The case for flexible fiscal targeting

There is growing concern that India will miss the fiscal deficit target of 3.2% of the gross domestic product (GDP) set in the Union budget for the year to 31 March. The Centre has been on a path of fiscal consolidation, narrowing its deficit from a high of 5.9% in FY12 to 3.5% of GDP in FY17. However, the government’s revenue collection in the current year is falling short of target, leading to concerns on the fiscal front. At the same time, with GDP growth slipping, there is increasing clamour for fiscal stimulus to revive the economy. In the given backdrop, what does missing the fiscal deficit target really mean for the Indian economy?

Higher fiscal deficit for an economy means increased government borrowing, which in turn implies higher interest burden. India has a debt-to-GDP ratio of 68%, which is the highest among its emerging market peers. Indonesia has a government debt-to-GDP ratio of 24%, while this ratio for Thailand is 41%. Most of India’s government debt is internal (from domestic market), implying less external vulnerability. Nevertheless, high government debt implies high interest burden and the threat of economic instability. Many of the developed economies like the US and Japan have much higher debt-to-GDP ratio (108% and 240%, respectively). However, their interest burden is much less as their governments are borrowing at much lower interest rates. US and Japan policy interest rates currently are zero and 1.25%, respectively against India’s 6%. In India, the government’s interest payment to total expenditure is around 24%, while for Japan and the US it is much lower at 9.5% and 11.2%, respectively.

Higher interest payment burden implies less headroom for developmental expenditure by the government. Capital expenditure accounts for only 12-14% of India’s total expenditure, whereas a high of 24% of government’s total expenditure goes into interest payment obligation. The other disadvantage of a high debt-to-GDP ratio is that it has an impact on the country’s credit ratings and investor sentiments. Here it is interesting to note that Moody’s has recently upgraded India’s sovereign credit rating. This is despite an increase in risks of fiscal slippage. Perhaps, Moody’s has taken into account the recent structural reforms and its likely positive impact on India’s economic growth in the medium term.

While there is no doubt that the government should be fiscally prudent, what is being increasingly debated is whether our fiscal management should be counter-cyclical. This means that when economic growth is above potential, policymakers should reduce fiscal deficit. Similarly, when economic growth is poor, fiscal deficit should be allowed to expand (within a ceiling) in order to support economic growth.

While it is ideal to have a rule-based fiscal consolidation path, experience shows that there are threats of genuine disruptions. For instance, the Fiscal Responsibility and Budget Management (FRBM) Act enacted in 2003 led to an improvement in the fiscal deficit of Centre from 5.7% of GDP in FY03 to 2.5% of GDP in FY08. However, there was a pause button on the FRBM Act post the global financial crisis. Fiscal deficit shot up to 6% in FY09 and it was only in FY12 that a path to fiscal consolidation was recalibrated.

The risk is that following a fiscal deficit target under all circumstances could result in adverse impact on developmental expenditure. For instance, in the current year, due to fear of fiscal slippage, there is pressure on the government to cut expenditure. This can result in capex falling short of the target. Capex expenditure for April-September has grown by 8.5% as against budget target of 10.7% for FY18.

Currently the private investment scenario in the economy is languishing. Non-food credit to the industrial sector has been on a decline, falling by 0.4% in September. Banks have been investing more than the mandatory requirement in government securities, reflecting the lack of better avenue for banks. Hence a higher government borrowing will not in any way crowd out private investment. In fact, higher government capex is badly required at this point to propel growth. While it is important that the government follows fiscal prudence, there should be some flexibility to increase fiscal deficit if the economic scenario warrants. However, at the same time it is very critical to ensure that the fiscal slippage, if any, is not due to unproductive expenditure on populist measures. In addition, the government should follow the discipline of tightening the fiscal belt when growth picks up. Only then can a counter-cyclical fiscal management work effectively.

The N.K. Singh Committee on FRBM has recommended reducing the fiscal deficit-to-GDP ratio to 2.5% of GDP by 2022-23. Even though the committee has said that using cyclically adjusted deficits may not be practical for India at this point of time, they have suggested flexibility in fiscal deficit targets in case of exogenous shocks (includes sharp drop in economic growth or structural reforms with fiscal implications). The committee has emphasized the need for increased focus on debt sustainability and recommended reducing India's debt-to-GDP to 60% by 2022-23 from the current level of 68%. Reduction in the government debt level would depend on the differential between GDP growth and interest rate, and the government's primary deficit. If high GDP growth—supported by substantial government capex—offsets any rise in interest rates and primary deficit, it would still keep the debt-to-GDP ratio in check.

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