

Using the snowball effect in Indian post Covid-19 paths to fiscal consolidation

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Abstract

In order to analyze how the excess of growth over the real interest rate can best contribute to Indian post Covid19 debt adjustment paths, we draw on historical experience, past adjustment episodes and special features of emerging markets (EMs). In many EMs growth (g) routinely exceeds real interest rates (r) because of good growth prospects. But borrowing costs are high and unstable. Volatility and uncertainty can raise risk premiums and interest rates. Both domestic and international risks have to be reduced to lower volatility. With regard to domestic policy, India does show a credible fall in primary deficit ratio (PD) as well as off budget items after fiscal responsibility legislation was introduced. The $g-r$ gap was also positive but pro-cyclical macroeconomic policy made this highly variable. Counter-cyclical policy that stabilizes shocks can keep average $g-r$ at around 5. A counter-cyclical PD will contribute, and together with a substantial $g-r$ gap, lower debt most efficiently, creating space for adequate fiscal response to future shocks. Reducing debt in the medium-term is consistent with Covid19 related fiscal spending.

Keywords: Deficits; Debt; Adjustment paths; Covid19; Emerging Markets

JEL Code: H63, E62, E63, O11

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1. Introduction

In this paper we analyze post Covid19 debt adjustment paths for the Indian central government. In order to understand how the excess of growth over the real interest rate can best be harnessed for this purpose we draw on historical experience, past adjustment episodes, and special features of emerging markets (EMs). Different possible scenarios of adjustment are examined.

The real debt ratio falls if the rate of growth (g) exceeds the real interest rate (r), but rises with the primary deficit ratio (PD). PD is the excess of real government expenditure over taxation as a ratio to output. When r is less than g public debt ratios can reduce over time even if the PD is positive. The first component is the snowball effect that is getting a lot of attention in advanced economies (AEs) after Covid19.

Covid19 has led to a jump in public debt as a result of governments' protection and stimulus expenditure¹. The largest rise by far has been for AEs who account for 80% of the rise in borrowing. But their interest costs remain low. In the G-7 AEs debt rose from 85% of GDP in 2005 to 140% in 2021, but average debt servicing fell from 2% of GDP to 1.5%. The reason is very low interest rates. One school of thought argues real interest rates are likely to remain below growth rates because of secular stagnation—an excess of savings over investment, so that these governments should borrow and spend more to raise growth (Blanchard 2020). Other economists, however (for example Aizenman and Hiro, 2020) fear real interest rates can rise enough to make debt unsustainable².

In many EMs also g is expected to exceed r because of good growth prospects. But borrowing costs are high and unstable³. Bond markets are more willing to lend to AEs.

¹ Average rise in spending: AEs 20% of GDP; emerging market and developing economies (EMDEs) 6%; low income developing countries (LIDCs) 3%. On the borrowing side: projected rise in 2021 debt/GDP AEs 20.6%, EMs 6.2%, LIDCs 8.4 (IMF, 2021).

² There was a warning jump in benchmark US government 10 year bond yields after a large US stimulus announcement as well as inflation that exceeded the April forecast. They rose from 1% at the end of January to 1.68% in May despite an accommodative Fed. Outflows followed from EMDEs. Their borrowing costs rose.

³ Indian government interest payments are the largest component of expenditure at above 3%.

Volatility and uncertainty can raise risk premiums and interest rates. Sources of risk are domestic and international. It is necessary to reduce both in order to lower volatility.

International measures to reduce volatility are required. After the global financial crisis (GFC) not enough was done to moderate spillovers from quantitative easing (QE) and exit on EMDEs. They faced larger shocks in 2011, 2013, 2015, 2018 than they did during the GFC itself. In ten major EMs pre-GFC IIP growth was 4.3 (2000-08); post-GFC (2009-17) it was 1.3 (Goyal et al 2021). Since 2005 EMs account for more than 50% of global growth –therefore a slowdown in EMs hurts growth in all countries.

Countercyclical macroprudential regulation in the major source countries can reduce capital flow surges. At present, this is used more in EMDEs than in AEs and applied more on debtors than on creditors, although research shows regulating the latter creates better incentives. For example, two major source countries, US and UK, have no prudential regulation of the non-bank financial sector. Excessive focus on banks led to arbitrage towards non-bank sectors. Moreover, zero AE policy rates induced large cross border flows in a search for yield that would reverse during global risk-off episodes. Careful US Fed communication will be required when it exits from QE to avoid a repeat of the taper tantrum induced rise in EM interest rates. EMs, meanwhile, should ensure foreign flows do not become too large a percentage of domestic markets.

