earned after fiscal profligacy, and rising debt payments led to an economic disaster and sovereign default in 2001.

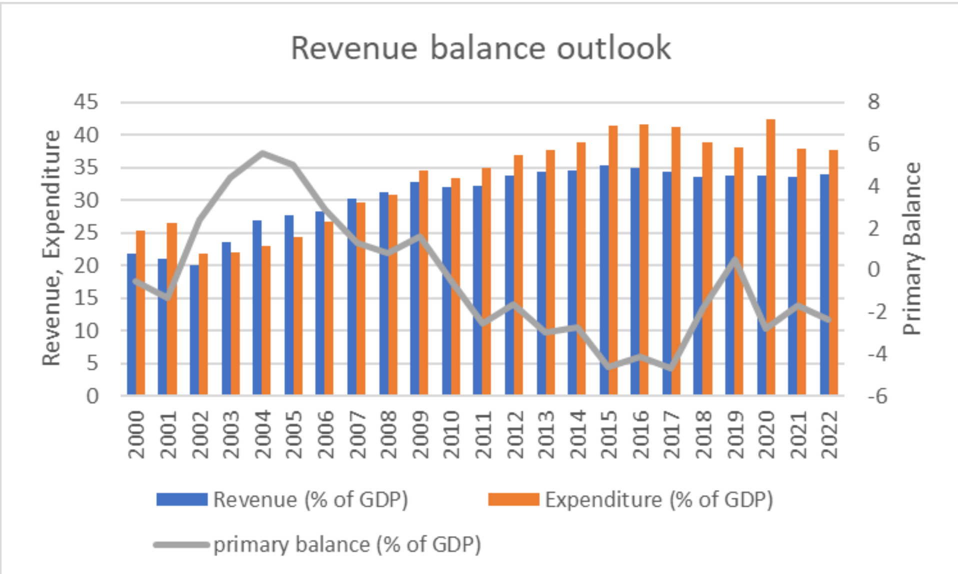

Fig 4) Source – IMF World Economic Outlook, 2023

Depreciation of the currency, a commodity boom riding on Chinese demand, a negotiated moratorium on debt repayments, and a tax-GDP ratio of almost 40% had boosted a quick recovery after 2002, followed by several years of high growth, fiscal surpluses, low inflation, and almost constant dollar value of debt.

The offending populist fiscal expansion after 2008 was financed by seigniorage and domestic debts, with no access to international markets since the default.

Even after access was restored in 2016, prohibitively high interest rates in international credit markets meant an increasing reliance on the inflation tax for fiscal financing, leading to runaway inflation and a decline of peso.

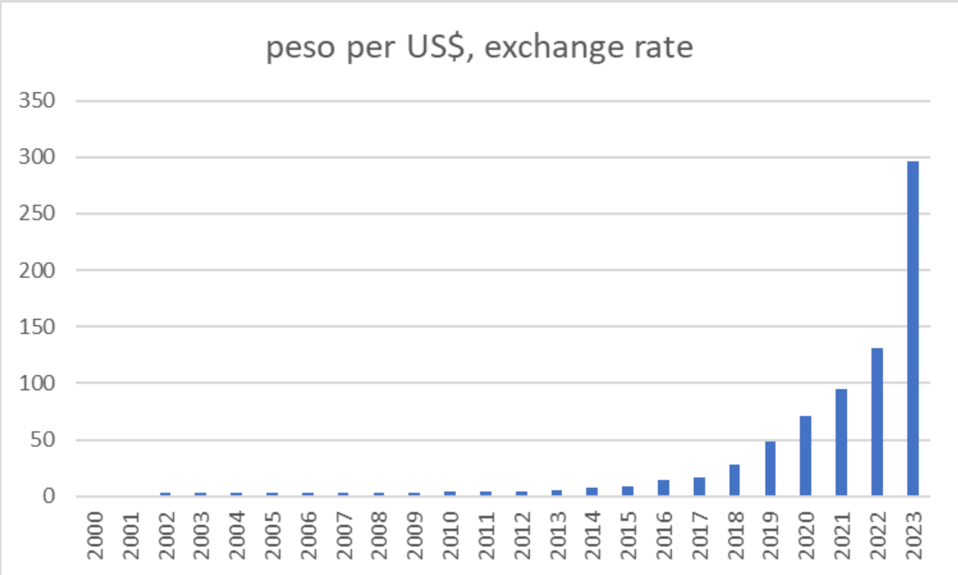

Fig 5) Source – World Bank, 2024

Private investments have lagged behind peers, owing to waning domestic demand and spike in inflation and input costs

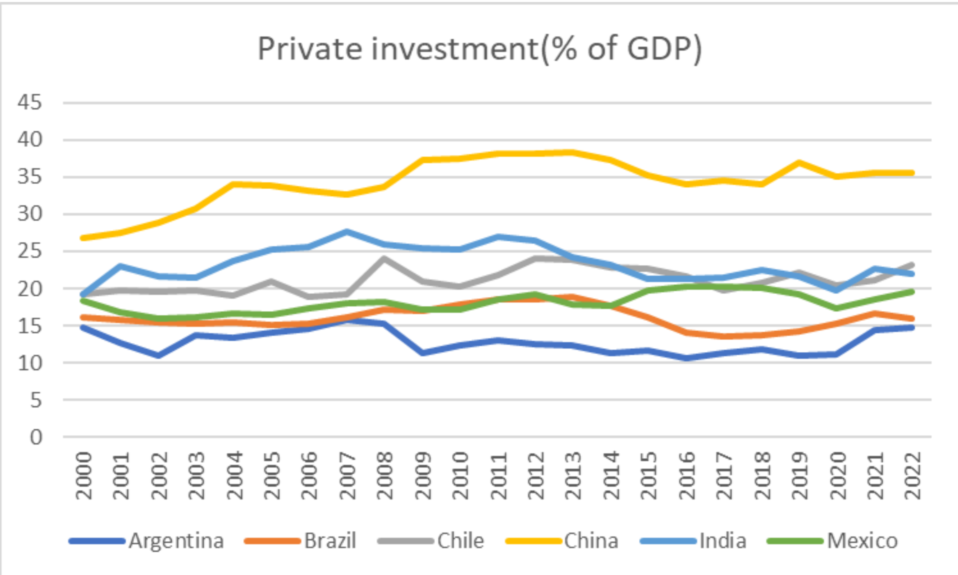

Fig 6) Source – World Bank, 2023

These distortions inflicted severe damage on investments, exports, and per capita income, over the last decade.
Deficits plummeted back to a worrying 6 percent within just a decade.
Argentina manifests the chronic inflation and economic distress that emanates from persistent deficits owing to public overspending, financed by money creation and debt.

