Advances in Economics and Business Management (AEBM)
p-ISSN: 2394-1545; e-ISSN: 2394-1553; Volume 6, Issue 4; July-September, 2019, pp. 341-343

http://www.krishisanskriti.org/Publication.html

A Study of India's Fiscal Deficit and Debt Sustainability Indicators

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Abstract—*This review paper seeks to evaluate the role of the government during times of economic slowdown. In this context it is looked into the concepts of sustainability of public debt specifically for India. In related analysis also looked at the various characteristics of fiscal deficit in India along with avenues of revenue generation and quality of expenditure.*

Keywords: *Fiscal deficit, public debt, debt sustainability, efficiency of expenditure, fiscal space.*

1. Introduction

Textbook macroeconomic theory for an economy suggests that the overall gross domestic product of the country would be a sum of all the spending of the country by various participants including private households, corporates and the Government. It stands to reason that if for some reason the private spending is to slowdown then government can take up the baton and support total growth in the system. This would be classified as fiscal stimulus and is the traditional fall back of combating crisis situations. However, looking around at events unfolding globally, we have seen that countries like the United States has given a fiscal stimulus even when there was no crisis to combat. Could it be that the time tested fiscal and monetary policies are changing in texture? If governments have to step in even during times of good growth what implications does it have for their ability to continue spending? Closer home, even in India the topic of government spending and the fiscal deficit occupies significant mind space especially currently in the context of slowing economic growth. The concept of fiscal prudence and rectitude as opposed to the need for intervention for alleviating the stress of struggling masses seems to be a very popular subject of discussion. This prompted us to examine the key characteristics of India's fiscal deficit, public debt levels and its sustainability.

2. Debt sustainability and debt to GDP ratio

Debt sustainability has various aspects including the rate at which debt is being added to the economy and also the country's ability to pay the interest on it. According to the existing academic literature debt sustainability is ensured if the entity is regarded as being solvent. Solvency would be the ability to service current debt out of future income or surpluses. At an intuitive level even for an individual who has some liabilities, she would be considered solvent only if her income grows at a rate higher than the rate at which she has to pay the interest on her loan. This principle should be true for the country as well. For a country's debt position to be sustainable, the growth rate of debt cannot exceed the growth rate of income. It turns out that as long as the interest rate exceeds the growth rate of GDP, it is not a favorable situation for the economy. When, on the other hand, the growth rate exceeds the interest rate, it is possible for the debt-to-GDP ratio to decline, even if an economy runs primary deficits as of now. This will ensure that over the long term, the debt to GDP ratio will decline. A simplistic way to judge this would be by analyzing how the trajectory of public debt is evolving over time and also the movement in the interest rate and growth rate difference. This is only one determinant of sustainability and the status of the country's primary balance is important as well.

However, recent experience has shown that any analysis of sovereign debt sustainability should not just be based on the classical definition of primary balances. It should encompass other aspects, such as maturity profile, cost of borrowing per se, external or domestic investor base – existing and potential, along with savings rate, potential tax to GDP ratio, etc. In this context, research by Cuddington (1996) shows that sustainability can be evaluated also by considering the net present value of future primary balances and if this is negative then regardless of what the current level of debt is, fiscal policy would be unsustainable. On balance, the larger the interest rate growth differential (r-g), the more primary surpluses the country has to run to make the debt sustainable.

However, the conventional interest rate and growth rate differential suggests that India's debt path is not likely to explode as the prospect for future income is more than enough to service current debt obligations. The last fiscal year saw some deterioration mainly because growth had fallen sharply.

As growth rates improve, this metric should improve in tandem.

However, this in itself is not sufficient. We take a look at the public debt to GDP ratio also for India. This ratio has also been trending lower over the past few years and seems to be sustainable for now. However, it is a matter of some concern that India's debt to GDP ratio is one of the highest among its EM Asia peers.

It is also not enough to only consider the Centre's debt path as India's states also have a large role to play and their fiscal health is also important to monitor. From an analysis of about 10 large states, we find that over the past 3-4 years the standard (r-g) metric has actually improved for most states. State governments now also have fairly stringent rules to govern their fiscal performance although the outcome has been mostly mixed. Overall state government deficits have also missed their targets of late and has kept the consolidated fiscal deficit for India elevated. However, the redeeming feature is the fact that the debt to GDP ratio for states has also been trending lower as addition to fiscal deficit has been coming down although targets may be missed.