Important among domestic policies that reduce volatility are reforms and shift in government expenditures towards those that raise productivity. Spikes in domestic interest rates, excessive volatility of exchange rates and real over- or under-valuation should be avoided. Reforms must avoid shocking the system, even as they remove supply-side bottlenecks that create volatility. A short run rise in deficits to protect incomes and prevent scarring from Covid19 is essential, but a persistent rise in debt can raise risk premiums. A sustainable fiscal stance requires debt to fall in the medium term.

Despite a measured fiscal response to Covid19, combined Indian government debt levels rose towards 90 per cent of GDP in 2021. The reset of the Fiscal Responsibility and

Budget Management (FRBM) Act in 2018 mandated a reduction to 40% debt as a percentage of GDP for the Central Government (CG) and 20% for state governments by 2025-26. The 15th Finance Commission (FC) in its report submitted in 2020, taking note of the extraordinary circumstances, indicated a path with a range for the FD, which is to be between 4 and 4.5% in 2025-26, while CG debt falls to 56.6%. For state governments the respective values are 3% and 32.5%. The path is worked out given expected reforms and revenue realizations and such as to maintain capital expenditures at the level they were during the 14th FC period. In view of many uncertainties, however, the 15 FC has recommended setting up a High-powered Inter-governmental Group to redraft the FRBM and set a new path for defining and achieving debt sustainability and to oversee its implementation. It is useful, therefore, to reexamine aspects of consolidation at this time.

There is a rapidly growing recent Indian commentary on debt issues. Blanchard et. al. (2021) argue the snowball effect is not reliable for EMs as both their g-r gaps and PDs are more volatile. But they do not analyze the factors that have created as well as those that are reducing or can reduce this volatility, as we do for India in this paper. For example, AE PDs are stable at high values, while Indian PDs came down steadily after the 2003 FRBM Act, with interruptions due to global shocks. The contribution of off-budget items also reduced steadily in this period. The pro-cyclicality of macroeconomic policy that created the volatility of g-r can also be moderated.

Chinoy and Jain (2021) emphasize the importance of higher growth for fiscal consolidation. They identify 9% as a knife-edge nominal growth rate to reduce debt if the fiscal deficit (FD) is reduced only by 0.5% per year. While 9% does deliver debt reduction we argue the phasing of PD also contributes. If PD stays at 3% for ten years a g-r gap of 4% and above is required for debt to reduce. But if it is higher in the initial years and reduces later a g-r gap of even 2% is sufficient for debt to reduce. We find a gap of 4% (implying a nominal growth of 8%), with a countercyclical PD will bring debt ratios down to 60 in ten years.

Mundle (2021) also argues for a countercyclical FD or PD. He wants absolute amounts to be derived from steady-state growth paths so that ratios would rise if growth fell and vice versa. But steady-state paths are controversial and difficult to agree on in an EM under growth transition.

Rangarajan and Shrivastava (2021), however, take a steady-state view. They argue the maintainable longer term nominal interest rate for government debt may have to be close to 7%. They combine a CPI inflation rate of about 4% and real interest rate of 3% to derive this. Since they expect a nominal growth rate of 9% the g-r gap is 2% so consolidation requires a fall in PDs. But they are ignoring counter-cyclical variations in the natural rate and changes in potential growth with reform. In today's world where natural rates are taken as negative in many AEs a real interest rate of 3% is on the high side. Since savings rise with growth and reform, they cannot be taken as a fixed constraint imposing higher interest rates.

The remainder of the paper is structured as follows. Section 2 has an analysis of the snowball effect in theory and over the years in India. Section 3 contrasts two recent adjustment episodes. Section 4 examines different scenarios of post Covid19 adjustment paths, before Section 6 concludes.