Once such inflationary expectations become 'ingrained' in the society, people develop "defence mechanisms" through "inflation hedged" real assets, indexed wage demands etc, that cause any fiscal and monetary counter-inflationary efforts to fail.
Instead, they likely push up gilt rates elevating the fiscal debt servicing costs further.
Although India has witnessed healthy revenue proceeds, expenditure has kept up in tandem – the relentless primary deficits incurring a high gross public debt ratio.

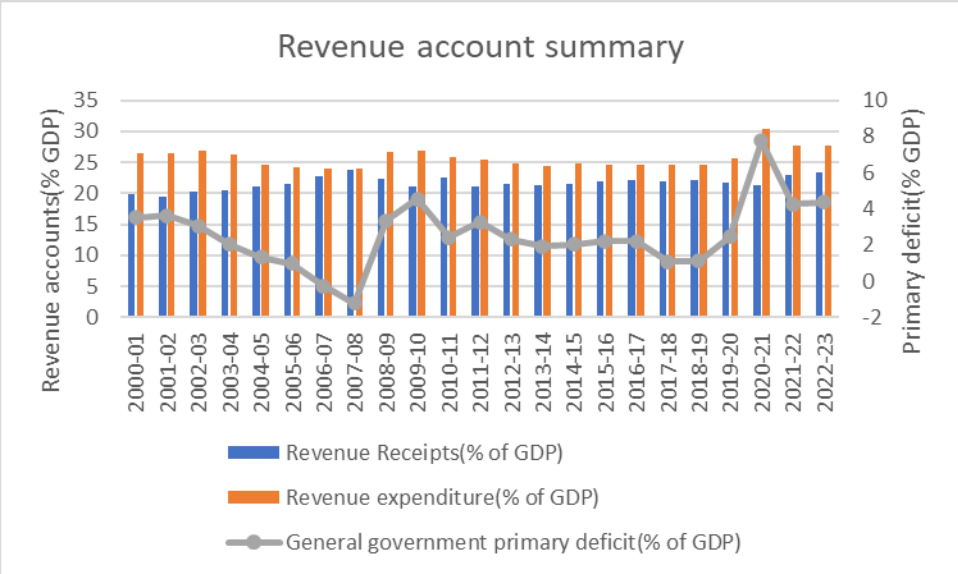

Fig 7) Source – RBI, 2024

Over the past few years, direct tax collections have reached unprecedented levels owing to aggressive tax governance and administration by the Central Government.
Smoother tax regime and tightened compliance under the Goods and Services Tax (GST) have mobilized robust indirect tax collections too.

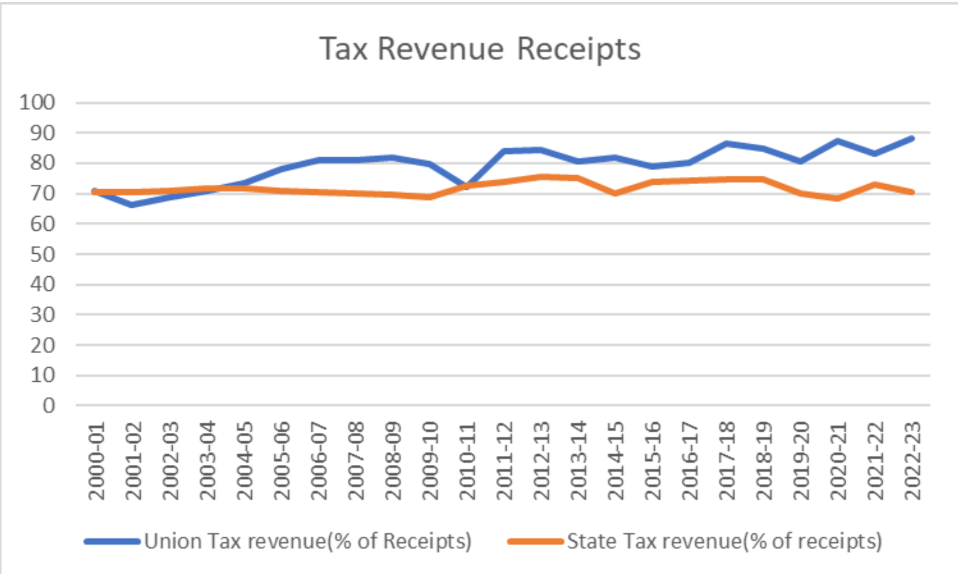

Fig 8) Source – RBI, 2024

However, India's tax-to-GDP ratio still stands below figures for similar emerging economies.
Source – World Bank
Direct taxes still account for less than half of India's overall sum.

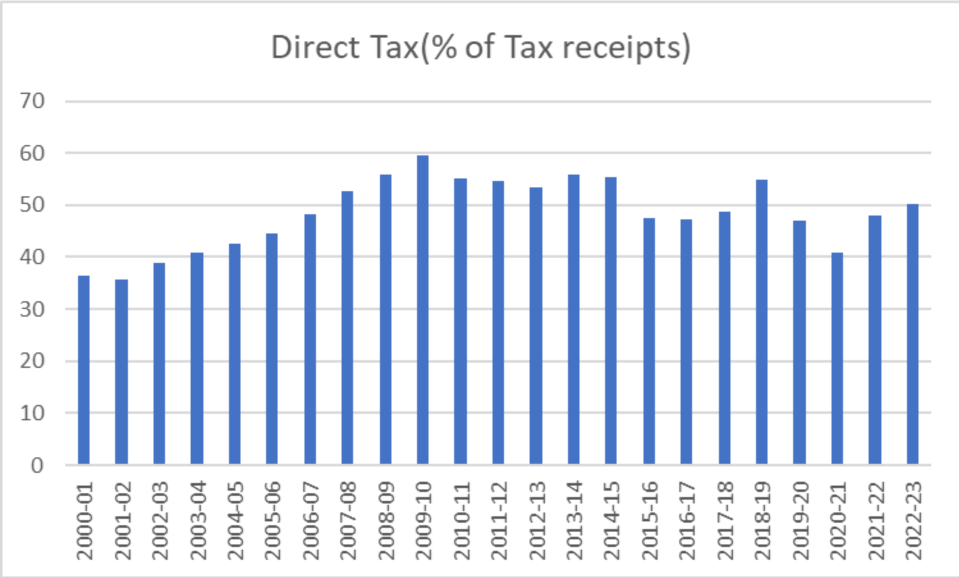

Fig 9) Source - RBI, 2024

There has also been a significant shift in its composition – between corporate and personal taxes. Revenue from corporate income tax has lagged nominal GDP growth rate in a concerning trend, despite relief in rates in 2019 to promote investments.

