

Stick to fiscal deficit as the norm for fiscal prudence

Government expenditures exceeding revenue by a high margin can lead to a difficult situation. In the 1980s, rising fiscal deficit accompanied by rising government debt led to a difficult balance of payments situation and a high ratio of interest payment to revenue receipts. This forced the government to borrow progressively more to meet developmental expenditures.

Budget pointer

In the final 2024-25 Union Budget, the Finance Minister said, "From 2026-27 onwards, our endeavour will be to keep the fiscal deficit each year such that the Central government debt will be on a declining path as percentage of GDP." The Budget speech also says that the Centre's fiscal deficit would be reduced to 4.5% of GDP in 2025-26 from its budgeted level of 4.9% in 2024-25.

With these levels of fiscal deficit in two consecutive years, the Centre's debt-GDP ratio is estimated at 54% in 2025-26, assuming a nominal GDP growth of 10.5% in these two years. After this, the central government aims to have only a reducing path of debt-GDP ratio without stating a debt-GDP target and specifying a path to reach that. This implies effective abandoning of the Centre's Fiscal Responsibility and Budget Management (FRBM) 2018 debt-GDP target of 40% for the central government and 60% for the combined government for an indefinite period. It can be shown that with a nominal GDP growth in the range of 10%-11%, a falling path of the debt-GDP ratio can be ensured year after year while maintaining a fiscal deficit-GDP ratio for the Centre at 4.5%. In fact, at this level of fiscal deficit, the debt-GDP ratio would reach a level of 48% by 2048-49 while showing a falling debt-GDP ratio all along. State governments, in their respective Fiscal Responsibility Legislations (FRLs), have adopted a fiscal deficit-Gross State Domestic Product (GSDP) target of 3%. They may also be tempted to abandon their targets and only show a falling path of their respective debt-GSDP ratios. If the two levels of government maintain, on average, fiscal deficit to GDP ratios of 4.5% and 3% net of intergovernmental lending, the average combined fiscal deficit would amount to 7.5% of GDP for several years.

Such a profile of debt and fiscal deficit, while consistent with a falling debt-GDP/GSDP profiles,



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With the current lower levels of household financial savings, having 3% of GDP as a limit to fiscal deficit should be the focus

would leave little space for the private sector to access available investible surplus unless current account deficit is increased beyond sustainable levels.

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 surplus by the central and State governments through their borrowing. In this context, the Twelfth Finance Commission had observed (paragraph 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 household financial savings to come down. In 2022-23, it was 5.3% of GDP as against 7.6% in the previous four years excluding the COVID-19 year of 2020-21. With 5.3% of household savings and about 2% of net inflow of foreign capital, available investible surplus of 7.3% will be fully pre-empted by the fiscal deficits of the central and State governments at about 7.5% of GDP. We can look at a higher level of fiscal deficit only if household financial savings rise.

Sustainable debt and fiscal deficit

There is a simple arithmetic relationship between fiscal deficit and debt-GDP ratio. To reduce the debt-GDP ratio, one has to act on fiscal deficit-GDP ratio, which essentially means change in the debt-GDP ratio between two consecutive years. The fiscal responsibility framework, which has been built in India after 2003, with States coming on board with their respective FRLs, has considered suitable combinations of debt-GDP/GSDP levels along with fiscal deficit-GDP/GSDP levels.

In India's context, if the debt-GDP ratio remains relatively high compared to the norms given in the FRLs of the Centre and States, the ratio of interest payment to revenue receipts would also remain high, pre-empting government's revenue receipts while leaving progressively lower shares for financing

non-interest expenditures. The ratio of Centre's interest payment to revenue receipts net of tax devolution, which had fallen to 35% in 2016-17, has increased to an average of 38.4% during 2021-22 to 2023-24. This ratio averaged 51.6% if we consider the Centre's revenue receipts after taking into account all transfers including tax devolution and grants.

An international comparison

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, however, are much lower. For example, during 2015-19, the ratio of interest payment to revenue receipts averaged only 5.5%, 6.6% and 8.5% for Japan, the United Kingdom and the United States, respectively (International Monetary Fund). In contrast, during 2015-16 to 2019-20, India's combined interest payment to revenue receipts ratio was 24% on average with the Centre's post transfer ratio averaging 49%.

While recent pronouncements talk of the debt-GDP ratio as the policy variable, they do not, however, specify what that target is for India and what the path would be to reach that target from the current levels of debt-GDP ratio. The problem in the context of macro-stabilisation is that when a major disturbance occurs, such as the COVID-19 pandemic in our recent past, it took just one year for the central debt-GDP ratio to shoot up from 50.7% in 2019-20 to 60.7% in 2020-21.

However, returning to the pre-COVID-19 level of debt-GDP ratio has taken much longer and we are still nowhere close to reaching that. The paths of adjustment of upward and downward movements of debt-GDP ratio due to a macroeconomic shock often tends to be asymmetric. Governments find it convenient to keep postponing the downward adjustment in the debt-GDP ratio while continuing to nurse high levels of interest payment relative to revenue receipts. There is no point in urging private investment to grow if the available investible surplus is limited. With the current lower levels of household financial savings, it is better for the central government to stick to 3% of GDP as a limit to fiscal deficit. We need to draw up a road map to achieve that level. Any relaxation of this rule will only lead to fiscal imprudence.