Indian Public Policy Review 2024, 5(5): 109-117
https://doi.org/10.55763/ippr.2024.05.05.003

IPPR

Reimagining India's Fiscal Architecture

Sajjid Z Chinoy

Toshi Jain

Divyanit Sood*

Abstract

Fiscal credibility in India has increased markedly in recent years underpinned by improved transparency (off-budget liabilities coming on budget), conservativeness (in the budgeting of revenues) and marksmanship (in the attainment of deficit targets). Yet, like around the world, India is left with higher public debt levels post-pandemic, and, despite ongoing fiscal consolidation, Combined Debt/GDP again inched up last year. This note therefore proposes a new, post-pandemic fiscal architecture built on five pillars that is anchored in debt and is holistic (encompassing center and states), dynamic (responsive to changing macro conditions) and conservative (creating fiscal space for future shocks).

Keywords: Fiscal Credibility, Marksmanship, Public debt, Fiscal architecture

Publication Date: 10 November 2024

* Sajjid Z Chinoy is the Head of Asia Economic Research at J.P. Morgan. Toshi Jain and Divyanit Sood are India Economists, J.P. Morgan.

As The Dust Settles

The pandemic upended fiscal dynamics all around the world. The sheer quantum of the shock alongside the realization in many advanced economies that their fiscal response after the 2008 crisis was initially inadequate and subsequently pro-cyclical, deepening the hysteresis, meant advanced economies went all-in this time. Lacking "exorbitant privilege," emerging markets were more constrained. Yet, public debt surged around the world in the pandemic. To be sure, high inflation and catch-up growth of the last few years, has partially reversed some of the increase. But as the dust settles, policymakers must contend with much higher levels of public debt in a shock-prone world.

This is therefore a good time to re-examine the fiscal architecture across countries. What will it take to progressively reduce public-debt and create fiscal space to respond to future shocks? Are pre-pandemic fiscal rules applicable in a post-pandemic world? In a large federal system, how should the burden be shared between the centre and states? How can one inject greater market discipline to facilitate the needed adjustment? We examine these questions in the case of India.

Correctly Focusing on Debt

Until 2017, India's fiscal architecture was centred around a path of fiscal deficits. That changed when public debt became the anchor in 2018, underpinned by the recommendations of the N.K. Singh Committee Report. This was necessary because debt dynamics are the ultimate measure of medium-term fiscal sustainability -- or lack thereof. Fiscal deficits, while playing an important counter-cyclical role, are – from the perspective of inter-temporal fiscal sustainability – simply a means to the end.

Focusing on debt is even more important in a post-pandemic world. India's Public Debt/GDP gapped up from 70% in 2018 to 89% in 2021, before re-tracing to 82% last year. To be sure, there is no sacrosanct *level* of debt in a post-pandemic world. Instead, what matters is how debt-dynamics evolve over time. A monotonic increase in debt ratios is a tell-tale sign of fiscal unsustainability. Conversely, making fiscal space for future shocks, entails putting debt/GDP on a firmly declining path.

The Centre's bar is not high

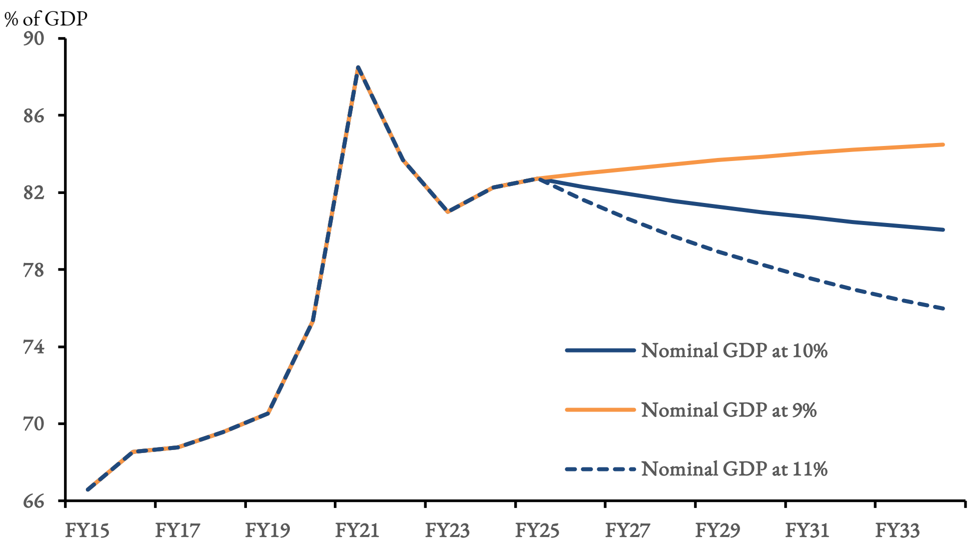
It's against this backdrop that the Centre's budget announcement that it will calibrate fiscal policy to ensure Central Government Debt/GDP is on a declining path must be welcomed. So what will this entail for the future path of central deficits? Recall, the central deficit is pegged at 4.9% of GDP this year and targeted to go below 4.5% of GDP next year. Prima facie, the Centre may not need to consolidate very much beyond that if the objective is to put Central Debt/GDP on a declining path. At the end of 2023-24, central government debt is estimated at 58% of GDP. If the Centre's deficit stabilizes just below 4.5% of GDP (say, 4.4%) and assuming nominal GDP grows at 10% a year (which was the five-year average before the pandemic) Central Debt/GDP will decline to about 52% of GDP over the next decade.