The 'tax gap' is largely owing to the narrow base - with the informal sector, agriculture, and the rapidly growing services sector largely outside the tax net. As per the PLFS survey, the informal sector still represents nearly a third of the non-agricultural workers in the economy.

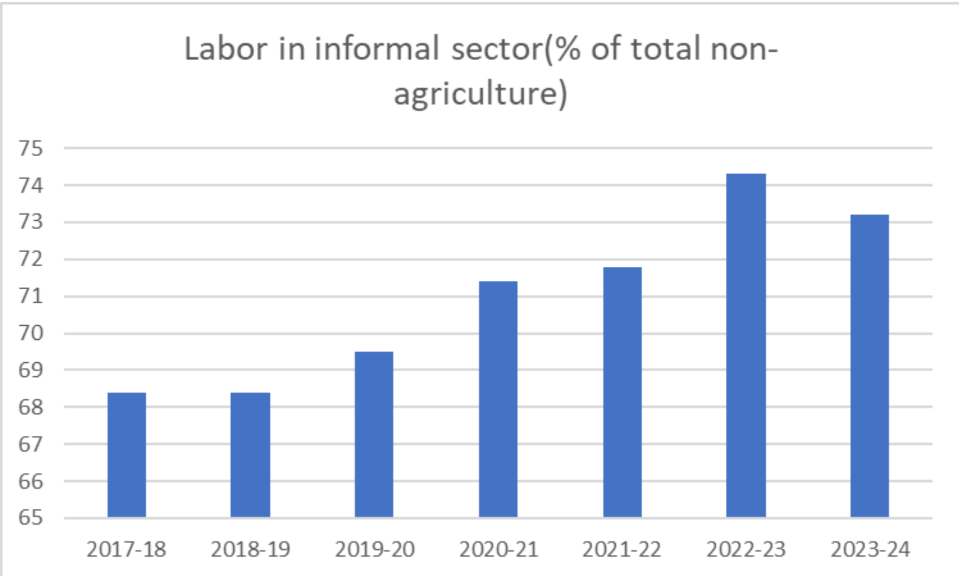

Fig 10) Source: Annual PLFS reports multiple years

Indirect taxes have some way to go too – despite a greater formalization with the GST policies, out of over 63 million enterprises, only about 14 million are in the purview of the GST network.
On the other hand - the combined total spending of the Union and states has averaged more than 30% of GDP.
Welfare-related spending has averaged more than 15% for more than two decades. This expenditure oversees some of India's most prominent and widely recognised welfare programs.

Notably, the total expenditure on subsidies has far surpassed the combined spending on these central schemes.

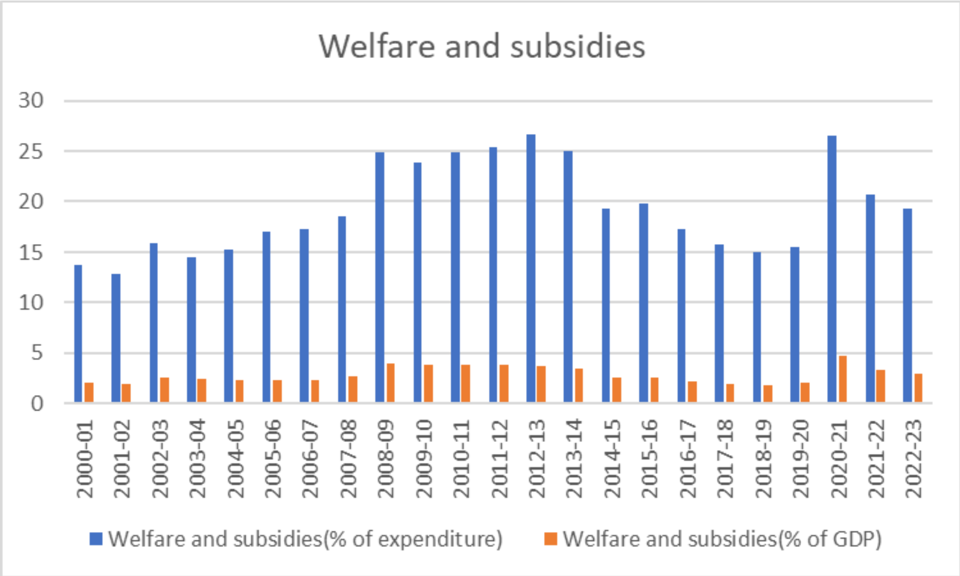

Fig 11) Source – RBI, 2024

Welfare spending and subsidies for all states and the Union to the revenue receipts has risen above 50% in recent years, and almost doubled since 2018.

