Alarmism over India's public debt is unwarranted

India's debt level is sustainable when seen in the context of it's economic growth. Therefore, it's important to avoid a hasty reduction in the ratio of fiscal growth to GDP ratio as borrowing has gone into creating building blocs of future growth. A Fiscal Council will help access debt level in an appropriate way.

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India aims to reduce the fiscal deficit to GDP ratio to 4.5 per cent by 2025-26, based on the medium-term fiscal framework announced amidst Covid-19, when we hit the ratio above 9 per cent of GDP. We have been firm on the medium-term fiscal framework and consistently reduced the fiscal deficit to GDP ratio in the subsequent years. The moot question now is this: After attaining the goal of 4.5 per cent, then what? Will further reduction in deficits costs us severely? These are the important questions before Finance Minister Nirmala Sitharaman, while preparing the next Union Budget.

Globally, in the post-pandemic fiscal strategy, the adoption of new fiscal rules and Fiscal Councils were put to test severely. However, India is an exception with no rollover risks. A clear articulation of a medium term fiscal framework with a target of reaching 4.5 per cent fiscal deficit-GDP ratio by 2025-26 was one of the novelties set in India, to keep the fiscal policy “accommodative” to get into a sustainable growth recovery path. This strategy has worked, as relatively higher deficits have been substantiated by linking it to gross capital formation, with steady capex transfers to the States. This is the macroeconomic framework for Viksit Bharat 2047 as well.

Globally, empirical evidence shows that fiscal rules, in general, have been flexible during the post-pandemic period and these deviations from the fiscal rules have been very difficult to reverse in countries where the financing pattern of deficits been pre-dominantly external.

In India, deficits do not impact interest rates

In India, the financing pattern of deficits has been pre-dominantly internal bond financing and empirical evidence shows deficits have no impact on interest rates in India. A NIPFP (co-authored) **paper of mine**, using the high frequency data, showed that there is no pressure of deficits on interest rates in the post-pandemic period in India. This will not lead to financial crowding out either. Rather, high interest rates do affect deficits. High interest rates do affect the public debt management as the debt servicing goes costlier.

As deficits have no significant adverse macroeconomic impacts, there is room for keeping fiscal policy accommodative in the Union Budget 2025-26. Any harsh attempts of fiscal consolidation – through expenditure compression than tax buoyancy route – can result in adverse economic growth consequences. The "golden rule" of keeping revenue deficit zero is also not plausible as it might lead to fiscal austerity measures through curtailing revenue spending. So any attempt in **Union Budget** 2025-26 for phasing out revenue deficit can lead to adverse growth consequences.

High public debt can create intergenerational inequities, as today's debt can be tomorrow's taxes. However, given the public debt is closely linked to public infrastructure investment and human capital formation in India, there can be no intergenerational inequities, as we are creating the infrastructure investment for future generations right now.

'Fiscal Reforms' need an institutional setting

Equally important is an announcement on "Fiscal Reforms" in the Union Budget 2025-26 about innovative data creation, institutional reforms (creating a Fiscal Council) and also towards strengthening the "budget transparency" through cleansing the OBB (off budget borrowings). The lack of time series data related to "general government deficit" or PSBR (Public Sector Borrowing Requirement) is a constraint to analyse the macroeconomic impacts of deficits. Data creation of PSBR is a crucial step, though the government has decided to keep fiscal deficits as the operational parameter (instead of primary deficits).

Announcing a Fiscal Council in the Union Budget 2025-26 to tackle the pathways to deal with the "excessive deficit procedure" for Centre and States can be a critical fiscal reform. The Fiscal Council can also help in strengthening informed debates in the Parliament about the cost-benefit analysis of Fiscal Rules – timing and sequencing of fiscal rules, the benefits in terms of budget discipline versus their costs in terms of lost flexibility in fiscal policy (and further costs in terms of output variability) – and provide clarity about the appropriate path towards fiscal consolidation through targeting the public debt.

India's public debt level is sustainable

Given the geo-political uncertainties and supply chain disruptions, the new RBI Governor is bound to vote to keep interest rates high to tackle mounting global inflation. Therefore new fiscal rules should give adequate fiscal space for policies related to sustainable economic growth recovery process, by linking it to public debt reduction judiciously. As far as India is concerned, public debt is sustainable, as the real rate of interest (r) is below the real growth of economy (g). India is indeed "growing out of debt", as r is less than g.

Private consumption is lagging. A sustainable way to boost consumption is to increase disposable income in the hands of people. The announcement related to 8th Pay Commission is crucial. Getting into fiscal austerity mode, by not considering the 8th Pay Commission will cost the nation dearly as it will further deteriorate the economic growth recovery process. My hunch is that there will be announcement of constituting the 8th Pay Commission nearing the Union Budget 2025-26. Reducing the personal income tax rates is yet another way to boost disposable income in the hands of people. Targeted cash transfers into the hands of people, however, can be only a short-term solution to boost demand.

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