Opinion

How far can the fiscal deficit be stretched?

C Rangarajan/DK Srivastava | Published on February 24, 2021

There may not be leeway to specify a combination of fiscal deficit and debt that is very different from the current FRBM norms

The Union Budget for 2021-22 has provided for a sharp relaxation of the Central government's fiscal deficit to 9.5 per cent in 2020-21 and 6.8 per cent of GDP in 2021-22. The combined fiscal deficit and debt of the Centre and States may be much higher in 2020-21 at about 14 per cent and 90 per cent of GDP. These levels, exceeding the current FRBM norms of 6 per cent and 60 per cent by wide margins, have been justified as a countercyclical response to the Covid crisis. Now, the issue is to guide these back to levels consistent with debt sustainability.

The Economic Survey 2021 has argued the case for raising the fiscal deficit on the basis of a positive growth-interest rate differential. The Survey contended that the line of causation runs from higher growth to debt sustainability rather than vice versa and that the higher the excess of growth rate over interest rate, the higher could be the primary deficit to GDP ratio consistent with debt sustainability.

The Survey, however, did not indicate a steady state or long-term combination of the levels combined debt and fiscal deficit relative to GDP, if the present FRBMA is to be amended.

For deriving a steady state, the focus should be on potential growth rate and the long-term interest rate. The relevant interest rate in the derivation of debt sustainability condition is the average interest rate on government debt. This is also indicated in the Economic Survey where the applicable nominal interest rate is derived by dividing interest payment in a given year by the outstanding debt at the end of previous period *(Volume 1, Chapter 2)*. This is a weighted sum of the contracted interest rates on past debts. This should be distinguished from the interest rate at which current borrowing can be done which may be referred to as the marginal interest rate.

If the marginal interest rate falls, the average interest rate would also fall but at a lower pace. This is reflected in the movement of the effective interest rate obtained by dividing combined interest payments by combined debt. During FY16 to FY20, this interest rate has fallen only from 7.4 per cent to close to 7 per cent. By pumping in additional liquidity, the current nominal interest rate can be driven down.

But this may raise the inflation rate above the policy target rate and may well reduce the real interest rate, having an adverse impact on the overall savings rate. Such a policy can only lead to financial repression with all the attendant problems.

Asset mis-pricing will also be a consequence which can have serious implications. Thus, the maintainable longer term nominal interest rate for government debt may have to be close to 7 per cent, derived by combining a CPI inflation rate of about 4 per cent and real interest rate of 3 per cent.

India’s potential growth rate

For assessing India’s potential growth rate, we may juxtapose India’s falling investment rate since 2011-12 with India’s rising capital-output ratio in recent years. The real investment (gross fixed capital formation) rate, at 2011-12 prices, has fallen from 34.3 per cent in 2011-12 to 32.5 per cent in 2019-20. The incremental capital output ratio (ICOR) estimated on trend basis has been in the range of 5.4-5.9 during 2015-16 to

2019-20. Taking an ICOR value of 5.5, the potential real GDP growth may be estimated at 6 per cent.

Earlier, Rangarajan and Srivastava (2017) had estimated India's potential GDP growth rate, based on a sector-wise decomposition of the ICORs, at 8 per cent plus. It has now come down due to a fall in the investment rate and increase in the ICOR. In order to derive the corresponding nominal growth rate, we need to add an implicit price deflator based inflation rate of 3 per cent. Combining 6 per cent and 3 per cent, we get a nominal GDP growth of 9 per cent.

Thus, in the medium term, the growth rate-interest rate differential may be about two percentage points. Clearly, a high primary deficit relative to GDP can only be created temporarily by raising the fiscal deficit well above its steady state path but it cannot be sustained. The average primary deficit over the last five years has been 0.7 per cent of GDP for the Centre and 1.8 per cent for the Central and State governments.

A study by us shows that between 1955-56 and 2000-01, the rise of debt-GDP ratio was due only to primary deficit. Of course, its impact was substantially reduced by growth rate — interest differential (see our book *Federalism and Fiscal Transfers in India*).

The growth rate-interest rate comparison has the implicit assumption that the current level of debt-GDP ratio is appropriate and keeping it at that level is the desired criterion of sustainability. If in fact it is felt that this ratio needs to be brought down as the NK Singh committee proposed, there has to be primary account surplus.

Fiscal parameters for general government (%)

Countries	Revenue receipts/ GDP	Interest payments/ Revenue receipts	Debt/ GDP
India	18.1	25.8	72.4
US	29.5	13.8	108.7
UK	36.6	5.6	85.4
Japan	35.0	4.7	238.0

Data pertains to 2019-20 for India. For UK, US and Japan data for revenue receipts pertain to 2018 and for interest payments and debt to 2019

Arguments are also being advanced that many developed and emerging market economies have a relatively high debt-GDP ratio (see Table). But it should be noted that in these and many other developed countries, the average and marginal interest rates have been close to zero for some years and their ratio of interest payment to revenue receipts is also very low.

In contrast, in India, the average interest rate is still above 7 per cent. More importantly, revenue receipts to GDP ratio is quite high in the countries with high debt-GDP ratio. Consequently, interest payments to revenue receipts ratio is low in these countries and high in India. Therefore, lowering this ratio is an important consideration.

Clearly, in the long run for India, the excess of potential growth rate over average interest rate is limited. Taking into account India's low revenue receipts to GDP ratio, an amended FRBM may not have the leeway to specify a combination of fiscal deficit and debt relative to GDP consistent with debt sustainability, which is significantly different from the current FRBM norms.

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