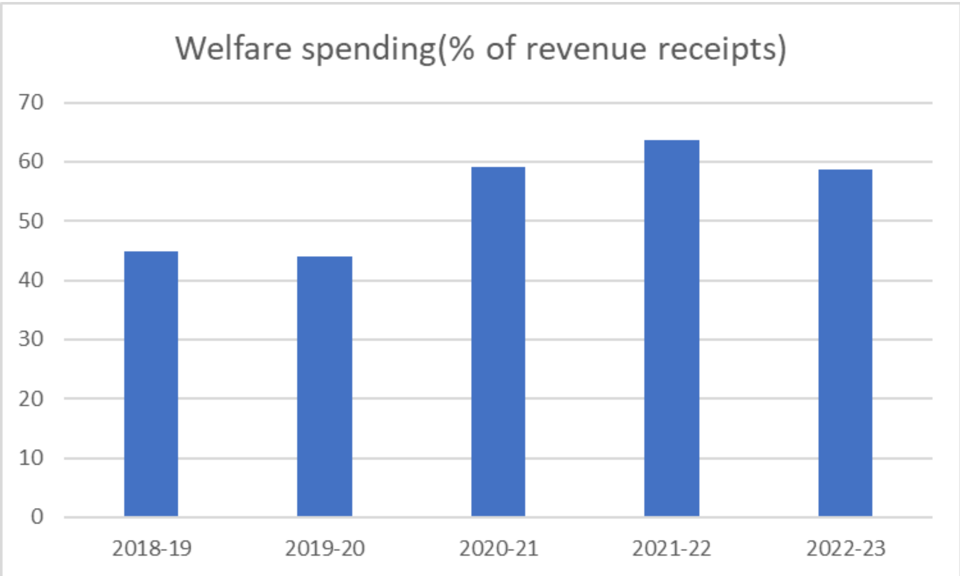

Fig 12) Source – RBI, 2024

The sharp rise in revenue expenditure – that oversees normal running of Government departments (interest payments, salaries of employees, subsidies, pensions etc) - amid freebies, subsidies and dole-outs is a growing concern.

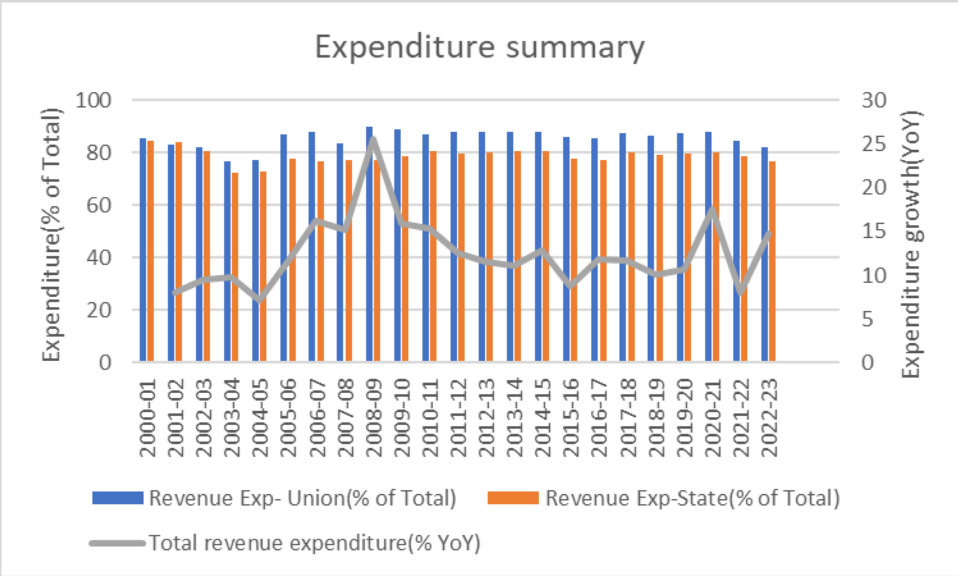

Fig 13) Source – RBI, 2024

The major states of Maharashtra, Madhya Pradesh, Rajasthan, Telangana and Orissa that had recently gone to polls, have revised their targets for fiscal deficit and revenue expenditure, to pay for the exorbitant cost of new freebie schemes.

India's public debt to GDP ratio is already the largest among similarly placed EMs.

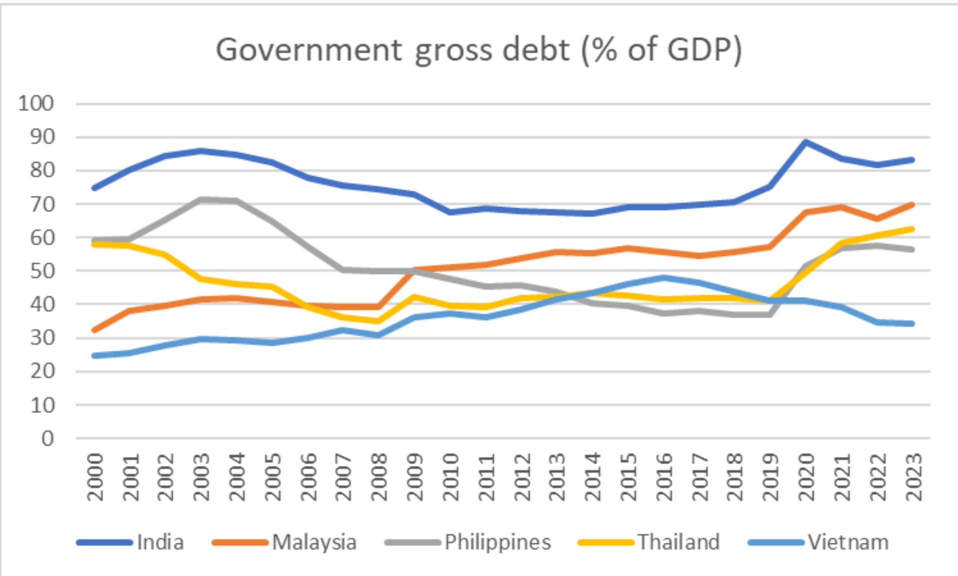

Fig 14) Source – World Bank, 2024

Moreover, Interest payments as percent of revenue receipts are much higher than the typical EM.

