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Focus of fiscal health: fiscal deficit or Debt-GDP ratio

1. Evolution of thought on fiscal consolidation

Containing fiscal deficit was one of the elements of fiscal reforms initiated in the early 1990s. Fiscal imbalances had started deteriorating in the late 1970s for both central and state governments. The central account went into consistent revenue deficit from FY1980 onwards. On the aggregate account of states, revenue deficit started appearing on a consistent basis from FY1988 onwards. Fiscal deficit for the GoI relative to GDP averaged 5% in the 1990s. An attempt was made to reduce the monetization of fiscal deficit in the 1990s. The system of issuance of ad hoc treasury bills was discontinued in April 1997. GoI's fiscal deficit increased to an average of 5.2% of GDP in the first five years of the 2000s. In order to check this significant increase in GoI's fiscal deficit relative to GDP, a Fiscal Responsibility and Budget Management Act (FRBMA) was enacted in 2003. This Act provided for achieving balance on the revenue account and limiting fiscal deficit to 3% of GDP.

In terms of budgeted fiscal deficit, a level of 3% of GDP was achieved only once in FY08. Subsequent amendments diluted the provisions of the GoI's FRBM Act. Finally, in its 2018 amendment, the target of achieving balance on revenue account was given up altogether. The Act provided,



The Central Government shall –(a) take appropriate measures to limit the fiscal deficit up to three per cent of gross domestic product by the 31st March, 2021.



It also said that the Central Government shall “endeavour to ensure that— (i) the general Government debt does not exceed sixty per cent.; (ii) the Central Government debt does not exceed forty per cent of gross domestic product by the end of financial year 2024-2025.”

Thus, the Act continued to emphasize fiscal deficit relative to GDP while adding additional targets with respect to debt-GDP ratios of the general government and for the union government. In the meantime, states also passed suitable legislations limiting the fiscal deficit at 3% of State Domestic Product. The general government debt-GDP ratio shot up to close to 90% in the COVID year with Gol's debt-GDP ratio increasing to close to 60%. In the FY26 Union Budget, it is contended that we should follow a different path. It has been stated that from now on, the focus will be on annually reducing the debt-GDP ratio. In the annexure statement titled 'Statements of Fiscal Policy as required under the Fiscal Responsibility and Budget Management Act, 2003', alternative paths of the debt-GDP ratio with nominal GDP growth assumptions of 10.0%, 10.5% and 11.0% are given. The glide paths are indicated with alternative assumptions regarding mild, moderate, and high degrees of fiscal consolidation. This makes the effort towards fiscal consolidation somewhat vague. The document outlines a declining path of debt-GDP ratio reaching a level of 50±1% of GDP by FY31. This path is likely to be affected as soon as the recommendations of the Eighth Pay Commission are implemented. It can be shown that if the nominal GDP growth is 10.5%, a fiscal deficit of 3.8% of GDP maintained year after year from FY27 onwards will bring the debt-GDP ratio down to 50% by the end of FY31 as shown in the Table A. This is consistent with a moderate degree of fiscal consolidation scenario, implying a much higher level of fiscal deficit than 3% of the GDP, which should be a matter of concern.

Table A: Path of debt and fiscal deficit with moderate growth and moderate fiscal consolidation (fraction of GDP)

	FY25	FY26	FY27	FY28	FY29	FY30	FY31
Fiscal deficit	0.048	0.044	0.038	0.038	0.038	0.038	0.038
Debt	0.57	0.56	0.55	0.53	0.52	0.51	0.50

Source (basic data): Union Budget documents and MoSPI.

There is no indication whether the FRBMA-2018 target of 40% of debt-GDP ratio has been given up altogether.