2. Factors affecting evolution of government debt

A simplified framework shows the factors affecting the evolution of government debt. The maturity value of nominal government debt is $B_t P_t$ in a cashless economy in which all government debt consists of riskless one-period nominal debt. Real public debt is B_t , real government purchases are G_t and real net tax collections are T_t . This value rises over time as the sum of the cost of servicing old debt, which is the interest payment on the nominal debt stock, plus new debt taken if the primary deficit is positive or real government expenditure exceeds taxation:

$$B_t P_t = (1 + i_t) B_{t-1} P_{t-1} + (P_t G_t - P T_t) \quad (1)$$

Dividing by output, Y_t , and making other manipulations, (1) can be written as:

$$\frac{B_t}{Y_t} = (1 + i_t) \frac{B_{t-1}}{Y_{t-1}} \frac{Y_{t-1}}{Y_t} \frac{P_{t-1}}{P_t} + \frac{G_t}{Y_t} - \frac{T_t}{Y_t} \quad (2)$$

And further using $1 + g_t = Y_t/Y_{t-1}$, $1 + \pi_t = P_t/P_{t-1}$ and the approximation:

$$(1 + i_t)/(1 + g_t)(1 + \pi_t) = 1 + i_t - g_t - \pi_t \text{ and } r_t = i_t - \pi_t \quad (3)$$

Gives:

$$b_t - b_{t-1} = (r_t - g_t)b_{t-1} + PD_t \quad (4)$$

Real output growth rate is g_t and the nominal interest rate on debt is i_t . Since the inflation rate is π_t , the real interest rate r_t . The real debt to output ratio is b_t . Equation (4) gives the change in this ratio. The primary deficit ratio (PD) is the excess of real government expenditure over taxation as a ratio to output. That is, the non-interest budget deficit. Inflation and growth rates do not affect the nominal value of public debt, $B_t P_t$, which increases in any year by nominal interest payments on debt plus the PD , $P_t G_t - P_t T_t$.

It is clear that if the real interest rate is lower than the growth rate real government debt falls, due to the snowball effect. Depending on the size of the gap, b_t can fall even if the PD is positive. If $r = g$, the PD alone adds to the debt ratio.

2.1. The $g-r$ gap and the PD over the years in India

Figure 1 graphs the $g-r$ gap since 1980-81. The growth rate is calculated as the rate of growth of real gross domestic product at market prices (GDPMP). The real interest rate is obtained by subtracting the GDP deflator from the nominal interest rate. The implicit average rate the central government pays on its debt is obtained by dividing actual interest payments in the budget documents iPB by PB . The source of the latter is the budget documents⁴. The analysis, in this paper, is only for the CG but results are similar

⁴Data is from ministry of finance and RBI websites. Debt and deficit figures are for the Central Government. The real interest rate was also calculated from the weighted interest rate paid on dated government securities (G-secs). This always exceeded the implicit average rate paid. The average real G-sec rate over the period was 2.3 while the implicit average rate was 0. Market borrowings through G-secs are only a part of total government borrowings. For example, according to 2021 budget documents, in 2020-21, G-secs were budgeted to finance 64.15% of gross FD, with the remaining share coming from net

if total government debt is taken. Moreover, states have to adjust since their borrowing ability is limited⁵. They responded well to the combination of carrots and sticks in FRBM 2003.