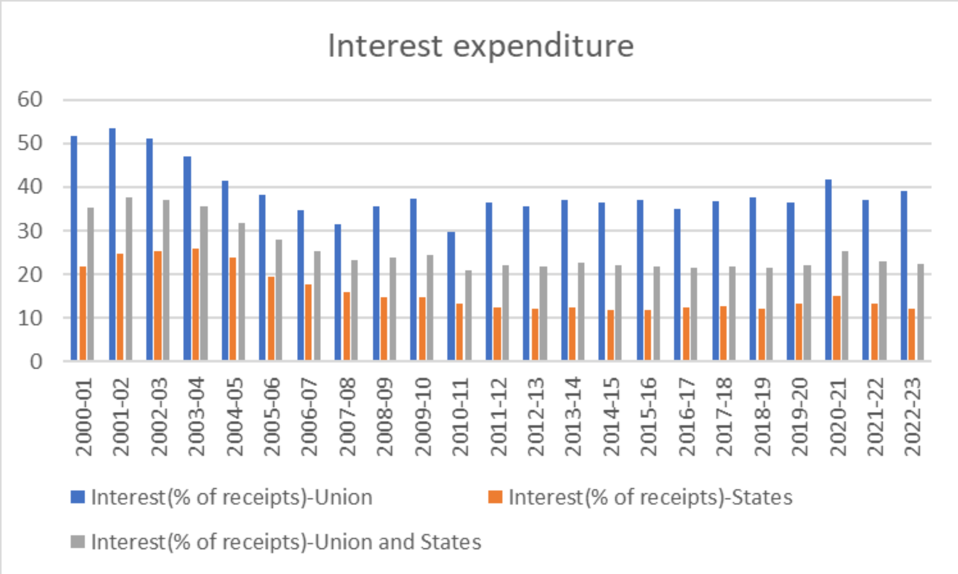

Fig 15) Source – RBI, 2024

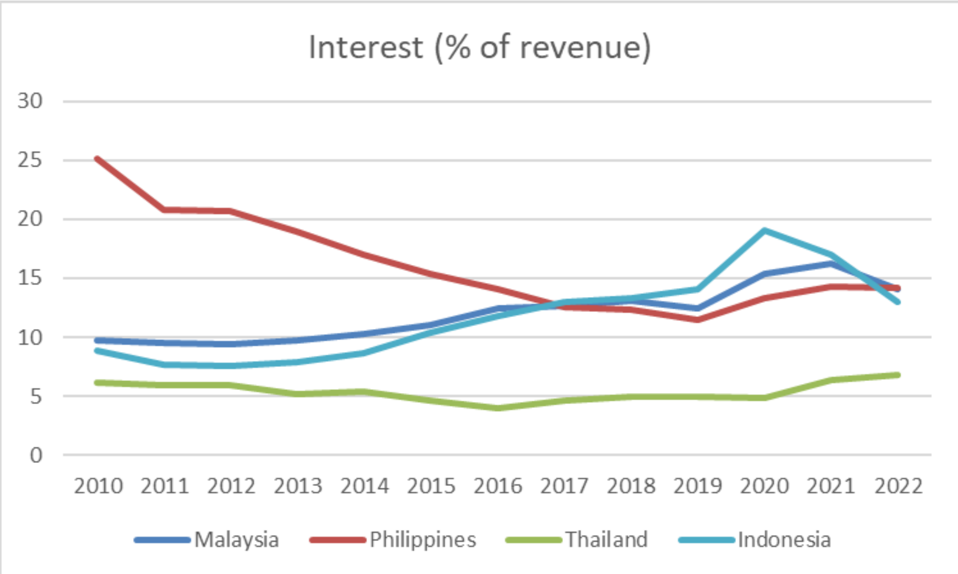

Fig 16) Source – World Bank, 2023

The states are as much responsible the macro-fiscal stability, as the Union. States' fiscal deficit composes more than 30% of the combined fiscal deficit.

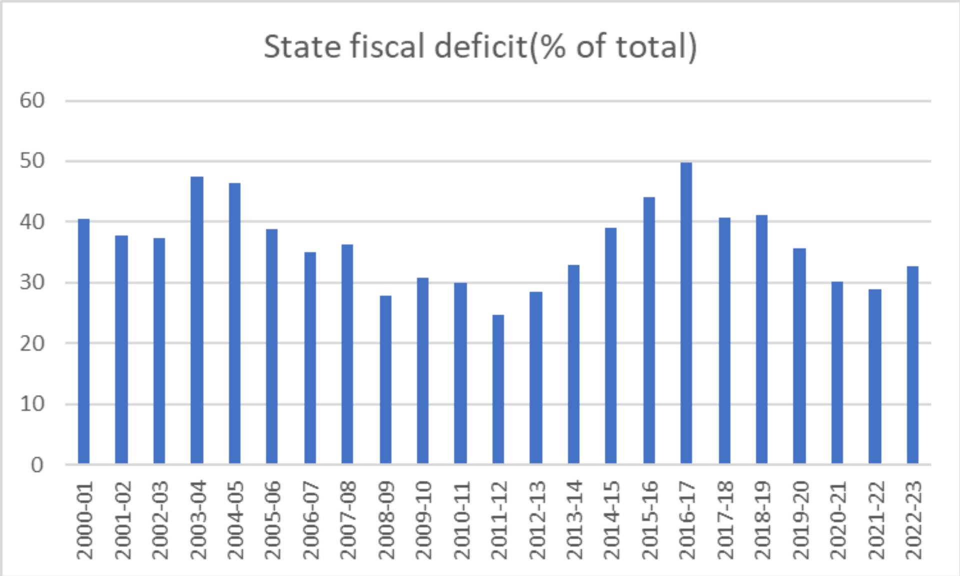

Fig 17) Source – RBI, 2024

States' share in total expenditure has gone up in recent years.

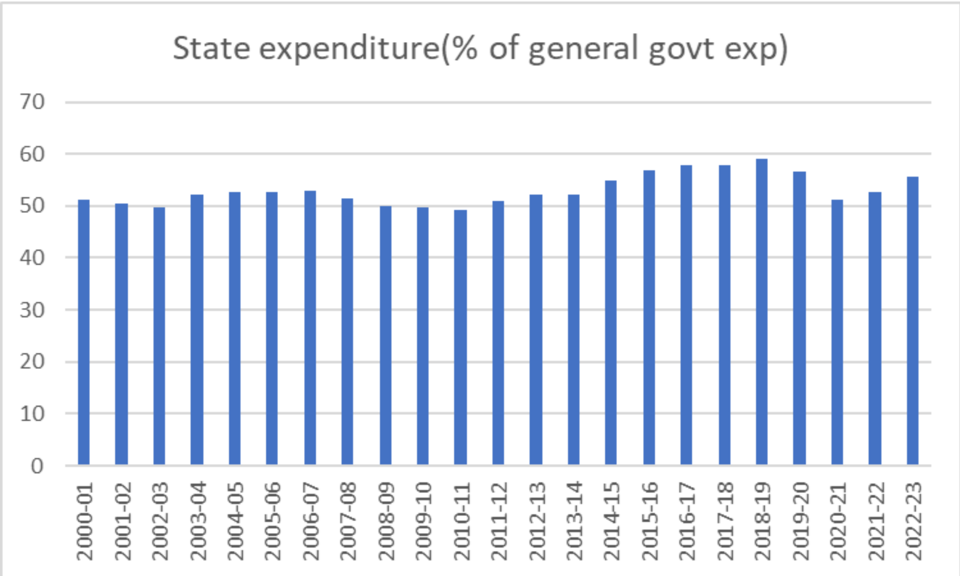

Fig 18) Source – RBI, 2024

States' liabilities are increasing at a double-digit rate, at a pace higher than nominal GDP growth.