2. FRBM target and sustainable combinations of fiscal deficit and debt-GDP ratios

In the discussion on sustainability, given an underlying nominal GDP growth, sustainable fiscal deficit and debt-to-GDP ratios are estimated as a combination. Government debt is sustainable if the debt-GDP ratio remains stable when a fiscal deficit-to-GDP ratio is maintained year after year. Combinations of these can be derived for different underlying nominal GDP growth rates. The FY26 Union Budget recognizes that there is some uncertainty regarding an appropriate nominal GDP growth, which can be considered for the medium term. For the three growth assumptions given in the 'Statements of Fiscal Policy as required under the Fiscal Responsibility and Budget Management Act, 2003' of the FY26 Union Budget, the levels of fiscal deficit at which debt-GDP ratio will be stabilized at 40% are given in the following table. A lower nominal GDP growth calls for maintaining a lower fiscal deficit relative to GDP for sustaining a given debt-GDP ratio, as illustrated in the Table B¹.

¹ With b^* and f^* representing sustainable levels of debt and fiscal deficit relative to GDP, their values are related to the nominal GDP growth g by the following relationship $b^* = f^* \cdot \frac{(1+g)}{g}$.

Table B: Sustainable combinations of debt and fiscal deficit relative to GDP for alternative nominal GDP growth assumptions

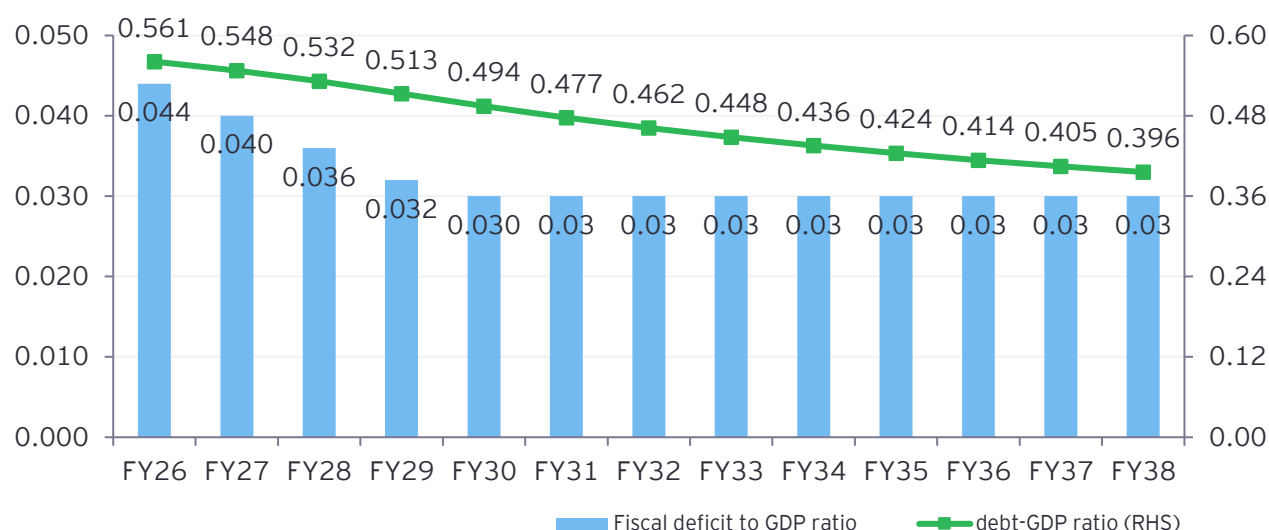
Debt GDP ratio (b*)	Fiscal deficit-to-GDP ratio (f*)	Nominal GDP growth (g)	Year by which desired level of debt-GDP ratio would be reached
0.400	0.0364	0.100	FY2087
0.400	0.0380	0.105	FY2084
0.400	0.0396	0.110	FY2082

Source (basic data): Union Budget documents and MoSPI.

Table B shows the terminal year by which different combinations of nominal GDP and fiscal deficit-to-GDP ratio would lead to a stable debt-GDP ratio of 40%. This FRBM target value would be reached in the 2080s in all the three cases. It can also be seen that throughout the period from now until these terminal years, Gol's debt shows a declining path as a percentage of the GDP. If the year for reaching the FRBM target is to be advanced, we may have to settle for a lower fiscal deficit.

Thus, assuming a nominal GDP growth of 10.5%, a declining path of fiscal deficit-to-GDP ratio reaching a level of 3.2% by FY29 and subsequently remaining unchanged at 3% of GDP, would enable reaching the FRBM debt-GDP target of 40% by FY38 as shown in Chart A.

