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EXPLAINER: Shifting focus to debt-to-GDP ratio

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Written by **Lekha Chakraborty**
July 30, 2024 04:30 IST

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Finance minister Nirmala Sitharaman, in her Budget speech, has said that from 2026-27 onwards, the endeavour would be to keep the fiscal deficit such that the central government debt is on a declining path as a percentage of GDP. **Lekha Chakraborty** explains what this approach means

Why is fiscal consolidation necessary?

A FISCAL RULE is a constraint on fiscal policy through numerical limits on deficits. Indian fiscal rule as per the Fiscal Responsibility and Budget Management (FRBM) Act envisions fiscal deficit at 3% of GDP. However in the post-pandemic fiscal strategy, the fiscal glide path is envisioned at below 4.5% by 2025-26. The present medium-term fiscal glide path might be to incorporate Budget transparency by including off-Budget liabilities. The fiscal deficit for 2024-25 is estimated at 4.9% of GDP. The fiscal rules envision general government debt to be 60% of GDP with 2:1 ratio between the Centre and the states. The golden rule is to reach zero revenue deficit.

The financing pattern of deficits is broadly threefold —seigniorage financing (monetary financing), internal bond financing and external financing. In India, internal bond financing predominates while in Sri Lanka, external financing of deficits is more. The role of the government in emerging economies is very crucial as a counter-cyclical policy tool in case of business cycles, especially when the economy is in the midst of a downturn.

Deficit targeting vs debt path surveillance

THE DEBT PATH surveillance towards fiscal consolidation is as important as deficit-debt targeting at threshold ratios. Fiscal consolidation can be attained either through increased revenue buoyancy or through cuts in public spending. The latter can affect the quality of fiscal consolidation as expenditure compression has negative consequences on economic growth.

Equally important is the maturity profile of the debt . The refinancing risks can be postponed if the maturity structure of the public debt is elongated. Given the high interest rate regime prevailing at present, public debt management is becoming costlier. However, the public debt is sustainable if the real rate of interest is lower than the real growth rate of the economy.

THE RESPONSIVENESS OF taxes to an increase in the GDP is termed as tax buoyancy. Increasing the tax-GDP ratio is crucial for revenue generation and to contain deficits. However, increasing the tax rates does not always result in rise in tax revenue.

In the context of an emerging economy, 'tax administration is tax policy.' Therefore, widening the tax base and strengthening the digital infrastructure in tax administration are crucial for raising tax revenue.

A widening of the tax gap (around 7% of the GDP at present) is because tax effort is not keeping pace with the tax potential.

The NK Singh FRBM panel

NK SINGH WAS the chairman of the FRBM panel which suggested the above-mentioned debt deficit targets. The Singh panel also suggested an "escape clause" in the FRBM Act, on the basis of national security, war, national calamity, etc., and structural reforms in the economy resulting in fiscal implications.

The escape clause can also be applied if the decline in real output growth is at least 3% below the average of the previous four quarters.

There is a dissent note in the FRBM panel about the possibility of making primary deficit (instead of fiscal deficit) as the operational parameter of fiscal policy. Primary deficit is fiscal deficit minus interest payments. Primary deficit reflects the current fiscal stance of the government. However, in India, fiscal deficit continues to be the operational parameter.

Other options available

A BROADER CONCEPT of deficit to measure the real resource gap is Public Sector Borrowing Requirement (PSBR). PSBR captures the general government deficit plus the borrowing incurred through public sector entities. That's why PSBR is a better measure of deficit as it incorporates the 'hidden debt' or the off-Budget borrowings incurred through the public sector entities. However, we have data constraints in constructing time series data on PSBR.

The fiscal rules are predominantly of two types — rules designed on the basis of absolute figures of debt, and rules articulated as a ratio of GDP. The US fiscal rules are of the former category, while the EU and India follow the latter.

While deconstructing the public debt, it becomes clear that debt can increase due to several reasons including (a) rise in interest rates (b) increase in past debt servicing liability (c) if the GDP growth is lower, (d) if there is a huge primary deficit. Normalising the public debt threshold ratio to GDP is a better measure than absolute debt targeting/ceiling. The rise in GDP can decrease the public debt-GDP ratio.

(The author is professor at NIPFP, and governing board member of International Institute of Public Finance, Munich)

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