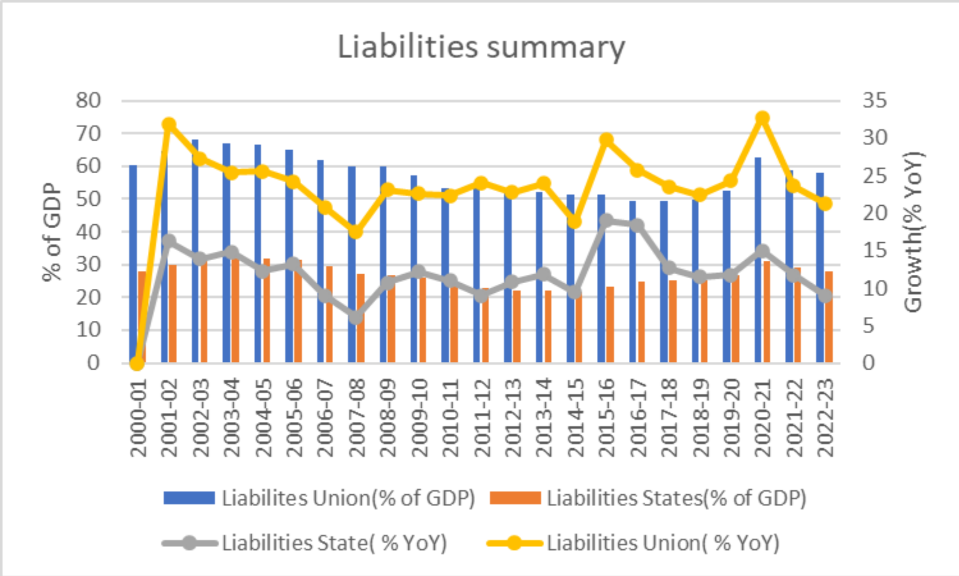

Fig 19) Source – RBI, 2024

While expenditure share has been rapidly spiralling, the nearly stagnant own tax revenue mobilisation means that States have been relying increasingly on transfers and grants from the Centre.

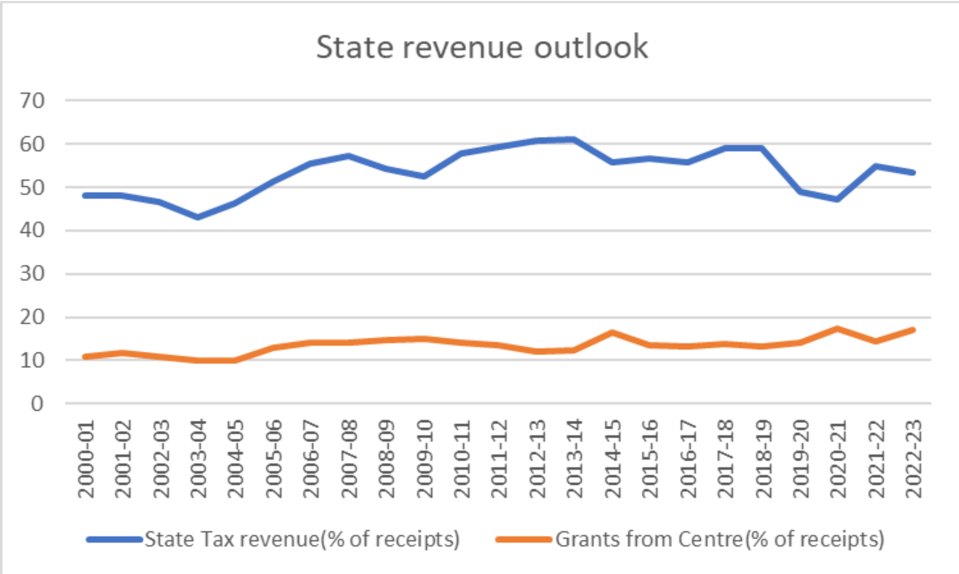

Fig 20) Source – RBI, 2024

As the economy slows down, this dynamics of high deficit, interest expense and debt may lead to a crisis. Hence the government's recent push for capital expenditure, mostly through roads and bridges, railways, and communications sectors.

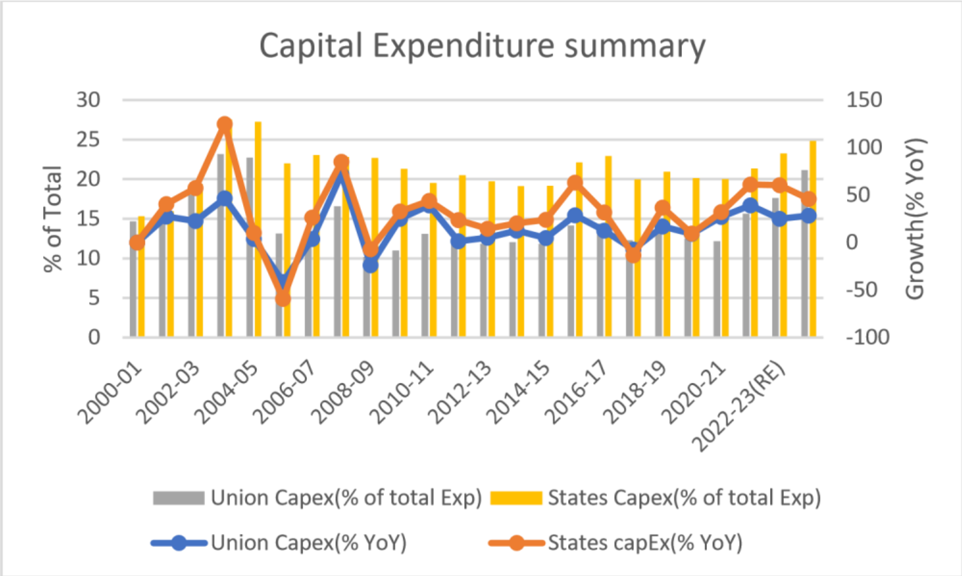

Fig 21) Source – RBI, 2024

On the contrary, private investment has witnessed a steady decline since 2011-12, despite slashed corporate taxes in 2019.

