OPINION

Budget needs a road map for reducing fiscal deficit

High levels of public debt are a cause for concern. But this can be managed by announcing a deft debt management strategy in the upcoming budget

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As the Union Budget is around the corner, there has been a lot of discussion on the possible growth trajectory of the economy. There has also been concern about the persisting inflation levels, and global agencies have been revising their growth forecasts as and when new data on inflation are released. But an issue that has not been addressed sufficiently in discussions on growth is the trends in public debt. This, in our view, warrants attention in the forthcoming Budget, as the levels of public debt affect both output and prices, and can derail macroeconomic stability and growth.

The path along which public debt may evolve is based on real Gross Domestic Product (GDP) growth, inflation, interest rate and the primary deficit. The movement of these variables determines the threshold level of debt, beyond which it becomes a drag on GDP growth. The Reserve Bank of India (RBI), in its Report on Currency and Finance (April 2022), states that the "general government debt in India surged to 89.4% of GDP in 2020-21, significantly higher than the Fiscal Responsibility and Budget Management target of 60%, posing risks to medium-term macroeconomic stability." Further, RBI pointed out that "accumulation of general government debt up to a level of 66% of GDP, leads to an increase in GDP growth, beyond which it impacts growth adversely." Against this threshold limit of 66%, the debt projections of various agencies have shown an alarming rise in the medium-term.

Data shows that debt projections as a percentage of GDP, as estimated by RBI, the International Monetary Fund, and the 15th Finance Commission, all show similar trends; they predict that overall debt would exceed levels in excess of 80% even in 2025-26. But this was not always the case. In the pre-Covid-19 period, government debt was less than 80% of the GDP. For FY 2020, it was 74.1%, 70.4 % for FY 2019, 69.7 % for FY2018 and 68.9 % for FY 2017.

It is clear what has happened in the current situation. The response to Covid-19 across countries was to raise government expenditure at a time when revenues were falling. The net result was a substantial rise in the government fiscal deficit, which could be financed only with the support of the central banks. The fiscal deficit in the United States (US) tripled in 2020, over 2019. The United Kingdom (UK)'s fiscal deficit increased five times during the same period. The US Fed's assets which stood at $4.17 trillion on January 1, 2020, rose to $8.96 trillion in April 2022. This massive expansion in assets is the consequence of quantitative easing. Most central banks followed a similar path. A natural consequence is an unusual level of inflation, which we are witnessing, and a high debt-to-GDP ratio. The Indian situation is not different, even though the fiscal deficit increase was more moderate than in the UK or the US.

In a low-inflation scenario, monetary policy can help in debt consolidation by keeping interest low. But that choice is not open now. The burden of debt management falls squarely on fiscal policy.

On the fiscal side, the situation is now a mixed bag. Regarding revenue mobilisation for the Centre, the Goods and Services Tax (GST) collections have been buoyant, and tax devolution could be performed without major hiccups. This gives the Centre some leeway in embarking on a fiscal deficit correction path. However, for the states, the end of the GST compensation period might pose some structural challenges, at least in some cases.

On the expenditure side, given the primacy of enhanced capital expenditure for reviving growth, it is important that both the Centre and state governments hasten capital spending. Bringing down the fiscal deficit, which is required for controlling debt, therefore, demands a careful look at revenue expenditures. In the medium-term, higher debt levels can be reduced only by accelerating the nominal GDP growth to around 11%-12% yearly. This will ensure revenue buoyancy to bring the fiscal deficits down.

In the final analysis, the debt-to-GDP ratio can be controlled only by reducing the fiscal deficit. The fiscal deficit of the Centre stood at 9.2% of GDP in 2020-21. It came down to 6.7% of GDP in 2021-22. It is likely to be 6.4% in the current year. These ratios are way above the norm of 3%. The Budget needs to spell out a new road map to reduce the fiscal deficit. Any sharp reduction may disrupt the economy. But a definitive trend towards lowering the fiscal deficit must be indicated. A deft debt-management strategy, coupled with the rationalisation of expenditure and raising resource mobilisation efforts, are key to the fiscal rebalancing needed to achieve a sustained high growth rate. The 2023-24 budget could provide signals to such a strategy, without reducing capital expenditure.

THE LEVELS OF PUBLIC DEBT AFFECT BOTH OUTPUT AND PRICES, AND CAN DERAIL MACROECONOMIC STABILITY, GROWTH

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The views expressed are personal