But the bar for consolidated debt is higher

But this is only half the story. What matters for the economy is how consolidated public debt (centre and state) evolve. And here the picture is quite different.

If the centre's deficit stabilizes at 4.4% of GDP and state deficits remain at their current level of 3% of GDP the combined deficit should be close to 7.1% of GDP (because central capex loans to the state are counted both as central and state capex and therefore add to both deficits and must be netted out to get the true combined deficit). Now, if the combined deficit is at this level and nominal GDP were to grow at 10% a year, combined debt/GDP barely declines over the next decade inching down from ~82% of GDP in FY24 to about 80% of GDP a decade later (Figure 1).

Figure 1: Debt Dynamics with Combined Deficit at 7.1% of GDP



Source: RBI, J.P. Morgan

And therein lies the nub. Central fiscal settings that are consistent with a gently declining Central Debt/GDP may not, by itself, be enough to put consolidated Debt/GDP on a meaningful declining path, because it is offset by rising State debt/GDP. Why is that? Even though the primary deficit of the centre and states is likely to be similar by next year, the Centre's larger starting debt stock (58% of GDP) means the automatic dynamics that reduce debt ratios (borrowing costs (r) being lower than nominal GDP growth (g)) are more impactful at the centre more than offsetting the primary deficit. In contrast, states start off with a lower debt stock (28% of GDP), so the impact of "r-g" is swamped by the primary deficit.

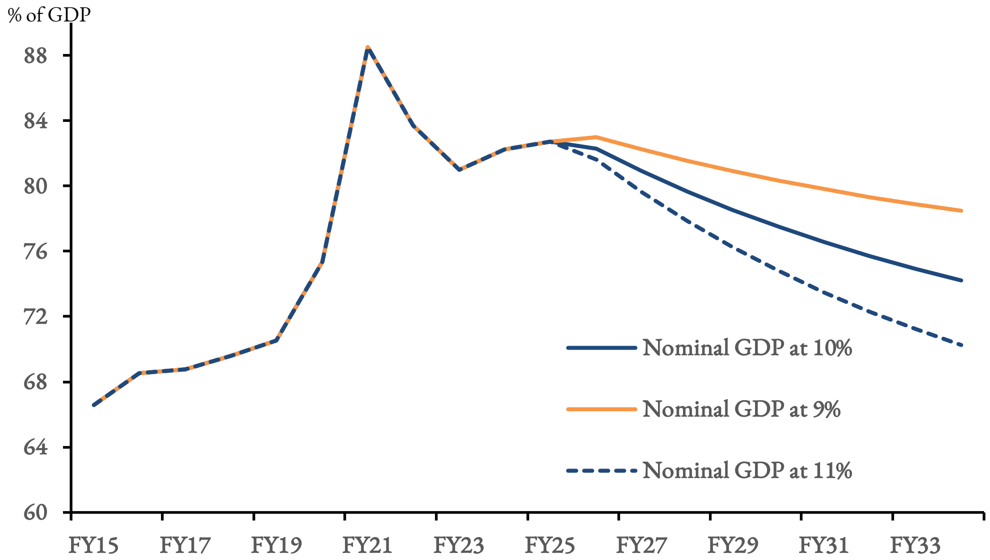
Therefore, to put Combined Debt/GDP on a declining path, one of two things has to happen. Either nominal GDP growth has to be stronger. Or more fiscal consolidation will be needed.