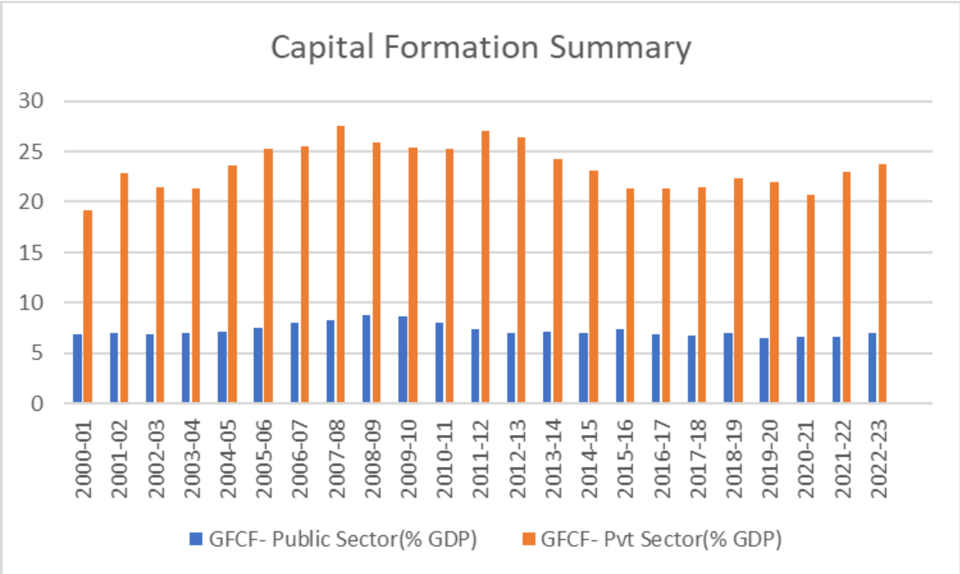

Fig 22) Source – RBI, 2024

With sovereign-rating concerns imposing pressure on fiscal consolidation, the government does not have the fiscal space to buoy the tempering growth, consumption, and fixed investment-to-GDP ratio by itself.

Despite the fiscal tightness, India enjoys some favourable macro-fundamental buffers vis-a-vis Argentina.

A largely unchanged primary budget deficit and a favourable interest rate-growth differential (largely owing to high nominal growth rates) has broadly kept the debt ratio stable in India.

Source – RBI and IMF

A captive market for public debt among state banks, private banks, insurance companies and provident funds, together with household savings, have enabled the government to fund its deficits without monetization or undue pressure on borrowing costs.

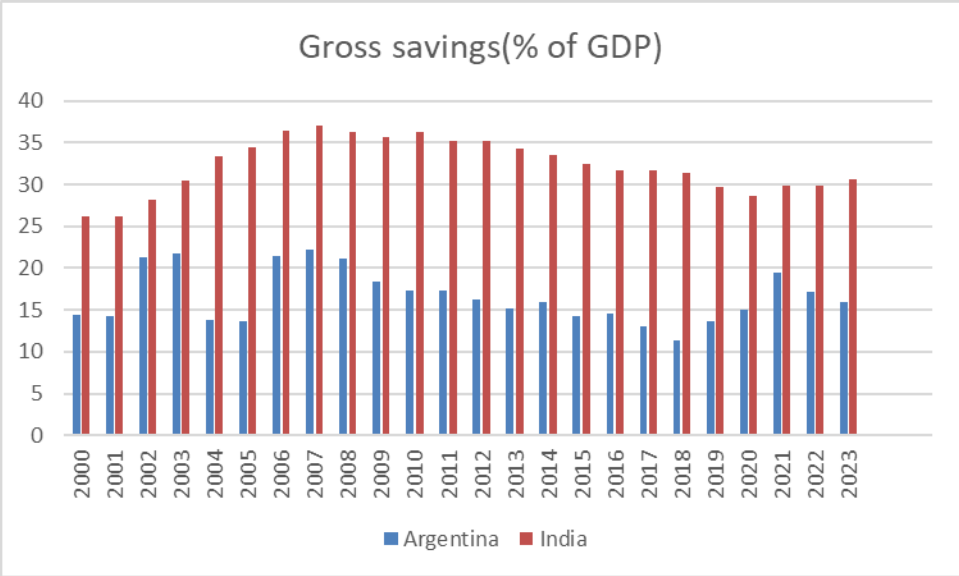

Fig 23) Source – World Development Indicators (World Bank), 2024

Dependence on market borrowing has increased in recent years however.

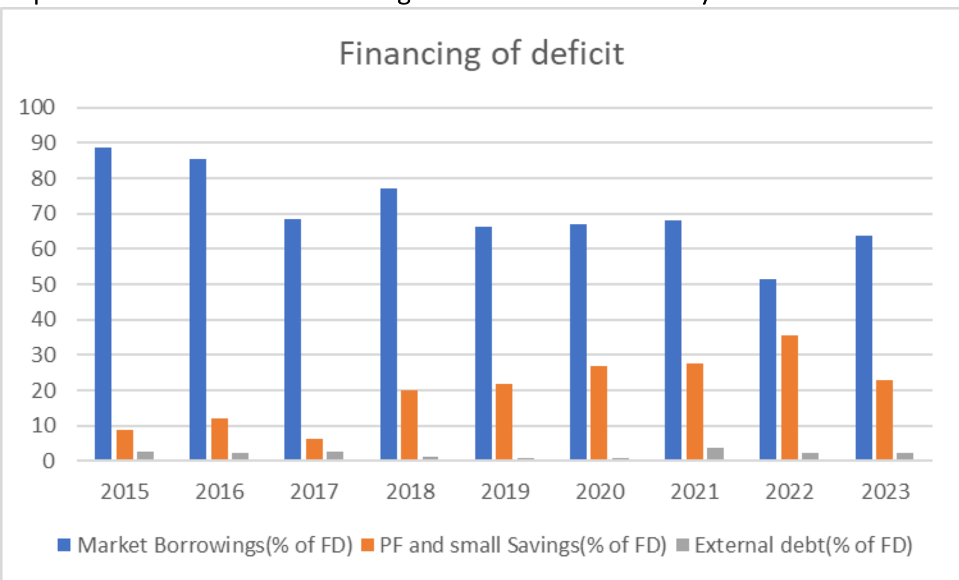

Fig 24) Source – India Budget multiple years

India’s debt has a favourable currency composition and maturity profile too. Nearly 90% of general government debt is long-term, while only 2.1% of central government debt was issued externally in 2022-23.

