Irrelevance of fiscal deficit and other stories

BUDGET ECONOMICS

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There are few surer ways of attracting flak than standing in a room full of armchair and sell-side economists and saying "India's public finances have rarely looked better."

For the past few weeks, we have done this several times, and almost without exception, have been asked: "What have you been smoking?" "How can you say this when the fiscal deficit is going to be 5%-plus?" "And that's not even counting the state-level deficits."

Well, the short point is: fiscal deficits don't matter—not when viewed in isolation.

The logic for hating fiscal deficits, and we agree with this, is that high fiscal deficits cause the country's debt burden to rise, and this leads to higher interest rates, apart from crowding out investments.

But this entire chain of logic breaks down when you relate it to India's public finances (*see graphic*).

The data speaks for itself. Despite running persistent fiscal deficits, the government (and the trend altered markedly for the better from the time the United Progressive Alliance, or UPA, came to power in 2004) has reduced total debt expressed as a percentage of gross domestic product (GDP) to 64%. While this is not intended as a pat on the back for the UPA, it may also be noted that this ratio worsened dramatically under the National Democratic Alliance (NDA) rule. As an aside, the nominal GDP growth under the NDA was the worst the country has seen since 1982. The turnaround in India's public finances under UPA has been highly impressive, given the mess it inherited from the NDA government. Separately, the debt of state electricity boards, at ₹400,000 crore (and not all of it is bad) doesn't add much to the national debt at all.

India's achievement of reducing the debt ratio has come despite growing rapidly from 2004 onwards, right up to FY08, and beyond. Clearly, the growth that we have seen hasn't been debt-fuelled, unlike in the case of the other high-growth large economy, China.

Even more creditable is the achievement on this front since the global crisis hit. Total debt/GDP has dropped from 69% in FY08 to 64% in FY12, and central debt/GDP has fallen from 49% in FY07 to 44%. This has come despite a doubling of the central fiscal deficit as percentage of GDP from 2.5% in FY08 to 5%-plus in the current year. Similarly, the ratio of interest payments as a percentage of overall budgetary receipts was in the high 40% range in the late 1990s and early 2000s. This ratio now stands at around 31%.

The analysis highlights the folly in focusing solely on the fiscal deficit, while completely ignoring its resultant, the debt/GDP ratio.

View it this way: a company can run persistent negative free cash flows. This, by itself, is not a bad thing as long as this negative free cash results in increased revenue and profits, which in turn reduces the debt/equity ratio substantially, thereby increasing borrowing headroom for adding more debt to fund expansion. The negative cash generation actually keeps the debt/equity ratio low and comfortable (and possibly even helping reduce it by ensuring the accretion to debt remains less than the accretion to net worth) and ironically enough, results in a situation where the company is in good shape and, in fact, is actually a growth story for investors. While national accounts are not strictly comparable to corporate accounts, the broad principles remain the same: the fiscal deficit is a cash-flow deficit, which by itself means nothing. One has to go further into the analysis and see if the deficit worsens the debt/GDP ratio or, in fact, reduces it, as it has in the case of India's public finances.

As is the case with cholesterol, there is good cholesterol and bad cholesterol. So with fiscal deficits. A good fiscal deficit is one that reduces the debt burden by engineering a debt-light growth, and as the data shows incontrovertibly, India's deficit has been of the "good, debt-light" variety: it has reduced debt and interest burdens (expressed as relevant percentages) dramatically, while fostering strong economic growth.

The correct approach to read the numbers, therefore, is to focus on the debt/GDP ratio and not on the fiscal deficit ratio.

How has this reduction in the debt/GDP ratio happened, despite the "terrible" fiscal deficit? Arithmetically, this has happened because GDP growth has far outstripped debt growth, but let's look at the data for a clearer picture.

The data again speaks clearly. The headroom in the budget, created by declining percentages of interest as a percentage of receipts has been put to use by the government in social programmes, through subsidies and other entitlement programmes. Termed by the intelligentsia as "wasteful subsidies" and "subsidy burden", the fact is that these programmes have pushed more money into the hands of the disadvantaged sections of India: the rural poor. This has, in turn, sparked off a consumption boom across small-town/rural India. Talk to any company in the consumer product or automobile business: there has been massive growth in consumption from these parts of India. This consumption boom has been a big driver of India's GDP growth over the last few years.

Which brings us to another interesting aspect: almost without exception, companies that serve rural India's consumption boom are those that pay the entire tax they are supposed to (since they are not in the infrastructure or project business, they do not enjoy the tax write-offs companies in those businesses do). Hindustan Unilever, ITC, Marico, Nestle and Asian Paints, all pay near full tax. So do most automobile companies such as Bajaj Auto and Maruti Suzuki.

Herein lies the crux: entitlement programmes benefit rural India. Rural India, in turn, consumes products sold by these companies (and others in these categories). This consumption boom drives GDP growth. These companies grow massively as a result of this rural boom. Their profits multiply handsomely. Better still, these profits come after payment of full taxes, as almost none of these companies enjoy any tax shields on their profits. This, in turn, benefits corporate tax collections dramatically, which helps keep national debt levels declining even as the economy grows fast. So it's a nice little virtuous cycle: GDP growth has been aided by the entitlement programmes, and corporate tax collections have kept revenues buoyant. The overall effect has been that debt/GDP has declined dramatically.

