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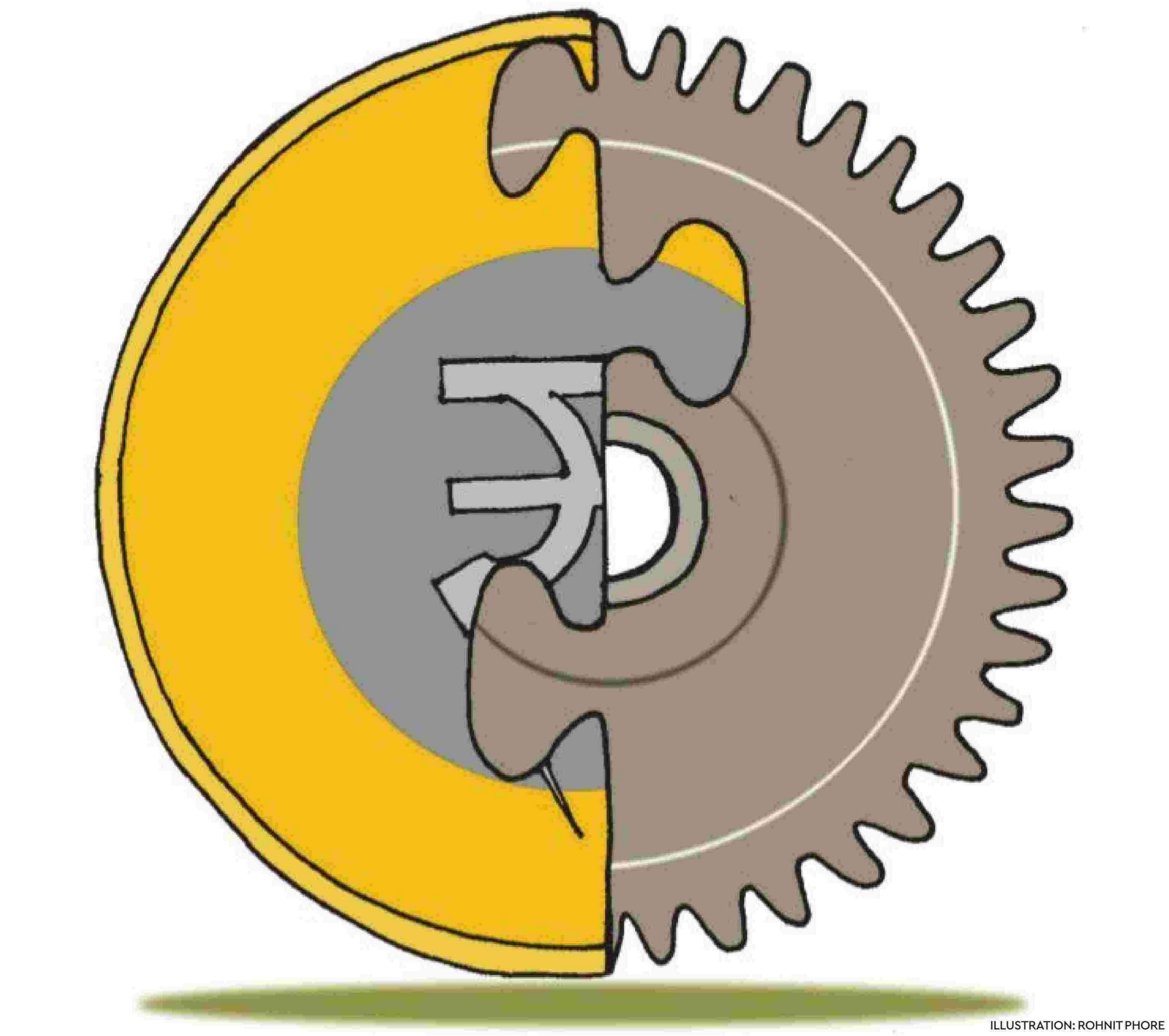

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# Can capital expenditure boost the economy?

With the current impetus rightly given to capital expenditure, emphasis must also be provided on timely implementation of projects within the earmarked outlay by strengthening monitoring, redressal mechanisms and processes for controlling project delays

THE DEBATE AROUND the ability of capital expenditure to boost long-term growth within the Indian economy, given both the pre- and the post-pandemic weak economic environment, has seen a wide range of varying opinions being presented by economists and policymakers.

**The Union Budget and the argument for capex:** The recent budgetary allocation towards capital expenditure at ₹5,54,236 crore in FY2021-22(BE) is a rise of 34.5% over FY2020-21. This is significant if we compare 21.71% rise in FY2020-21(BE) over FY2019-20(BE). This move is significant against the backdrop of the economic slowdown caused due to the Covid-19 pandemic, coupled with a decline in employment ratio.