In the case of India, therefore, the gradually declining level of general government debt estimated over the medium term does answer the sustainability issue somewhat positively. At the same time the characteristics of existing debt profile and parameters such as high savings rate, longer residual maturity, fixed rate of interest, higher proportion of domestic currency denominated debt and wide gap in potential and realised tax to GDP ratio, puts India in a good position.

3. Scope for further study: Fiscal space

This is a preliminary analysis of India's debt profile and for the sake of completeness there exists scope for further analysis in this field by evaluating the amount of fiscal space that India has and what would be an indicative interest rate for the economy beyond which the debt path becomes untenable.

Existing literature defines fiscal space as the distance between the public debt to GDP ratio and the level of debt beyond which the country would default unless policy intervention comes into play. The amount of fiscal space can be determined by modeling the primary balance function which would depend on several variables including a country's dependency ratio, ideologies of the country's ruling political party, degree of openness of the economy, output gap, expenditure to GDP ratio etc.

Typical ways in which governments can boost fiscal space is by augmenting stable sources of revenues such as taxes and improve tax administration. Unproductive expenditure or activities which typically would not require government intervention should be hived off or measures could be taken to boost efficiency of expenditure.

4. Characteristics of fiscal deficit and its funding: An Indian perspective

We have established in the previous section that India's public debt dynamics are for the most part sustainable and should not be a significant cause for concern. However, there are some components of the overall fiscal deficit which are troubling.

On the expenditure side, revenue expenditure as percentage of total is more than 85%. Of this almost 60% is spent solely on pensions, interest payments, subsidies and defense spending. Interest payments alone are more than 80-85% of gross fiscal deficit. These expenditure heads are almost entirely inelastic and although subsidy burden has been lowered over the last few years but other heads like pension, interest, wages etc. will keep growing.

On the revenue side, India is significantly dependent on indirect taxes and the base for direct taxes viz. income tax is still very low. Consequently, significant importance is placed on other modes of revenues such as dividends from public sector undertakings, monetization of assets in various government held companies, fees from resources auctioned such as telecom spectrum etc. These avenues, while substantial, are at a disadvantage as they tend to be one-off. The ultimate aim for a more fiscally sustainable economy should be one of more stable sources of revenue.

Even beyond the entire spectrum of revenues available to the government, there is still substantial deficit which needs to be funded and the Government usually resorts to market borrowings to fund a sizeable chunk of the deficit. This trend will inevitably keep interest rates high and this is also a source of vulnerability as during times of exogenous or endogenous adverse shocks to growth, the seemingly robust debt dynamics could come under stress.

However, there are some mitigating circumstances. India's public debt is mostly local currency denominated and is largely held by domestic institutions such as banks, insurance and pension funds etc. A limited amount is held by foreign investors but capital controls are still significant. Our primary deficit numbers (especially the shrinking trends) are also fairly encouraging (net of interest payments) and a strong revenue stream will help to stabilize our fiscal situation further. We have to endeavor to generate primary surpluses on a sustainable basis, to reach sustainable fiscal deficit levels.

5. Conclusion

It seems conventional debt sustainability indicators are favourable for India as long as expenditure prudence is observed. At an institutional level, India has now formally adopted the Fiscal Responsibility and Budget Management Act which requires strict adherence to a fiscal consolidation path both by the Centre and States. This is a significant strength as a check on fiscal deficit ensures that broad inflation situation remains under control and the government's credibility is also preserved.

Another landmark development has been the introduction of the Goods and Services Tax which is likely to be a game changer for India. It would have multi-pronged benefits. It helps to reduce the multitude of taxes which used to prevail in the country and brings in some semblance of uniformity among various states. It will also in time to lower general price levels in the economy. By construction it should also help to bring more people under the taxation fold and help to significantly augment revenues. Apart from these it also fosters efficiency gains and will help in faster interstate movement of freight traffic. All of these are over the long term supportive of growth, which in turn would generate higher tax receipts thereby leading to a more virtuous and stable cycle of revenues for India.

India is also a young economy and it should also be a policy priority to ensure that in expenditure shifts over time to more allocations towards education, healthcare, skill development etc. Hence, a stable and growing revenue source is critical for the Government to have more room to spend on more meaningful heads. It is also critical to ensure that the quality of expenditure remains good and the mix moves more towards creation of physical and social infrastructure rather than just making large scale cash payments.

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