- **Small changes in growth have a large impact on debt dynamics.** If nominal GDP growth were to average 11% a year in the steady state, instead of 10% as assumed, combined debt/GDP consistently reduces from 82% in FY24 to 76% in FY34, though still discernibly above the 70% of GDP level that existed in 2018-19. Furthermore, India's nominal GDP growth averaged 10% in the five years before the pandemic and has averaged 9.5% over the last 7 quarters. Finally, the sheer quantum of excess capacity in China is likely to weigh on India's Wholesale Price Index – which is the bulk of India's GDP deflator – and therefore weigh on nominal GDP growth. It's therefore prudent to work with a more conservative nominal GDP growth assumption of 9.5-10%.

- **In light of this, at least another percentage point of fiscal consolidation will be required in the steady state** -- below the 7.1% of GDP combined deficit envisaged in 2025-26 -- to put combined Debt/GDP on a declining path. For instance, if the medium -term combined deficit stabilized at 6.4% of GDP, public debt will decline to about 74% of GDP a decade from now, even if nominal GDP growth averaged 10% (Figure 2). This would also mean interest/GDP would be back to pre-pandemic levels a decade from now.

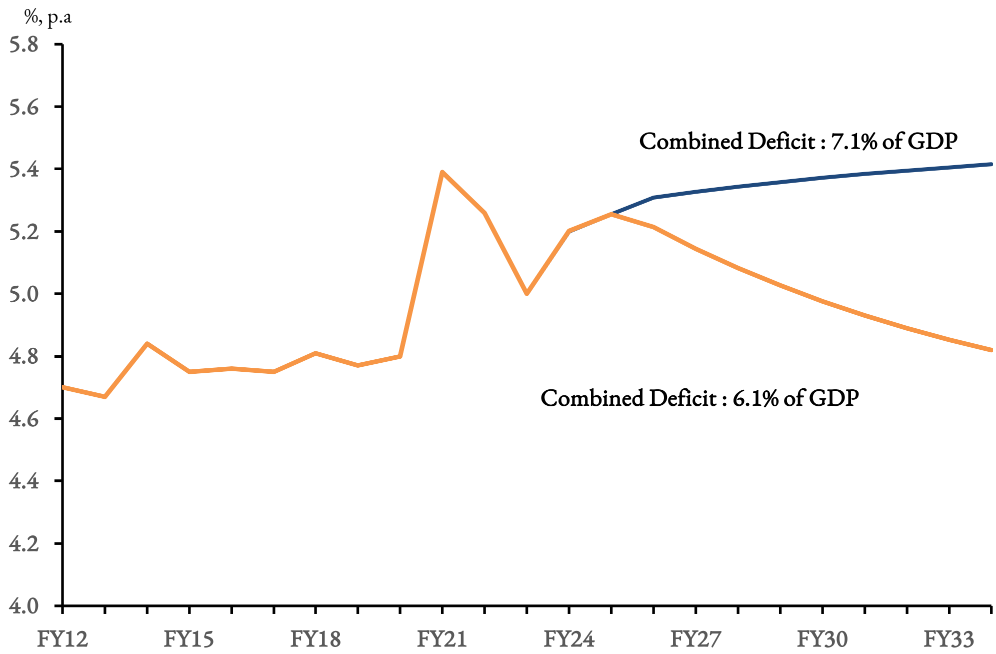
But if more fiscal consolidation is required, where should it come from? Centre or States?

Figure 2: Debt Dynamics with Combined Deficit at 6.1% of GDP



Source: RBI, J.P. Morgan

Figure 3: Total (Center + state) Interest Costs



Source: RBI, J.P. Morgan

Fiscal Burden Sharing

This brings to the fore several delicate questions on fiscal federalism:

- The Centre's Debt is much more than the states. So, should the Centre take on the bulk of the additional consolidation?
- On the other hand, even if the Centre consolidates only modestly from here, Central Debt/GDP will still be on a declining path, as shown. In contrast, if state deficits remain at current levels (3% of GDP), state debt will continue to increase, albeit slowly. So, should states take on some of the extra adjustment to stabilize their own debt dynamics?
- Or should central debt be reduced and state debt be allowed to increase so that they converge at some mid-point?
- More fundamentally, however, shouldn't the quantum of debt be a function of repayment capacity? With the Centre having more taxation powers, shouldn't it be allowed to carry a higher level of debt?

