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Role of government capital expenditure in India's capital formation

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Introduction

Over the past three decades, developing countries, including India, have been facing crucial challenges in their development paths. One notable concern is the widening gap between revenue and capital expenditure. This discrepancy arises from the exponential growth of revenue expenditure and the comparatively slower linear increase in capital expenditure. The latter plays a crucial role in the economy, since capital investments are well-justified, as they hold the potential to trigger a substantial multiplier effect on both economic growth and employment (Bose and Bhanumoorthy 2013). The primary goal of it is to bolster the economy's productive capabilities, thereby facilitating the optimal utilization of previously untapped labour and natural resources (RBI, 2023). Moreover, these strategic investments play a vital role in fostering efficiency and stimulating innovation across various sectors of the economy. By wisely channelling resources into projects that boost infrastructure and expand key sectors, governments can set the stage for sustainable economic development and overall progress. Against this back drop this study aims to analyse trends and patterns of India's capital formation and specifically focuses on the role of government capital expenditure in contributing to India's capital formation.

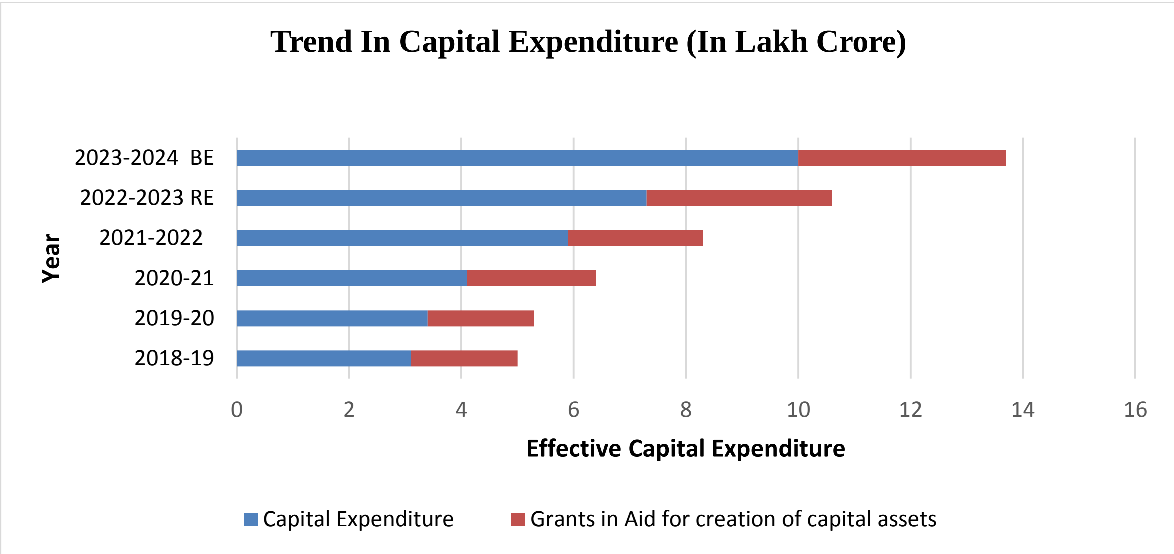
The analysis is divided into six sections. Section two examines the trends and patterns of India's capital expenditure over the years. Section three and four are focused on the role of capital expenditure in India's capital formation, specifically analysing its impact on the Union

Budget 2023-24 and overall capital formation. The discussion concludes with presenting the findings derived from the analysis.

Trends and patterns of India's capital expenditure

The trends in allocation for capital expenditure over different budgets (Figure 1) shows that considering the past five years, allocation for capital expenditure has gone through a drastic shift. 2021-22 budget onward allocation for both capital expenditure and grants in aid for creation of capital assets for states also witness a major hike, in 2018-19 the effective capital expenditure was 5 lakh crore which increased by 174 percentage that is 13.7 lakh crore in 2023-24 budget.