A lack of capital expenditure has often been criticised as neglecting long-term targets of economic growth and employment. While creating direct consumer demand is an important lever for immediate boost to the economy, it may not sustain a high growth trajectory in the longer term. The creation of capital assets generates future cash flows for the economy and adds to value creation.

Capital expenditure is expected to achieve this through a multiplier effect (a change in rupee value of output with respect to a change in rupee value of expenditure). In India, the multiplier effect of capital expenditure made by the central government is estimated at 2.45, whereas for state governments it is around 2 (according to the RBI Bulletin, December 2020). A ₹1 crore increase in capital expenditure leads to more than ₹1 crore increase in GDP. This multiplier effect works through expansion of ancillary industries and services and job creation. On the supply side also, it can facilitate labour productivity. Thus, capital expenditure is an effective tool for countercyclical fiscal policy and acts as a macroeconomic stabiliser.

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## Concerns

However, this multiplier effect will not take into account the time-lag to kick in, capacity availability in the industry, and undisposed inventory and work in progress before the pandemic-induced lockdowns. Most importantly, given the pandemic, the multiplier effect loses value if people hold idle cash out of fear of unforeseen expenses and survival paramountcy during possible future lockdowns. This appears a distinct possibility in the raging second wave of the pandemic. Inflation-induced price rise, particularly in food and health, could also affect the multiplier impact as households would tend to give them priority over other consumption items. This was indeed the case until the last quarter.

Also, capital expenditure funded by the government through heavy domestic borrowing (of the order of ₹18 lakh crore by the Centre plus ₹78,000 crore by 21 states towards loss in GST compensation due to the lockdown effect) has the potential of crowding out capital expenditure by the private sector, thus severely weakening the multiplier effect.

Besides, for viability of a particular capital project, the Internal Rate of Return (IRR) should be more than the Hurdle Rate (HR)/Cost of Funding (CoF). The IRR depends on net cash flow generation from a capital project during its life time. The HR/CoF is decided by the cost of raising capital for the implementation of a project. The IRR should be more than the HR/CoF in order to make the project both economically and financially viable, and contribute to actual value creation in the economy.

The IRR has been benchmarked for capital projects funded by the private sector. For example, the IRR on infrastructural projects on a global scale ranges between 8% and 12%. However, trends in India reveal that the range is 6-8% only, which can be a deterrent to private sector funding of infrastructural projects. Low IRR in the Indian context has traditionally been a result of cost and time overruns. According to the Ministry of Statistics and Programme Implementation (MoSPI) project database as of January 2018, 345 projects have incurred a cost overrun of ₹2.19 lakh crore and 354 projects have time overrun of 45 months. The reasons behind these overruns are lack of forward-planning, identification of risk factors and poor collaboration amongst stakeholders. Besides, the regulatory uncertainty arising out of sudden legal, legislative changes or change in government policies like the imposition of the retrospective tax (like Vodafone and Cairn India cases) adversely impacts IRR margins. The Asian Development Bank also noted that the project implementation costs in India's transport industry were substantially higher than in Sri Lanka and China.

Also, an aspect that goes under the radar is the defective and often-manipulated Detailed Project Reports (DPRs) that exaggerate output and outcome forecasts; for example, in an ayacut area (area served by an irrigation project such as a canal, dam or a tank) that would be irrigated once a mega or medium irrigation project is being evaluated for implementation, just to show economic viability for the project knowing fully well that, eventually, the IRR would be far less than the HR/CoF.

What is also equally important is the long-term quality of capital creation, as poor quality necessitates recurring maintenance costs attached to a project after its completion.

## The way forward

With the current impetus rightly given to capital expenditure, emphasis must also be provided on timely implementation of projects within the earmarked outlay by strengthening monitoring, redressal mechanisms and processes for controlling project delays. The solution lies in optimising project management processes of all the key stakeholders, including implementation agencies, state governments, vendors and others. This would also help in ensuring quality control, which, in turn, will result in capital assets providing benefits over a longer term following the multiplier effect. The maintenance, repair and operation (MRO) expenditure, which is part of revenue expenditure, will have to be monitored during project implementation to see to it that it goes on to increase the ability of the capital asset to deliver the projected benefits during the lifetime of the asset.

The government should also aim to cut down on inefficient revenue expenditure and focus on creating a balanced and stable virtuous cycle, which can have positive knock-on effects over the long term. This will help set the foundation for stimulating growth and future investments, while eventually leading the economy to overcome the recessionary pressures it might once again confront if the second wave prolongs.