One can imagine a robust debate between the Centre and the States on these delicate fiscal issues. For now, we assume the extra fiscal consolidation of 1% of GDP to take the combined deficit to ~6.5% of GDP is equitably distributed between the Centre and States. This will simultaneously ensure state debt/GDP stabilizes and begins to gently decline even as consolidated public debt trends down more convincingly.

But just because the state deficits have to narrow, it doesn't mean that all states must retrench in tandem, as we discuss next.

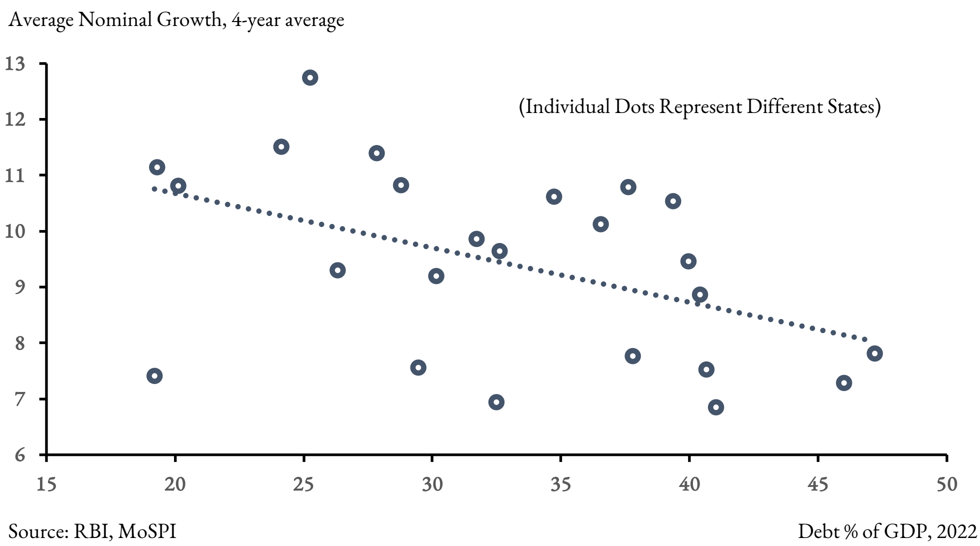
One Size Does Not Fit All?

Debt can only serve as an anchor for the economy if that logic is applied equally to the Centre and States. Else, as shown above, Central Debt/GDP could decline only to be offset by rising State Debt/GDP. Like with the Centre, therefore, the focus at the state level must be on debt, with deficits again being the means to an end.

The fact that all states face the same fiscal deficit threshold of 3% of GDP may suggest they have similar debt levels and dynamics. Such impressions are deceptive. Significant heterogeneity exists in debt levels across states ranging from 19% to 46% of GDP alongside very different debt dynamics.

This should not be a surprise. If states are subject to the same fiscal deficit rule but have very different underlying growth rates, it's natural to expect a negative correlation between growth and debt (Figure 4). Higher growth states will have lower debt levels and more favourable debt dynamics, while lower growth states will have higher debt and more challenging debt dynamics. This is simply an endogenous outcome of having the same fiscal rule across heterogenous states.

Figure 4: States Debt Inversely Correlated With Growth



In fact, a debt sustainability analysis (DSA) throws up four clusters of states:

- A group of states with high debt levels and relatively low growth rates where, if fiscal deficits of 3% of GDP continue to be permitted, debt levels will remain sticky, elevated and much above the state average over the next decade

- A second group of states where debt levels are elevated, but the problem is not the fiscal rule but its compliance. Deficits tend to be above 3% of GDP and if that continues, debt levels will remain elevated and sometimes even increase further.
- A third group of states with the opposite problem. Debt levels are low, and deficits have always averaged much below 3% of GDP. If this continues, Debt/GDP will remain very low, suggestive of unused fiscal space which, in principle, can be used to for more developmental spending.
- Finally, a fourth group of states in a healthy equilibrium where debt is close to the 30% of GDP average and expected to stay that way

In other words, there is a lot of heterogeneity across states. Going forward the objective must be to ensure debt levels are inter-temporally sustainable for every state and eventually converging across states. To achieve this, however, state fiscal rules may need to be risk-based and therefore differentiated reflecting state fundamentals. For instance, one can envision two sets of risk-based fiscal rules across states:

- A group of higher debt and lower growth states will potentially need to have more austere fiscal rules for sustainability. Here the fiscal threshold may need to be reduced to below 3% of GDP to ensure debt is sustainable over time.
- For states where debt is deemed to be sustainable under the current fiscal rule, the current threshold can continue. But compliance is crucial. Deficits in some states consistently remain above the threshold and will need to aligned lower towards 3% of GDP. Conversely, in states with a lot of unused fiscal space, incentives will be needed to productively use that space.

