Primary Deficit, Fiscal Deficit - Debt Dynamics in India

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Abstract
There are ample of studies and evidences from the literature that shows the relationship between fiscal deficit and public debt. Primary and fiscal deficit plays a vital role in Debt dynamics. There has been always debate whether fiscal deficit is important or primary deficit. This paper brings out answer to some important questions. This paper attempts to explain the debt dynamics followed by an ongoing debate on primary versus fiscal deficit in India and this paper ends with a conclusion.

Keywords*: Debt Dynamics, Debt-to-GDP ratio, Fiscal deficit, Primary deficit/ Surplus.*

I. INTRODUCTION

Fiscal Policy plays a vital role in an economies development. Fiscal Deficit is important thing in economic policy making. According to economics literature, Debt and Monetary financing are the sources of financing fiscal deficit. Monetary financing consists of Minting of currency and increase taxes while Debt consists of domestic and external borrowing.

There are ample of studies and evidences from the literature that shows the relationship between fiscal deficit and public debt. Primary and fiscal deficit plays a vital role in Debt dynamics. There has been always debate whether fiscal deficit is important or primary deficit.

For any economy the most important thing matter is 'Debt Dynamics'. The term is defined as decline in Debt as a percentage of Gross Domestic Product (i.e. Debt-GDP ratio) as a result of high economic growth and keeping inflation under control.
It is very much essential to understand 'Debt Dynamics'. This paper attempts to explain the debt dynamics followed by an ongoing debate on primary versus fiscal deficit in India and this paper ends with a conclusion.

II. VERY IMPORTANT CONCEPTS (TO KNOW BEFORE UNDERSTANDING DEBT DYNAMICS)

These terms are often used whenever there is a discussion about Debt Sustainability / Dynamics.

"Primary Balance" is one of the terms which are often used in the context of debt sustainability. Technically, a primary balance means government budget balance excluding interest payments on the debt stock.

*"**Interest payment**"* is the payment that a government makes on it borrowings to the Creditor.

"Interest rate" is a rate charged for the Money used or invested. From Borrower perspective, an interest paymentsmeans rate charged for the money lent. For an Investor, interest payments are an earned income on cash accounts or fixed and variable rate.

"Debt-to-GDP" *or* ***"Debt/GDP"***ratio is a comparative measure of countries debt burden (to the GDP). It is a measure which shows the capacity of a countries debt sustainability (including all taxes to pay off the debt).

"***Outstanding interest payments"*** *means the interest payments which are need to paid for the money borrowed or to be received for the money earned/ lent.*

"***Primary Deficit***" is fiscal deficit minus interest payments. A primary deficit needs to be financed by further borrowing.

"Fiscal Deficit"shows the requirement of borrowing (or) borrowing requirements of the Government to finance the expenditure including the interest payments. Fiscal deficit includes interest payments.

***An illustration to understand the difference* is -** *If primary deficit is zero (0), then fiscal deficit is equal to interest payment (0+i). If primary deficit is one (1) then fiscal deficit is one plus interest payments (1+i).*

III. DEBT DYNAMICS

The basic debt dynamics talks about or defined as accumulation of debt over a period of time. It is said that debt grows due to primary deficit (Pd) and outstanding interest rate payments (i).

There are two important things about the Debt-dynamics of the Government. They are:

a. Difference between real interest rate and Growth rate *(r-g)*

b. Primary Budget Balance as a % of GDP (i.e. before interest payments) (p)

A. *Difference between real interest rate and Growth rate (r-g)*

For any given period (usually a year) the debt stock grows by the existing debt stock (d_0) multiplied by r-g minus primary budget balance (p). In a equation form

$$\text{Debt Stock (ds)} = d_0 * (r-g) - p$$

The most important simple r-g assumption in debt dynamics

[1] If r-g is greater than zero, (i.e.) when interest rates are greater than GDP growth, means that the debt stock has increased over time.

[2] If r-g is less than zero, (i.e.) when interest rates is lesser than GDP growth, will cause the debt stock to fall.

B. *Primary Budget Balance (i.e. Primary Surplus/ Deficit)*

The second important thing is Primary Budget Balance. A "**Primary Budget Surplus"** is the Government Revenues minus expenditures not including the interest earnings and expenses.