Figure 1: Trends in effective capital expenditure

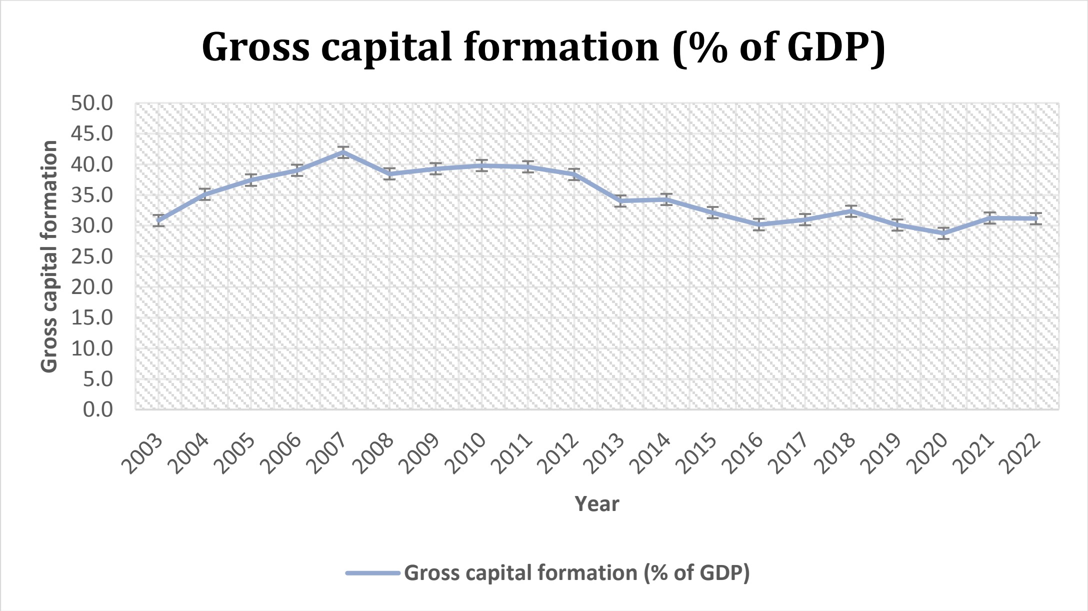


Source: -Various Union Budget documents

India's capital expenditure: A pivotal force for capital formation

As an emerging economy, India places significant emphasis on capital formation to drive sustainable economic growth and development. Figure-2 illustrates that India's gross capital formation has exhibited fluctuations over the years, reflecting the nation's economic cycles and the impact of policy interventions. According to the World Development Indicator Database, India's capital investment to GDP ratio stood at 31.2% in 2022, which is notably higher than that of other BRICS countries.

Fiqure-2: India, Gross capital formation (% of GDP)

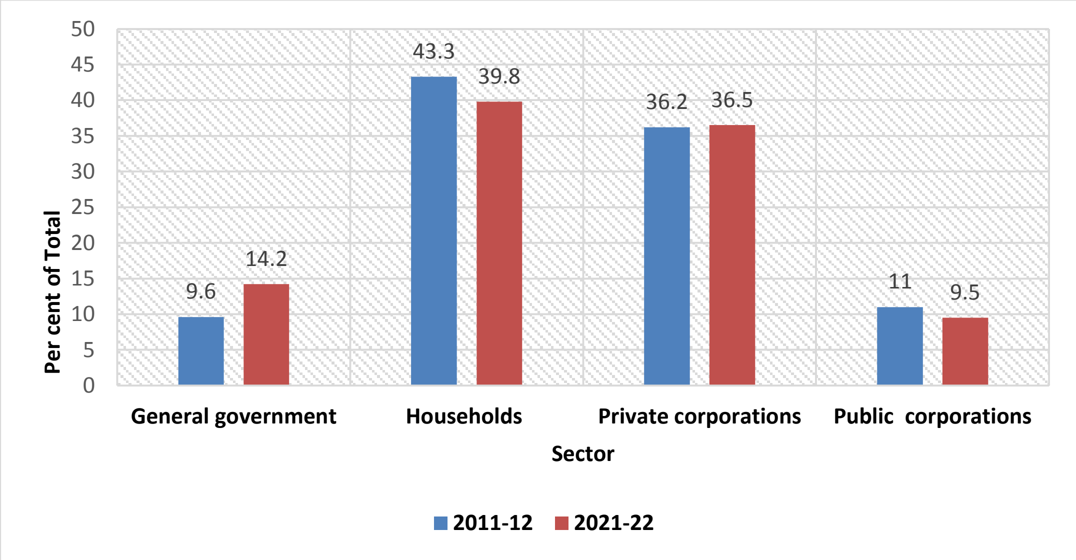


Source: WDI, World Bank

This higher capital investment to GDP ratio also indicates India's potential for increased productivity, job creation, and economic diversification. By directing substantial investments into various sectors, India is laying the foundation for sustained economic expansion and enhancing its global competitiveness. Additionally, the increase in gross capital formation is also a testament to India's efforts to foster an investment-friendly environment. Government initiatives like "Make in India," "Startup India," and "Atmanirbhar Bharat" have incentivized both domestic and foreign investors to participate in India's growth story. Moreover, the emphasis on digitalization, innovation, and research and development has attracted significant investments in technology and knowledge-intensive sectors.

One significant aspect of India's Gross Capital Formation is the notable contributions made by different sectors, namely households, private sector, and general government. Official data indicates that these three sectors play critical roles in driving the country's capital formation. A sector-wise analysis of India's Gross Capital Formation in Figure-3 reveals that in 2022, the household sector contributed approximately 40 percent, the private sector contributed 36.5 percent, and the general government contributed 14.2 percent to India's overall capital formation in 2021-22.

