Contemporary Macro-Fiscal Issue: Targeting Deficits and Debt

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Fiscal deficits are like obesity. You can see your weight rising on the scale and your clothing size increasing, but there is no sense of urgency in dealing with the problem.

--Martin Feldstein

Address to Reserve Bank of India, January 12, 2004
Some Contemporary Policy Issues

• Targeting revenue deficit
  – Issue of 7th Pay Commission Award
  – Reducing transfer payments

• Targeting debt
  – Public debt vs total liability
  – Debt stability issues

• External shocks and domestic macro-fiscal situation
  – Shock to international oil prices
  – Shock from China (devaluation/stock market crash)

• Option of expansionary fiscal consolidation

• Possibility of achieving higher growth
Is India’s debt, sustainable?

(As % of GDP)

Combined Public Debt (Centre+state)
Total Liabilities of the government include debt contracted in the Consolidated Fund of India (defined as Public Debt) as well as liabilities in the Public Account.

Public Debt is the sum of internal debt and external debt.
Deficits resembling 1991?

Combined Fiscal Deficits (as % of GDP)

- Fiscal deficit
- Revenue Deficit
- Capital Expenditure
**Measurement of liability of the government (Centre and States) by different sources:**

<table>
<thead>
<tr>
<th>Source</th>
<th>Reserve Bank of India (RBI)</th>
<th>Government Debt Status Paper, MoF</th>
<th>Indian Public Finance Statistics (IPFS)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Outstanding Liabilities (TOL) Includes:</strong></td>
<td>a) Internal Liabilities of Centre</td>
<td>a) Internal Liabilities of Centre</td>
<td>a) Internal liabilities of Centre</td>
</tr>
<tr>
<td></td>
<td>b) External Liabilities of Centre at current exchange rate.</td>
<td>b) External Liabilities at current exchange rate.</td>
<td>b) External Liabilities of Centre at historical exchange rate.</td>
</tr>
<tr>
<td>c) Total Liabilities of States excluding following factors:</td>
<td>c) Total Liabilities of States</td>
<td>c) Total Liabilities of States</td>
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</tr>
<tr>
<td><strong>TOL excludes:</strong></td>
<td>i) Loans and advances from Central government to States</td>
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</tr>
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<td></td>
<td>ii) Special Securities issued to NSSF</td>
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<td>iii) State governments’ investment in Centre’s treasury bills.</td>
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<td></td>
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<td></td>
<td>iv) Market stabilization scheme</td>
<td></td>
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</tr>
</tbody>
</table>

Total Liabilities as per the definition of RBI, MoF and IPFS (as % GDP)
If $b_t = b_{t-1} = b^*$, then the liability-stabilizing fiscal deficit to GDP ratio is $f^* = b_{t-1} \times \frac{g_t}{1+g_t}$

Where, $b$ symbolizes liability GDP ratio, $g$ is growth rate of GDP and $f$ is fiscal deficit to GDP.
Questions for India

• With the onset of global financial crisis following issues were raised
  – Issues of sustainability of combined fiscal deficits and debt;
  – Has the large structural fiscal deficits constrained the fiscal policy as a tool of stabilisation?
  – Is there need to formulate fiscal rules and targets to stabilise debt and deficits?
  – Does quality of expenditure matter?
  – Issue of crowding-in and crowding-out
  – Size of fiscal multipliers
Issue of sustainability

• The most popular one is Domar rule
  – Debt/GDP is sustainable if the growth rate of nominal GDP is higher than the nominal interest rate
  – Real GDP growth to be higher than real interest rates (necessary condition)
  – Primary balance to be non-negative (sufficient condition)
Fiscal deficits and growth

• Primarily there are three schools of thought
  – Neo Classical view: Fiscal deficits adversely affect investment and growth; emphasis long run
  – Keynesian view: Expansionary fiscal policy as the main policy tool; focus on short run
  – Ricardian equivalence: Deficits does not matter except for smoothening fiscal adjustments; believe in long run adjustment
Theoretical explanations

• Neoclassical view
  – Believe in quality of expenditure – revenue vs capital
  – Higher revenue deficit vis-à-vis fiscal deficits leads to lower government saving or an increase in government dis-saving.
  – detrimental effect on growth if the change in government saving not fully matched by change in private saving
  – Such mismatch could put pressure on the interest rate, will adversely affect growth.
  – Assume full employment and, hence, the market clearing.
  – Fiscal discipline promotes long-term growth
Theoretical explanations

• Keynesian view
  – Assumes there exists unemployed resources
  – Increase in autonomous government expenditure financed by borrowing would expand output through a multiplier process.
  – Does not distinguish between alternative uses of the fiscal deficit as between government consumption or investment expenditure
  – Does not distinguish between alternative sources of financing the fiscal deficit through monetisation or external or internal borrowing.
  – No explicit budget constraint in the analysis.
  – Deficits leads to rise in the demand for money
  – Interest rates would rise if deficit is bond financed with money supply constant partially offsetting the multiplier effect.
  – However, increase in profitability due to rise in aggregate demand would more than offset rise in interest rates
  – Deficits would crowd-out only in the case of full employment.
Theoretical explanations

