

The post-pandemic economy needs a new fiscal policy framework

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Aiming for an absolute fiscal-deficit target rather than a ratio would let counter-cyclical stabilizers kick in automatically

India's second wave of the covid pandemic is advancing at a frightening pace. On the economic policy front, a sharp contraction has upended the Fiscal Responsibility and Budget Management (FRBM) Act. As Arvind Subramanian and Josh Felman have suggested, after the ongoing crisis, our dysfunctional FRBM framework should be completely reformed ('A Post-Covid Fiscal Framework', Indian Express, 7 April 2021). Their proposed framework, rigorously derived from debt-sustainability conditions, is an important step forward in this direction. But some issues remain. The alternative approach suggested here, also derived from debt sustainability requirements, is less discretionary, simpler to implement, and additionally builds in automatic stabilization.

The original FRBM Act set a target for the Centre's annual fiscal deficit ratio (FD) at 3% of gross domestic product (GDP). The states were subsequently persuaded to legislate their own FRBM Acts, limiting a state's FD to 3% of its own GDP. This translated to a combined FD target of 5.8%. Such an arbitrary setting of FD targets, unrelated to the actual requirements of debt sustainability and independent of the prevailing state of the economy, makes fiscal policy pro-cyclical and inherently destabilizing.

When GDP growth and hence revenue growth are high, a fixed FD target translates to high expenditure growth, pump-priming even higher growth. Conversely, when GDP and revenue growth are low, the fixed FD translates to slow expenditure growth, which tends to further reduce growth. Successive finance ministers have tried to get around this problem by amending the FRBM Act, or by pushing some

borrowing off-budget, a practice fortunately discontinued by current finance minister Nirmala Sitharaman.

Subramanian and Felman's proposal is derived from the Domar-Blanchard condition that debt will be sustainable if the primary balance (PB)—fiscal balance net of interest cost—is greater than the interest rate-growth rate differential ($r-g$). This condition was violated in India in 2020-21 because the PB remained negative while $r-g$ turned positive, consequent to the steep decline in growth. Hence, the authors have argued that the PB should be increased. But instead of setting yearly PB targets, they propose the PB be raised gradually, by half a percent of GDP per year on average, allowing for fiscal consolidation to be accelerated or moderated when the economy is more or less buoyant, till PB becomes positive.

The proposal is logically sound, but too discretionary to serve as a rule for guiding annual budget-making. Deciding whether the PB target should be accelerated or moderated in a given year would require *ex ante* application of debt dynamics math to reliable forecasts of interest rates and growth. It would be preferable for the budget team, typically led by a generalist civil servant, to have a more clear-cut, non-discretionary rule.

In an alternative framework, which I have often suggested since the FRBM was first enacted in 2003, the Act would specify for, say, five years, the absolute amounts as warranted levels of fiscal deficit (WD) each year. The WD can be derived from the warranted nominal growth rate, which in turn is calculated as the required growth rate for debt sustainability. This framework can also be extended to derive the warranted primary balance (WPB) path, i.e. FD net of the interest cost of past debt. Such a rule builds in automatic stabilization, since the fixed WD in a given year will automatically raise the FD (or PB) when actual growth is lower than warranted growth, and lower the FD (or PB) when growth is higher than warranted growth, thereby tending to drive actual growth back towards the warranted growth path. Note that the WD is an absolute level, while the FD and PD are ratios of GDP.

How are the warranted growth rate and the WD to be determined? In their recent paper ('Fiscal Policy and Growth in a Post-Covid-19 World', Economic and Political Weekly, 27 February 2021), which also applies the $PB > (r-g)$ rule, Chinoy and Jain identified 9% as a knife-edge growth rate. Assuming a high debt-to-GDP ratio of 85% in 2021-22 and allowing for annual reduction of the FD by 0.5% of GDP, as per the 15th Finance Commission recommendation accepted by the government, they show that with nominal growth of less than 9%, the debt-to-GDP ratio will rise, while at growth over 9%, that ratio would gradually decline. So 9% is the warranted nominal GDP growth rate. If the Reserve Bank of India can maintain an average inflation rate of 4%, as specified in its monetary policy framework, then the required warranted real growth rate would be 5%, which is quite feasible. The warranted growth rate also defines a warranted nominal GDP path. Applying the consensus FD path—declining by 0.5% of GDP per year—to this warranted GDP path determines the warranted fiscal deficit level, or WD, for each year.

This 5-year series of WD, consistent with a gradually declining debt-to-GDP ratio, can serve as a reformed FRBM framework. It can be apportioned between the Centre and states in accordance with the 15th Finance Commission's recommendation for their respective FRBM Acts. This is a simple, non-discretionary deficit rule that is also automatically stabilizing. FRBM Acts should also provide escape clauses to deal with extreme shocks like the present pandemic.

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