Which brings us to the so-called "poor quality" of India's fiscal deficit, i.e., almost 80% is contributed by the revenue deficit and just 20% by the capital deficit. Common wisdom is that a deficit with a higher capital deficit component and lower revenue deficit one is desirable. It's time to question this assumption.

In general, investment in capital assets, say infrastructure, adds to debt/GDP, because it does not generally produce profits for the government. In fact, most infrastructure projects incur losses. This further worsens the debt/GDP. Yes, the logic is that in the long run, these investments will pay off, but in reality, this is a long shot. Further, and equally important, companies that benefit from the government's infrastructure spending—say, cement, steel, capital goods companies—rarely pay full taxes, because they are capital-intensive industries, and given this, they have generous tax shields. So, the tax intensity of a rupee spent on capital spending is a lot less than a rupee spent on entitlement or revenue spending. This, therefore, hurts the national finances as it doesn't add as much to revenue, but adds dramatically to the amount of debt on the national balance sheet. This is what pushes countries into debt traps.

Japan applied the Keynesian model when it got into recession in 1991. It entered the recession with debt/GDP of 65%. By the middle of the 1990s, this had become 150% as Japan listened too much to the Americans and spent recklessly on trains and bridges to nowhere. Now the debt/GDP of the country stands at 230% or higher.

China is in exactly the same boat. Capital spending has seen it achieve tremendous GDP growth—from being the same size as India in 1990, it has now grown to about three times India's size but its total debt/GDP ratio has gone from 78% in 1990 to 155% now, and will hit 180-200% by 2016. China will have $22 trillion of debt by 2016!

By any measure, India's public finances stand head and shoulders above that of its peers. Its household consumption expenditure as a percentage of GDP is 60% vs 38% for China and 49% for Russia. Its gross fixed capital formation is 31% vs 43% for China and 20% for Russia. India's economy has also handled this global recession admirably on nearly all parameters, such as differential GDP growth over global GDP growth, and lowered debt/GDP ratio (nearly all large economies have seen this ratio rise dramatically in this period).

The fact that India has achieved high GDP growth while lowering its debt ratios (even through this recession) has made its DIG (debt intensity of GDP) ratio look very good: for India, this ratio has been around 0.7x, ie, India's growth is not debt-intensive. For China, this ratio has generally been in the 1.5 to 2x range, and for Brazil, generally above 1. This shows that China needs to add two units of debt to generate one unit of GDP, which is what has led it right into a debt trap. The US has a ratio higher than 1x. And the UK, more than 2x.

Finally, two points the finance minister must keep in mind: 1. He must figure out a way to incentivize high corporate tax paying companies serving rural India through excise duty cuts or any other measures. He must avoid the temptation to raise excise duty on two-wheelers and consumer products. In fact, he should lower them. The revenue foregone will be more than made up through volumes sold to a consumption-hungry rural and small-town India; 2) He must avoid the temptation to pump-prime the economy through capital-spending programmes. India must only encourage the private sector to spend on big-ticket infrastructure projects. The national balance sheet should be used sparingly for only the most essential infrastructure projects. The debt/GDP must keep declining. That's the key. And this can happen as long as India feeds its rural consumption boom—which, by its nature, is not capital- or debt-intensive—and keeps reaping the fruits of this boom via increased direct tax receipts from its beneficiary companies.

As we can see from the above, India's public finances are in great shape. And they will get better if the Reserve Bank of India (RBI) obliges with some rate cuts. (RBI's logic is circular: it says it will not cut rates unless the deficit is controlled. But the deficit can be controlled largely if it cuts rates, as cuts will spark off growth, which will lead to sharply higher tax collections, both of which combined will lower the deficit percentage. In fact, it is monetary tightening that has contributed in large part to India's slowdown which, in turn, has slowed tax receipts down thereby worsening the deficit.) It is our take that this year India will overtake China in headline GDP growth numbers.

Forget the fiscal deficit. It's a poor way to look at a country's macro picture. It's the debt/GDP that matters most. And we are in good shape on that. The dismal scientists are wrong in their obsessive focus on the fiscal deficit—and on their dire view of the Indian economy.

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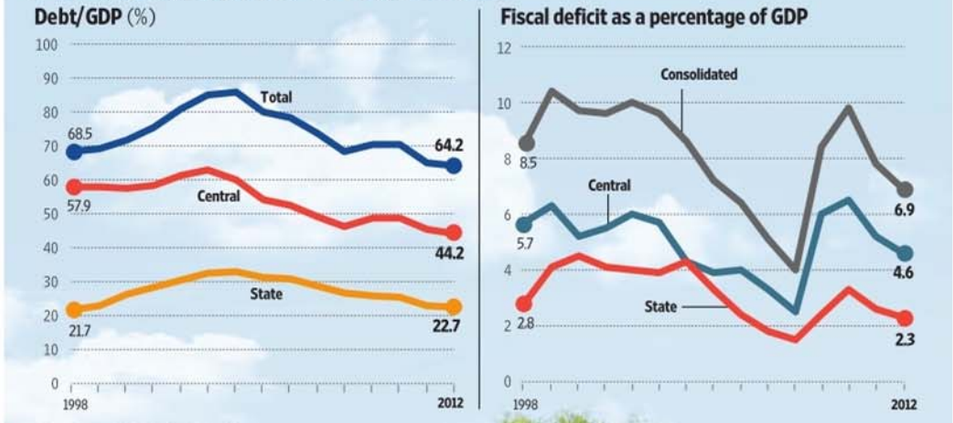

Source: Reserve Bank of India, ministry of finance

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