Chart A: Illustrative glide path to reach FRBM target of 40% of debt-GDP ratio



Source (basic data): Union Budget documents and MoSPI.

The problem arises when an economic shock occurs. Then a decision to depart from the fiscal deficit path is taken to introduce a fiscal stimulus. At that point, the idea of a declining debt-GDP ratio path may have to be given up. The debt-GDP ratio is likely to shoot up and the margin of deviation cannot be indicated a priori. In fact, fiscal deficit always comes first with respect to which the annual decision has to be taken. Then the net borrowing is added to the outstanding debt of the previous year to derive the outstanding debt for the current year.

3. Fiscal deficit and saving-investment balances

The Twelfth Finance Commission had argued that the investible surplus for the private corporate sector and the non-government public sector can be derived as the excess of household financial savings and net inflow of foreign capital over the draft of this total investible surplus by the central and state governments through their borrowing. In this context, the Twelfth Finance Commission had observed (Para 4.41 of their Report),



The transferable savings of the household sector of 10 per cent of GDP combined with an acceptable level of current account deficit of 1.5 per cent would be adequate to provide for a government fiscal deficit of 6 per cent, an absorption by the private corporate sector of 4 per cent, and by non-departmental public enterprises of 1.5 per cent of GDP.



The recent tendency is for the household financial savings to come down. As per information available from the RBI, in FY23 and FY24, it was 5.0% and 5.3% of nominal GDP respectively as against an average of 7.6% during FY18 to FY22 excluding the COVID year of FY21. With 5% of household savings and about 2% of net inflow of foreign capital, available investible surplus of 7% will be fully pre-empted by the fiscal deficits of central and state governments at about 7.4% of GDP. The non-government public sector and private corporate sector may have to borrow from abroad, increasing the net inflow of foreign capital well above sustainable levels. Conditions may also not be conducive to reduce the policy rate when investment demand exceeds available investible surplus. There is thus, strong logic behind maintaining the fiscal deficit of Gol and states taken together at 6% of GDP and a path of fiscal consolidation consistent with this may be followed.

4. Interest payments and revenue receipts

In India's context, if the debt-GDP ratio remains relatively high compared to the norms given in the Gol's and states' FRLs, the ratio of interest payment to revenue receipts is also likely to remain high, pre-empting government's revenue receipts while leaving progressively lower shares for financing non-interest expenditures. The ratio of Gol's interest payment to revenue receipts net of tax devolution, which had fallen to 35% in FY17, has increased to an average of 38.4% during FY22 to FY24. This ratio has fallen to 36.9% in the revised estimates for FY25 but is budgeted to increase again to 37.3% in FY26. In fact, there has been a tendency for Gol's effective interest rate to rise. This is because the Gol has been extending to the state governments interest-free loans since the COVID year of FY21. Estimates indicate that Gol's effective interest rate has crossed 7% in FY26 (BE) from an average level of 6.77% during FY20 to FY25 (RE).

There are many countries which have a far higher level of government debt-GDP ratio as compared to India. Their interest payments to revenue receipts ratio, however, are much lower. For example, during 2015 to 2019, the ratio of interest payment to revenue receipts averaged only 5.5%, 6.6% and 8.5% for Japan, the UK and the US, respectively (IMF). This is because their revenue receipts relative to GDP are much higher and interest rates are much lower than comparable ratios in India's case. In contrast, Gol's interest payment to net revenue receipts, that is, after excluding tax devolution to states, is estimated at 37.3% in FY26 (BE). This ratio increases to 50.4% of Gol's net revenue receipts after both tax devolution and grants to states are excluded.

As it stands now, the goal is unclear. Since the operating variable is fiscal deficit, we need to translate the preferred path of debt-GDP ratio into the implied path of fiscal deficit to GDP ratio. We can then find out whether that fiscal deficit is appropriate for the targeted debt-GDP path. In fact, a larger claim on the available investible resources by the government may make it difficult for the private investment to pick up. The Gol may also be mindful of the impact of the message it is sending to the states by shifting the focus to only annually reducing the debt-GDP ratio.

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Views expressed are personal.