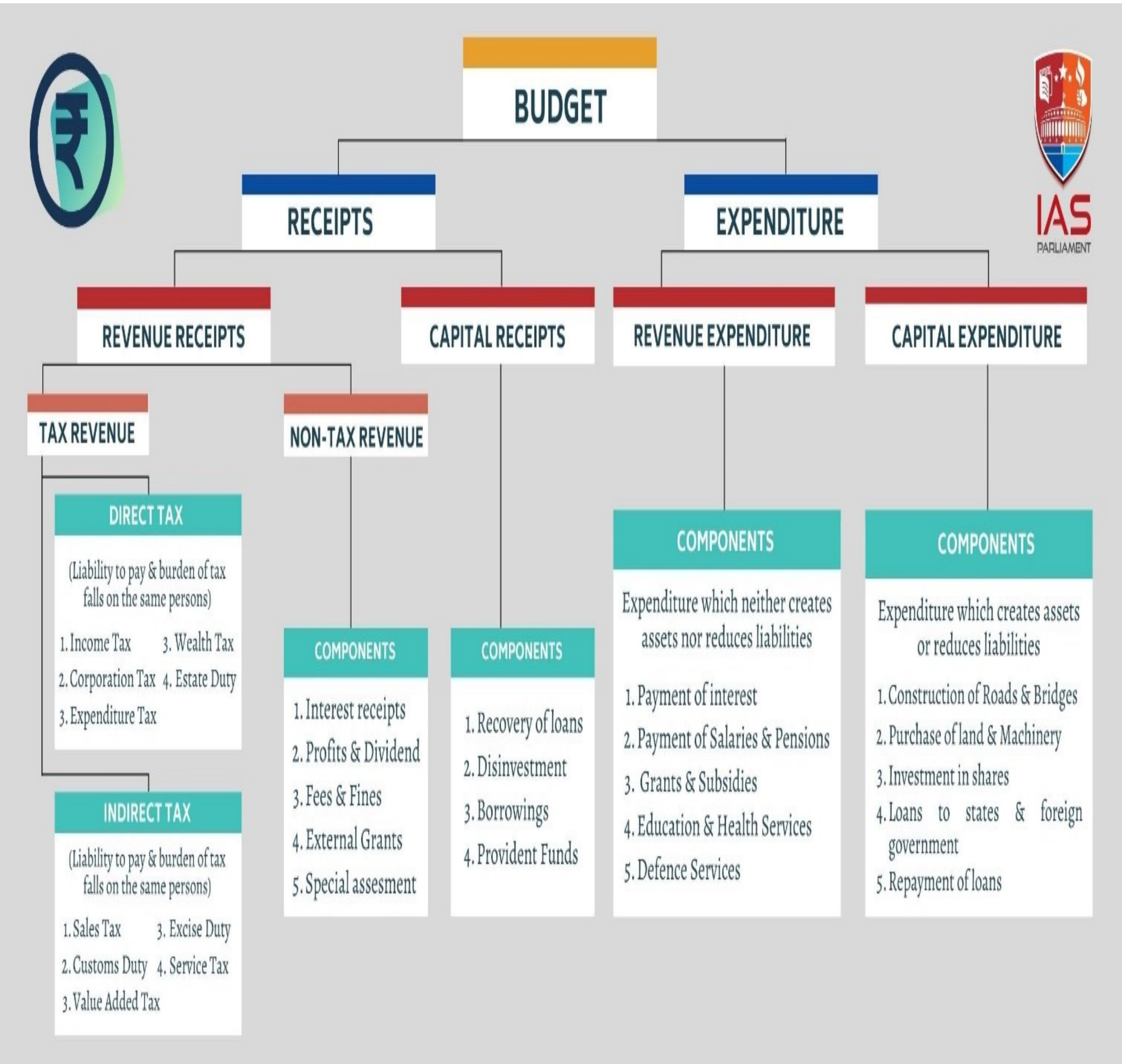
The Emphasis on Capital Expenditure

What is the issue?

Recently, Finance Minister Nirmala Sitharaman held a meeting with Chief Ministers and Finance Ministers of all the States and Union Territories to push the States to focus on capital expenditure.

What is capital expenditure?



- Capital expenditure (Capex) is the money spent by the government on the development of machinery, equipment, building, health facilities, education, etc.

