Article

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Debt Dynamics in India - Is Fiscal Deficit Good or Bad for an Economy?

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Abstract

Fiscal Policy plays a vital role in any economies development and also plays an important role in their policy making. According to the economics literature, Debt and Monetary financing are the sources of financing fiscal deficit. There are ample of studies and evidences from the literature that shows the relationship between fiscal deficit and public debt. For any economy the most important thing that matters is to understand 'Debt Dynamics'. This paper attempts to explain what debt dynamics means, it goes further why fiscal deficit is important and also attempts to explain whether Fiscal Deficit is Good or bad for an economy.

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

Introduction:

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. Fiscal Policy plays a vital role in any economies development and plays an important role in their policy making. According to economics literature, Debt and Monetary financing are the sources of financing fiscal deficit. For any economy the most important thing that matters is to understand '***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.

There is always a question arises not only for a layman but also even for a policymakers whether Fiscal Deficit is Good or Bad for an economy. In order to understand whether fiscal deficit is Good or Bad for an economy it is essential to know why Fiscal Deficit is important and also iti is very much essential as well as important to understand '***Debt Dynamics***'. This paper

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attempts to explain the *Debt Dynamics,* also to understand why fiscal deficit is important and also attempts to explain whether Fiscal Deficit is Good or bad for an economy. Before proceeding on ***'Debt Dynamics'*** a few important concepts are explained.

Very Important Concepts (to know before understanding debt dynamics)[2]:

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 payment smeans 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).*

Debt Dynamics[3]:

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)

[2] Madhusudhanan S, Primary Deficit, Fiscal Deficit - Debt Dynamics in India, SSRG International Journal of Economics and Management Studies (SSRG-IJEMS) – volume 4 Issue 11 – November 2017

[3] Madhusudhanan S, Primary Deficit, Fiscal Deficit - Debt Dynamics in India, SSRG International Journal of Economics and Management Studies (SSRG-IJEMS) – volume 4 Issue 11 – November 2017

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

- 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.
- 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.

Now we have seen in short what 'Debt Dynamics' is and now a question arises which is more important as a part of '*Debt Dynamics*' is it Fiscal or Primary Deficit? As we all know that both Primary and Fiscal Deficit plays important role in '*Debt Dynamics*', one should remember that Primary Deficit does not include interest rate payments whereas Fiscal Deficit includes interest payments.

Therefore, Fiscal Deficit *(which includes the interest rate)* is the best target to control debt-GDP ratio. The increasing of debt implies the deficits including interest payment (i.e. Fiscal Deficit) and not excluding interest payments (i.e. Primary Deficit). Therefore, the Interest payments do really matters in '*Debt Dynamics*' and it is very evident that Fiscal Deficit as a target measure of Fiscal Responsibility will definitely take any economy to the Right Path. Targeting Fiscal Deficit is more important than primary deficit, because, Fiscal Deficit will take care of Primary Deficit. Now let us move on to our question whether fiscal deficit is good or bad for an Economy.

Is Fiscal Deficit is Good or Bad for an Economy?

For any economy Fiscal deficit is one of the best indicators of how an economy functions. The difference between income and expenditure of the Government is called Fiscal Deficit. This may be due to increase in either capital expenditure or due to increase in revenue expenses exceeding income. Usually, Fiscal Deficit is expressed as a percentage of a country's Gross Domestic Product (GDP). Some countries opt for higher fiscal deficit in order to boost aggregate demand. By doing so, government will boost consumer spending and also make up for the decline in investment which will stabilize the aggregate demand.

However, long-term fiscal deficits are detrimental to economic growth and stability. Fiscal Deficit is one of the best Macro Economic indicators to show the stability of the economy. Higher Fiscal Deficit for longer time will delay investment decisions and also affect job markets. Continuous increase in deficit and government debt will take away large junk of the economy's income towards interest payments and will be huge burden for the economy.

Conclusion:

Any economy, especially developing, cannot ignore interest payments. The best example for why Fiscal deficit matter is Greece. Greece's Government which had large budget deficits found that their interest rate has increased and as a result it became very difficult for them to reduce primary deficit. Therefore, resulted in default. 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. Whether Fiscal Deficit is good or bad depends entirely on where the major portion of it is spent. If it is spent on Capital Expenditure then it may be considered as good, as this will boost the economy's growth, income and also will result in Job creation. If it is not spent on capital expenditure and spent mostly on paying interest payments, then it is not good for the economy. Ungoverned fiscal deficit can lead to runaway inflation and can affect the economy badly.

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