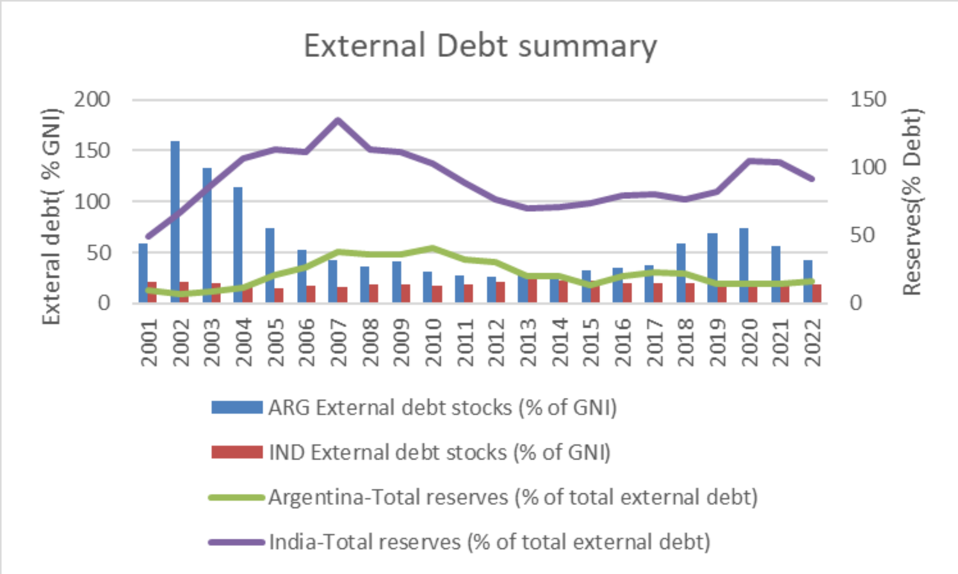

Fig 25) Source – World Bank, 2023

But available fiscal resources leave no room for meeting emerging priorities, notably climate change, or responding to shocks, such as declining rates of domestic and global growth.

The combined fiscal deficit of central and state governments accounted for almost the entire investible surplus in the form of household financial savings and net capital inflows in 2022-23, leaving limited scope for borrowing by the private sector and the PSUs.

Interest payments currently absorb 25 percent of total revenues and could become explosive if yields were to rise.

Though the moderation in government investment spending this fiscal helped reduce the Centre's budget deficit, it also impacted the impulse to growth.

As a large part of revenue expenditure is committed, and politically beneficial welfare seems here to stay - persistent increase in tax revenue through robust growth is critical for lowering the fiscal deficit.

An elevated growth also suppresses the interest-growth differential, causing a higher probability of successful future debt repayments. This motivates lower risk default premium, which in turn shrinks the deficit, freeing economic resources for growth - in a virtuous cycle.

Higher growth is THE only means to sustainability of debt for India, in its current fiscal trajectory.

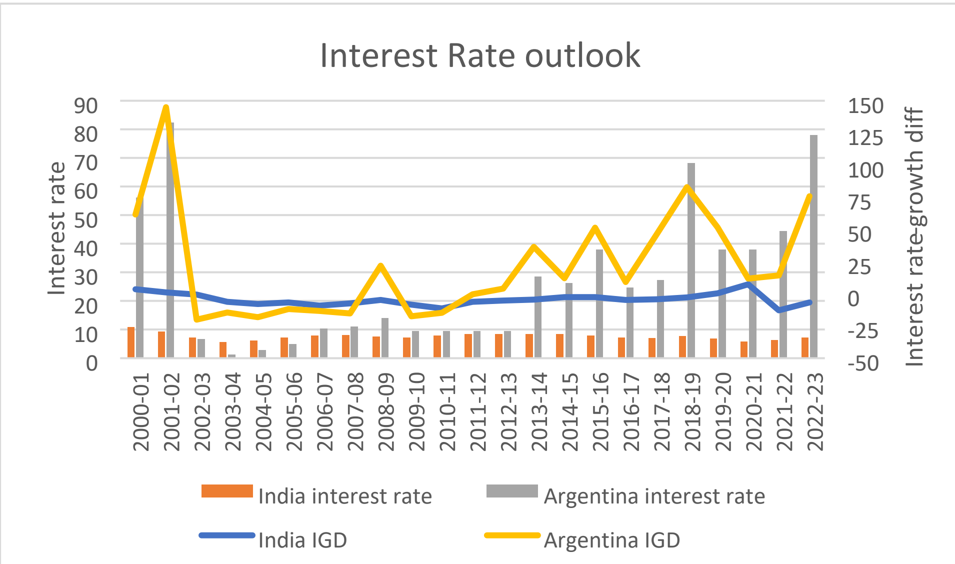

Fig 26) Source – RBI, IMF and World Bank multiple years

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Conclusion

Moving forward, achieving a balance between growth focused investments and fiscal discipline will be essential. With the limited fiscal space available, it is essential to ensure optimal expenditure efficiency for both recurrent and capital outlays. While continuing with the investment-led approach to bolster economic growth since the onset of the pandemic, crowding in more private investments through effective public private partnerships is critical to maximize the benefits from the fiscally constrained capEx allocations. Private investors are better allocators of capital, helping avoid wasteful spending.

It is worthwhile to remember that in the case of a protracted growth shock, market sentiment toward sovereigns with large fiscal imbalances can shift abruptly – Argentina being a stark reminder.

Statements and Declarations

- Conflict of Interest – None
- Data availability – Publicly available data (mentioned in references)
- Funding – None
- Author contribution – Author is sole contributor in concept, data collation, presentation, manuscript

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