The Primary Surplus must be large enough to cover the excess of interest cost on the national debt over GDP growth, or else the Debt to GDP ratio will rise. In simple equation form:

Primary Surplus / GDP > Debt/ GDP* (r-g)

…where r is the interest rate on the government debt and g is the rate of growth in GDP; r and g are either both expressed in real (inflation-adjusted) or nominal terms.

In Debt dynamics a primary budget surplus causes debt stock to fall and primary budget deficit (or primary deficit as they say) causes debt stock to Rise.

Primary Surplus causes debt stock to fall by allowing Government to pay off some of the existing debt whereas primary deficit induces further borrowing in order to finance the expenditure.

In reality, many countries (commonly seen in developing countries) have primary deficit rather than primary surplus. This means unless their GDP growth is astounding than the interest payments their Debt to GDP ratio will go up.

Primary Deficit and Fiscal Deficit plays important role in '*Debt Dynamics*'. Now let us move on to Primary versus Fiscal deficit, in order to find out which one is to be addressed by an economy in order to have sustainable growth.

IV. DEBATE ON PRIMARY DEFICIT VERSUS FISCAL DEFICIT IN INDIA

There is an age old debate among Economist (specifically Fiscal economist), that whether an economy should target primary deficit or fiscal deficit. Recently in India this debate started again and received different views from different economist and analyst. Some economist/ analyst batted for Primary Deficit and some for Fiscal Deficit.

In recent Fiscal Responsibility Budget Management report, there was dissent note from Chief Economic Advisor, Ministry of Finance, which sparked this debate. The CEA in his dissent note has clearly vouched for primary deficit as a target rather than the fiscal deficit (which is at present). This was supported by few economists.

Few economists has differed from this including internationally acclaimed and noted economist Mr. Montek Singh Ahluwalia. He said "Fiscal rules should focus on macroeconomic stability and the relevant targets for this are the fiscal deficit, the primary deficit, and the debt/GDP (gross domestic product) ratio. The committee has focused on the fiscal deficit, the debt ratio, and also the revenue deficit, which in my view is not relevant." He further stated that "Our fiscal deficit and debt ratio are much higher than those of other comparable emerging market countries."

Mr. Ahluwalia emphasized that since India's fiscal deficit and debt ratio are weak the fiscal rules should try to correct the both.

Few economists and analysts, who vouched for fiscal deficit, argue that the Government pays higher interest rate to the depositors in small savings schemes. As there are accumulated unfunded liabilities is of the order of around Rs 1.14 trillion and to offset the higher interest payments to depositors, Government borrows at a higher rate from the small savings fund. This also widens the unfunded obligations in small savings schemes. Since the policy decisions of the Government affect the overall interest burden on the Government, it has to be held responsible for interest payments too. This means that appropriate measure of Fiscal Responsibility must be on Fiscal Deficit and not on Primary Deficit.

V. CONCLUSION

The above debate is still widely open and debated not only in India but across the countries. The debate raises two important question for any economy, they are

- If a country with higher or increasing Debt-GDP ratio is Insolvent?
- Is primary deficit or fiscal deficit an appropriate target to control Debt-GDP ratio? Or in other words does Interest payments matters?

The answers are

i) one cannot say that a country is insolvent just because its debt is increasing. If a country/ economy have the capacity to generate surplus in the future which is more than the level of debt today, then that country cannot be insolvent. The Fiscal adjustment has to stabilized, in order move the economy to be solvent.

ii) Deficit financing always involves interest rate too. Therefore, Fiscal Deficit – which includes the interest rate – is the best target to control debt-GDP ratio.

Any economy, especially developing, cannot ignore interest payments. The best example for Fiscal deficit side is Greece. Greece's Government which had run large budget deficits found that their interest rate has increased and as a result it became very difficult for them to reduce primary deficit.

The answer is of course yes Interest payments do really matter. The increasing of debt implies the deficits including interest payment (i.e. Fiscal Deficit) and not excluding interest payments (i.e. Primary Deficit). Therefore, it is very evident that Fiscal Deficit as a target measure of Fiscal Responsibility will definitely take any economy to the Right Path.

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