Such differentiated rules can be developed subject to the overall constraint (i) that the combined state deficit/GDP is lower than current levels and therefore combined state debt ratios do not keep rising, and (ii) total public debt (centre and states) is on a downward trajectory, creating space for future shocks for the economy as a whole.

Finally, any such framework will need to be dynamic and responsive to changing circumstances. As debt levels and underlying fundamentals (e.g. trend growth) change at the state level, debt dynamics can be recalibrated every 5 years (say by the Finance Commission) and states can be moved from one fiscal bracket to another.

The immediate objection to such an architecture will be "equity". Some states where debt levels are high – and where fiscal rules need to be more austere – may be lower growth or lower income states. Why are they being asked to tighten more? Isn't that a form of pro-cyclicality? But it's important not to confuse "equity" with "sustainability". Equity needs to be addressed through the quantum of horizontal transfers by the Finance Commission. So, states that need to tighten more can be compensated through higher transfers, if their per-capita incomes warrant as much. But the answer is not to let lower-growth, higher-debt states run deficits that make their future fiscal positions even more untenable.

Injecting Market Discipline

Another reason why state deficits and debt have diverged so much is that market discipline is not playing its part. The cost of borrowing across states is virtually identically and completely uncorrelated to underlying fiscal health. States with very different levels of deficits and debt experience the same borrowing costs (Figure 5). This is because there are perceptions of an implicit sovereign guarantee of state bonds. Armed with this belief, markets have no incentive to differentiate across states. In turn, there is no incentive for profligate states to tighten or unduly austere states to expand.

But given how debt levels have gapped up post-pandemic, it's imperative to let market signals enable the needed fiscal adjustment. If perceptions of an implicit guarantee are removed and state debt can be independently rated, healthy market forces may emerge. Profligate states will pay a premium on their borrowing and be incentivized to rein in deficits. Disciplined states will see lower borrowing costs and will be incentivized to make use of any unused fiscal space. This should enable increased convergence of debt over time.

Figure 5: State Borrowing Costs Uncorrelated with Debt Levels

Optimizing Over the Cycle

Finally, if the objective is to progressively reduce Debt/GDP, how does one operationalize this? Trying to target an annual reduction in Debt/GDP is undesirable. First, it risks making fiscal policy pro-cyclical. If the economy suffers a growth shock, but Debt/GDP has to be brought down mechanically every year, then the fiscal consolidation needed is even larger that year, making fiscal-policy undesirably pro-cyclical. Second, it creates increased uncertainty about annual fiscal deficits, because they have to respond to contemporaneous changes in the macro-environment, with the increased uncertainty likely to eventually drive-up risk-premia in interest rates.

Instead, the optimization should occur over the course of the cycle. So, under a set of macro assumptions, a path of fiscal deficits should be laid out for a few years that are consistent with declining Debt/GDP. If those assumptions are subsequently belied, the path is accordingly re-calibrated.

Five Pillars of a Post-Pandemic Fiscal Architecture

Fiscal credibility in India has increased markedly in recent years underpinned by improved transparency (off-budget liabilities coming on budget), conservativeness (in the budgeting of revenues) and marksmanship (in the attainment of deficit targets). Yet, like around the world, India's is left with higher public debt levels post-pandemic, with Combined Debt/GDP again inching up last year. This calls for a post-pandemic fiscal architecture that is anchored in debt and is ***holistic*** (encompassing centre and states), ***dynamic*** (responsive to changing macro conditions) and ***conservative*** (creating fiscal space for future shocks).

We propose such an all-encompassing framework, built on five-pillars:

- **Pillar I:** Re-establishing Debt/GDP as the anchor, so that Consolidated (Centre + State) Debt/GDP is put on a declining path in the coming years
- **Pilar II:** Deciding on burden sharing between the centre and states so that central and state debt dynamics do not offset each-other, which remains a real risk
- **Pillar III:** Establishing risk-based fiscal rules across states to ensure debt is inter-temporally sustainable and cross-sectionally convergent at the state level
- **Pillar IV:** Injecting Market Discipline into State Borrowing Costs to serve as an automatic corrective mechanism
- **Pillar V:** Avoiding trying to target an annual Debt/GDP but instead optimizing over the cycle