• Ricardian equivalence
  – Deficits are viewed as neutral in terms of their impact on growth as financing of deficits amounts only to postponement of taxes.
  – Deficit in any period is equal to the present value of future taxation
  – Deficits is a device for smoothening the impact of revenue shocks or for meeting the requirements of lumpy expenditures, the financing of which through taxes may be spread over a period of time.
  – No impact on aggregate demand as consumers will have infinite time perspective with good foresight
  – Decrease in government saving due to deficit will lead to equal increase in private saving with total saving, investments and interest rates unchanged
Targeting deficits and debt

• Need a macro framework (model) to endogenise these targets
• Understand the link between fiscal deficits, current account deficit and growth
• Understand the composition of debt-deficits
• Subsidy is the major part of revenue deficit...
Issue of crowding-in and crowding-out

Combined Fiscal Deficits and Private Capital Formation (as % of GDP)

- Fiscal deficit
- Revenue Deficit
- Capital Expenditure
- Private Capital Formation
On the size of fiscal multipliers

Expenditure Multipliers without any constraint on fiscal variables

<table>
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<th>Variable</th>
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<tr>
<td>Capital expenditure Multiplier</td>
<td>2.45</td>
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<td>Transfer Payments Multiplier</td>
<td>0.98</td>
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<tr>
<td>Other Revenue Expenditure Multiplier</td>
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Policy Scenarios

DOMESTIC SHOCKS

Scenario 1: 7th Pay Commission award with 15% permanent hike in `Other revenue expenditure’ in 2016-17, compared to base case.

Scenario 2: Higher capital expenditure with 10% rise in capital expenditure/ GDP ratio 2017-18 onwards, compared to Scenario 1.

Scenario 3: Liability/GDP to be contained at the present level of 65% by the end of the projection period, compared to Scenario 1.
Baseline Projections

Base case outcomes for 2015-16 to 2019-20 (%)

<table>
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<tr>
<th>Year</th>
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<td>3.5</td>
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<td>2019-20</td>
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<td>34.0</td>
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- Driven by higher World growth assumptions, overall GDP growth is expected to revive to over 6.5 per cent with inflation rate moderating to 6 per cent.
- Both fiscal deficit as well as revenue deficit decline marginally.
- Current account deficit decelerate moderately to 2.3 per cent.
Flowchart 1: Impact of a shock to OTHER REVENUE EXPENDITURE (EXOGENOUS) on real output, prices, fiscal deficit and government liabilities. OTHER REVENUE EXPENDITURE is obtained from combined government's total revenue expenditure after netting out transfers and interest payments.
## Scenario 1

### Impact of 7th Pay Commission Award

*(15% increase in Other revenue expenditure in 2016-17 (%))*

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- Compared to base case, almost one per cent increase in all the fiscal parameters while the current account deficit increases to 3.3%.
- Pay hike also expected to result in slightly higher GDP growth as well as inflation with sharper rise in the shock year 2016-17.
- Total liability increases close to 70% by 2019-20.
Flowchart 2: Impact of a shock to government’s CAPITAL EXPENDITURE (EXOGENOUS) on real output (in the present period and the next period), prices, fiscal deficit and government liabilities.
## Scenario 2

**Impact of Higher Capital Expenditure (%)**

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Public capital expenditure is exogenously increased (from the year 2017-18) from current level of about 4 per cent to 4.4%:

- Leads to higher output growth through increase in investment rate
- Fiscal variables also show some moderate decline from the base case (7\textsuperscript{th} Pay).
- The risk is that such strategy could be inflationary as well as widen CAD and may not be a viable policy option.
Scenario 4

Targeting liability and deficits
(through expenditure switching (%))

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Expansionary fiscal consolidation results in:

- Bringing down transfers from 5.6% of GDP to 4.4 % (pre-crisis levels) and increase public capital expenditure from 4% to 4.4%
- Liability/GDP reverts back to current levels of 65% when the public capital expenditure increases to 4.4%
- Results in fiscal deficit of 6% and revenue deficit to 1.8%.
- Such fiscal adjustments results in higher GDP growth compared to base case with almost no change in both CAD and inflation
Summary Conclusion

• Here following policy simulations are worked out
  – 7th Pay Commission award impact, targeting debt-deficits for re-drawing fiscal consolidation road map, higher growth, etc.

• Results suggest Pay Commission award would result in slightly higher growth compared to the base case, but with higher inflation, fiscal-revenue deficits, CAD and government liability.

• Expansionary fiscal consolidation (expenditure switching policy) could result in higher growth with a fiscal deficit of 6% that also brings down government liability to its present level of 65%

• Such higher growth with lower fiscal deficit could be due to strong multiplier effect of government capital expenditure compared to revenue expenditures.
Thank You