- Capital expenditure includes money spent on the following:
    - Acquiring fixed and intangible assets
    - Upgrading an existing asset
    - Repairing an existing asset
    - Repayment of loan

Capital Expenditure	Revenue Expenditure
Capital expenditure is the expenditure by the government for the development of fixed assets.	Revenue Expenditure is the expenditure by the government which does not impact its assets or liabilities.
Along with the creation of assets, it also includes repayment of loan.	It includes salaries, interest payments, pension, and administrative expenses.
If an item has a useful life of more than one year, it is be capitalized (i.e., can be considered CapEx).	If an item has a useful life of less than one year, it shouldn't be capitalized (i.e., cannot be considered CapEx).
Capital expenditure is a payment for goods or services recorded - or capitalized - on the balance sheet.	Revenue Expenditure must be expensed on the income statement instead on the balance sheet.

What is the significance of capital expenditure?

- **Multiplier effect** - Capex has the maximum multiplier effect (change in rupee value of output with respect to a change in rupee value of expenditure).
- This multiplier effect works through expansion of ancillary industries and services and job creation.

According to National Institute of Public Finance and Policy, every rupee spent as a revenue expenditure has a multiplier effect of Rs 0.98 while capex delivers a multiplier effect of Rs 2.25 in the year it is incurred and Rs 4.80 during the course of the entire expenditure.

- **Labour productivity** - On the supply side, Capex can facilitate labour productivity.
- **Macroeconomic stabiliser** - Capital expenditure is an effective tool for countercyclical fiscal policy and acts as a macroeconomic stabiliser.
- **Revenue generation** - Capital expenditure leads to the creation of assets are long-term in nature and allow the economy to generate revenue for many years and boosts operational efficiency.
- **Liabilty reduction** - Along with the creation of assets, repayment of loan is also capital expenditure as it reduces liability.
- **Economic growth** - Government capex catalyses private investment,

increases production capacity thereby speeding up economic growth which in turn creates a lot more jobs.

What is the status of Government spending on capital expenditure?

- The budgetary allocation towards capital expenditure is Rs 5,54,236 crore in FY2021-22 which is a rise of 34.5% over FY2020-21.
- The States cumulatively spend more on capex than the Centre. In FY21, the states spent Rs 4.46 lakh crore while the Centre's spend was Rs 4.12 lakh crore.
- States spending on capex has better multiplier effect than the expenditure incurred by the Centre because the Centre's capex includes defence capital spending (roughly about Rs1 lakh crore) which provide little impetus to the Indian economy.
- But, the money spent by states is not uniform throughout the year but is bunched up and spent in the last quarter of the fiscal.
- Sometimes, the states are unsure of the revenue flow and prioritise revenue expenditure and asset creation happens towards the end of the fiscal.

What measures have been taken to boost the states' Capex spending?

- The Finance Ministry recently fixed quarterly targets and incentivised those that achieved it to borrow more.
- The States were supposed to spend 15% of the budgeted capex by Q1, 45% by Q2, 70% by Q3 and 100% by Q4.
- In Q1 of FY22, combined capex of 23 States rose by 15% than in FY20 and the Centre's capex rose by 55% in Q1 FY22 than in FY20.
- Some States opposed that such a policy impinges on fiscal federalism and argued that States had the right to spend the money they get from devolution the way they want.
- Most of the high GDP States like Maharashtra, Tamil Nadu, Gujarat and Rajasthan failed to meet the target.
- The Finance Minister decided to release a month's devolution in advance (Rs 95,082 crore was released on November 22) to leave enough cash in the hands of the States so that they could ramp up the capex.

Will the States change their approach?

- This is debatable considering the uncertainty that the pandemic has created when it comes to revenue generation.
- **Uncertainty in economic recovery** - Even though GST collections have

risen sharply, it is not clear if it is due to increased demand or a sustained recovery and it is too early to say if the Coronavirus has been vanquished.
- States may want to wait and watch before ramping up capex with many European countries imposing total lockdown again.
- The Centre is better placed to spend more on capex as it gets revenue from various types of cess that are not shareable with the States.
- **Additional debt -** For many States the additional borrowing is not an incentive as they are already heavily leveraged and would not want to add to the debt.
- Tamil Nadu, Andhra Pradesh, Sikkim and Manipur, have negative cash balance as of end-October and it is unclear if they will use it on capex or prefer to clear their pending revenue expenses.
- **Need for Capex** - Spending on roads, power plants, ports and airports generate better multiplier effect than investing in buildings.
- Both the Centre and the States should also focus on the quality of capex.
- It is necessary if India has to escape its current moderate pace of economic expansion and post strong double digit GDP growth in a sustained manner in the future.

References

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