Figure-3: Gross Capital Formation in India -Sector wise



Source: National Statistics Office (NSO)

The household sector's substantial contribution reflects the participation of individuals and households in savings and investments, which supports the growth of the economy. However, over the years, there has been a slight reduction in households' contribution to gross capital formation.

On the other hand, the private sector's contribution remains significant and indicates the robustness of entrepreneurship and investment activities in India. Moreover, the general government's increasing contribution to gross capital formation highlights the government's role in infrastructure development, social investments, and public expenditure. The government's initiatives in investing in key sectors such as healthcare, education, and transportation contribute to the overall growth and development of the nation.

Does the union budget 2023-24 contribute to the capital formation process?

To accelerate the upward cycle of investment and job creation, the capital expenditure budget increased by 37.4% in BE 2023-24 to a staggering Rs. 10 lakh crores over Rs. 7.28 lakh crore in RE 2022-23. This is consistent with the government's focus on and commitment to the Four I's - infrastructure, investment, innovation, and inclusion for a long-term perspective. Over and above that, it is an indication that the new budget seeks to ensure the equity and equality of these investments throughout the country.

The capital expenditure is allocated across various sectors, including transport, rural development, railway, and defence. The transport sector, which includes roads, ports, and railways has been allotted the highest capital expenditure of 5 lakh crore. This is in line with the government's focus on improving the country's transportation infrastructure to enhance connectivity and promote economic growth. Another important sector which comes under the capital expenditure head is the defence sector, the sector has been allotted a capital expenditure of Rs. 1.72 lakh crore, among various ministries; ministry of communication (63 lakh crore), and ministry of urban affairs (25 lakh crore) are allocated more fund for capital expenditure.

According to RBI report this increase in the allocation for capital expenditure, will have a dynamic capital expenditure multiplier which rises from 1 in the first year to 2.45 in the second year, 3.14 in the third year and peaks at 3.25 in 2026-27. Capex on railways and loan assistance to States will contribute 43 per cent of this increased income while investment in logistics is expected to generate 19 per cent of the increased income during 2023-27.

Is capital expenditure only matter for economic growth?

Capital expenditure is undoubtedly vital for economic growth; however, it is equally crucial for the budget to address the growth and demand for human capital simultaneously. This can only be achieved by a balanced investment plan in both capital and social sector. When we are considering certain programmes like MNREGP, the budget is keeping with the recent trend of cutting the allocation for its flagship rural jobs programme. The budget allocation for the Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS) is only 60,000 crores. That is 18% lower than the ?73,000 crore budget estimates for FY 2022-23 and 33% lower than the ?89,000 crore revised estimates of FY 2022-23. This trend was preceded in FY 2021-22 as well. There was a slash of 25% to ?73,000 crores from 2021-22 revised estimates. Apart from MGNREGS, some of the vital segments of the economy such as rural development receive less allocation as it was reduced to 238204 crore which is less than revised estimates for 2022-23. The Micro, Small and Medium Enterprises (MSME) sector is a vital contributor to India's rural economic growth, providing employment opportunities and contributing to the country's GDP. But the current budget gives only less weightage to this sector, the allocation for MSMEs is not adequate and there is not much improvement in fund allocation for this sector. However, an increase in infrastructure investment without sufficient employment elasticity and a reduction in social sector spending could negatively impact social indicators and contribute to inequality. Therefore, while investment in capital expenditure can boost the economy, it is crucial for the budget to simultaneously focus on growth and demand for human capital. This would involve not only investing in physical infrastructure but also supporting education and skill development to create a more educated and skilled workforce that is better equipped to meet the demands of the economy for the future. In conclusion, a balanced approach that considers both capital and revenue expenditure and prioritizes human capital development is necessary to ensure sustainable economic growth and reduce inequality.

Concluding remarks

The primary goal of capital expenditure is to strengthen the economy's productive capabilities, facilitating the optimal utilization of previously untapped labour and natural resources. Over the past five years, there has been a significant shift in the allocation for capital expenditure. For instance, in 2018-19, effective capital expenditure was 5 lakh crores, and it surged by a remarkable 174% to reach 13.7 lakh crore in the 2023-24 budget. Data from the National Statistical Office further indicates that the government's contribution to the country's overall capital formation has been increasing. It rose from 9.6% in 2011-12 to 14.2% by 2021-22. This growing contribution highlights the government's efforts in boosting capital expenditure. While capital expenditure is crucial, a balanced approach is equally important, encompassing both capital and revenue expenditure, to ensure sustainable economic growth and reduce inequality effectively. By wisely considering both aspects, the government can foster an environment conducive to lasting economic development and equitable prosperity.

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