DAILY EDITORIAL ANALYSIS

TOPIC

INDIA NEEDS TO KEEP ITS DEFICIT TARGET FLEXIBLE

INDIA NEEDS TO KEEP ITS DEFICIT TARGET FLEXIBLE

Context

- As India aims to become a developed nation by 2047, it is crucial **to adopt a more flexible approach to fiscal deficit targets** to ensure **long-term investments** without compromising fiscal prudence.

Understanding the Fiscal Deficit Target

- A **fiscal deficit** occurs when a government's total expenditure exceeds its total revenue, **excluding borrowings.**
- In India, the **Fiscal Responsibility and Budget Management (FRBM) Act, 2003** initially set a **fixed target for the fiscal deficit** to ensure fiscal discipline.
- However, evolving macroeconomic conditions and economic shocks have led policymakers to consider a **more flexible approach**—termed the **Flexible Deficit Target.**
- It allows for adjusting fiscal deficit goals **based on economic cycles, external shocks, and investment priorities.**

Key Components of Flexibility

- **Counter-Cyclicality**: Allowing higher deficits during economic downturns and consolidation during high-growth periods.
- **Expenditure Prioritization:** Focusing on essential spending such as infrastructure and welfare while cutting non-urgent outlays.
- **Revenue Considerations:** Adapting targets based on tax collection efficiency, disinvestment proceeds, and other fiscal inflows.
- **Escape Clauses:** Built-in mechanisms to deviate from deficit targets during crises (e.g., pandemic, global shocks).

Fixed vs. Flexible Deficit Targets		
Parameter	**Fixed Deficit Target**	**Flexible Deficit Target**
Definition	A strict numerical cap on the fiscal deficit (e.g., 3% of GDP)	Allows deviation based on economic conditions
Adaptability	Rigid, less responsive to shocks	Dynamic, adjusts to changing economic realities
Growth Consideration	Prioritizes fiscal consolidation	Balances fiscal prudence with growth needs
Example	FRBM Act's initial 3% target	FRBM Act's revised escape clause allowing deviations

Evolution of Flexible Deficit Targeting in India

- **FRBM Act and Amendments:**
  - **FRBM Act, 2003:** Mandated reducing the fiscal deficit to 3% of GDP.
  - **FRBM Review Committee (2017, N.K. Singh Panel):** Recommended a more flexible approach, with a 2.5% - 3% target and an escape clause allowing **deviation of 0.5% in exceptional circumstances.**
  - **COVID-19 Impact (2020-21):** The government increased the fiscal deficit target to 9.5% of GDP, demonstrating the necessity of flexibility in fiscal management.
- **Union Budget 2021-22 & Beyond:** The government set a medium-term goal of **reducing the deficit to 4.5% of GDP by FY2025-26**, instead of enforcing an immediate return to pre-pandemic levels.
  - Allowed for higher spending on infrastructure and social welfare to boost economic recovery.
  - The government emphasized pragmatic fiscal management over strict adherence to targets.

- Capex boost to sustain economic growth.
- Gradual deficit reduction instead of aggressive fiscal tightening.
- A willingness to recalibrate targets based on economic needs.
- It signals a de facto shift towards flexible deficit targeting.

Why India Needs a Flexible Deficit Target?

- **Economic Shocks & Global Uncertainty:** Events like COVID-19, geopolitical tensions, and oil price volatility demand fiscal space for counter-cyclical measures.
  - A rigid deficit target could limit government intervention during crises.
- **Investment-Driven Growth Strategy:** The government's capital expenditure (CapEx) push requires sustained spending on infrastructure, which may exceed fixed deficit limits.
  - Flexible targets allow the government to borrow strategically rather than enforcing arbitrary spending cuts.
- **Counter-Cyclical Fiscal Policy:** During economic slowdowns, the government should increase spending to boost demand.
  - In periods of high growth, deficit targets can be tightened to maintain fiscal discipline.
- **Infrastructure and Social Sector Needs:** Developing economies like India require continuous investment in infrastructure, health, and education.
  - A rigid deficit target could force spending cuts in these critical areas.
- **Private Sector Confidence**: A balanced approach — where fiscal discipline is maintained without excessive rigidity — can boost investor confidence.
  - The key is ensuring that fiscal expansion is targeted and productive.

Challenges of Flexible Deficit Targeting

- **Risk of Fiscal Indiscipline:** A lack of strict targets may lead to uncontrolled borrowing, increasing debt-to-GDP ratios and risking credit rating downgrades.
  - Markets and credit rating agencies prefer clear deficit targets for policy predictability.
- **Market Perception & Investor Confidence:** International investors prefer fiscal predictability. Frequent adjustments to deficit targets could create policy uncertainty, affecting bond markets and FDI flows.
- **Inflationary Pressure:** Increased government borrowing may fuel inflation, especially when supply-side constraints exist.
- **Higher Interest Costs:** Persistent high deficits lead to increased government debt and interest payments, limiting funds for development projects.
- **Welfare Programme Constraints:** States with extensive welfare models, like Kerala and Tamil Nadu, struggle to expand services like healthcare and education.

International Best Practices

- **USA:** Adopts countercyclical fiscal policies, allowing higher deficits during recessions and aiming for gradual consolidation during growth phases.
- **Germany:** Traditionally follows strict fiscal discipline but relaxed its **'debt brake'** during COVID-19.
- **Japan:** Prioritizes economic growth and employment stability, despite a 200% debt-to-GDP ratio.
- **Australia:** It uses public-private partnerships (PPP) to finance infrastructure, reducing its reliance on public debt.

Way Forward: Balancing Flexibility with Responsibility

- **Strengthening Fiscal Rules:** Introducing a clear range-based deficit target (e.g., 2.5% - 4% of GDP) rather than a strict fixed number.

- **Institutional Oversight:** Setting up an independent Fiscal Council to ensure responsible deficit deviations.
- **Gradual Deficit Reduction:** Committing to a credible glide path toward fiscal consolidation without abrupt spending cuts.

Conclusion

- India's shift towards a Flexible Deficit Target reflects the need for adaptive economic policies in an unpredictable world.
- While flexibility helps manage crises and promote growth, it must be implemented prudently to maintain long-term fiscal sustainability.
- A balanced approach—allowing temporary deviations while maintaining a clear medium-term fiscal roadmap—is key to ensuring both economic stability and development.

Source: IE

Mains Practice Question

[Q] Evaluate the importance of maintaining flexibility in India's fiscal deficit targets. How can a dynamic approach to deficit management balance the needs for economic growth, public investment, and fiscal prudence in the context of India's developmental goals?

■■■■