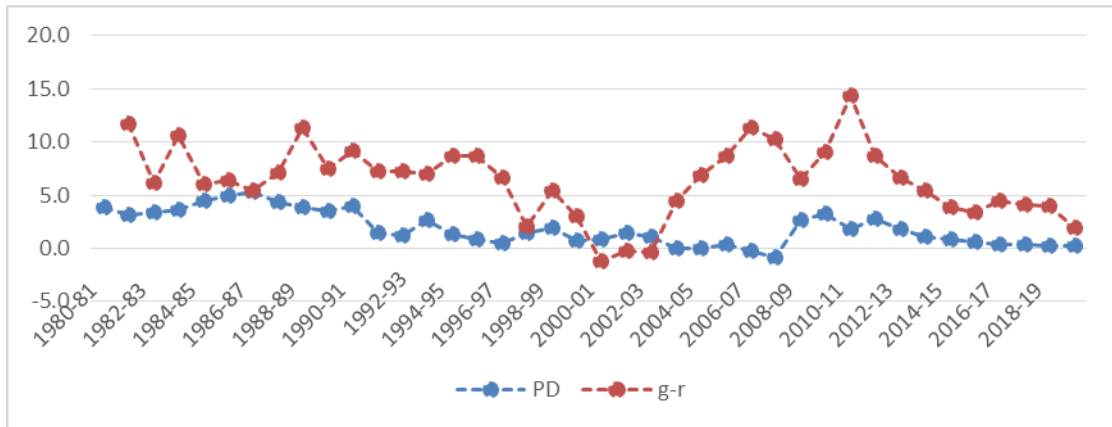


Figure 1: The primary deficit and the g-r gap over 40 years

Except for a couple of years over 2000-03 when it fell marginally below zero, for 40 years growth substantially exceeded the real interest rate paid on government debt. The PD, however, has also been positive except for a surplus of -0.9 in one year 2007-08. The debt ratio rose in the late eighties, a period of debt financed public expenditure. The stresses this resulted in partly forced the liberalizing reforms of the early nineties. The PD fell through the nineties and especially after the FRBM Act with commitment to a path of reduction, was adopted in 2003. But a sharp rise after the GFC, as part of the coordinated global stimulus, upset the fiscal consolidation.

borrowing from Treasury Bills, small savings fund, state provident fund, net external assistance and cash draw down.

⁵ States have to get the center’s permission for market borrowings. States that signed the 2003 FRBM legislation were given special debt forgiveness by the 12th FC. This, together with buoyancy in shared central revenues from high growth, led to remarkable improvement in state finances. But assuming the burdens of state electricity distribution companies as part of reform in the 2010s and farm loan waivers raised their debt levels again. The international experience is that fiscal unions where the center unconditionally bails out states or provinces tend to have very poor macroeconomic outcomes. The 15FC again gives relief for states conditional on improving their fiscal health.

Since $g-r$ substantially exceeded the PD central government debt percentage to GDP should have been falling for much of this period. Instead we find it rose from around 40% in the early eighties through a decade of high PDs and low g to about 60% in the early nineties. Painful consolidation with the nineties reforms brought it down to 54.3% in 1996-7 but it had again touched 67% in the early 2000s. It fell through the post FRBM period, despite the GFC stimulus, and was at 50% in 2019-20 prior to the Covid-19 crisis.

3. Debt adjustment episodes in India

With high growth over 2003-08 and the adoption of an FRBM Act, Indian debt levels did come down but not much. According to the debt evolution formula (4) they should have come down much more than they did.

Figure 2 shows the percentage change in b . It also shows the two components of the change in debt from Equation (4), over the Indian post-reform period. Calculated $b_{t-1}(r_t - g_t)$ and reported pd are graphed. Since r was normally less than g after 2000 and the negative $b_{t-1}(r_t - g_t)$ value was larger in absolute value than a mostly positive pd , b should have fallen much more than it did. The fall in debt over 2000-20 from the formula should have been 46.8%, but the actual fall was only 6.8%.

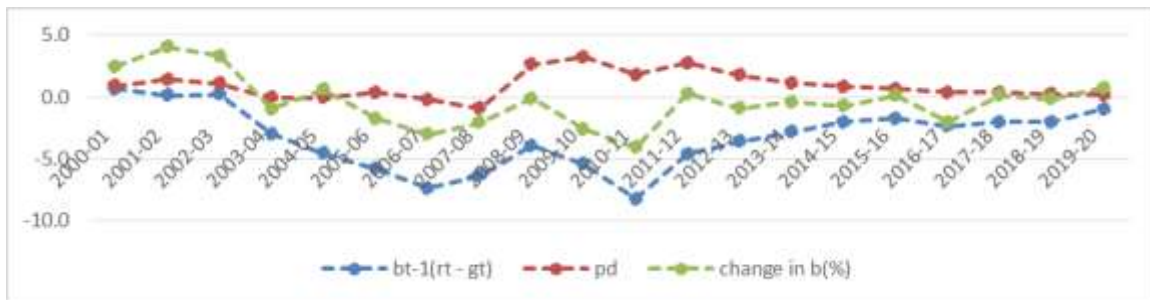


Figure 2: Change in debt and its components

The discrepancy is particularly acute in the high growth period of the 2000s, since $r-g$ was low and the pd was also falling over this period. That actual b did not fall as much as the components of Equation 4, indicates off-balance sheet items must have added to debt. The difference between the fall in debt from the equation and the actual fall in debt

gives an estimate of these items. If the 20 year period 2000-2020 is broken into 5 year periods the estimate in successive 5 year periods is 12.7, 14.2, 7 and 6.1. So after peaking over 2005-2010 these additions to debt have been falling, even though in the 2015-20 period bank recapitalization bonds added to government debt.

The fall over the years points to more transparency and better budgetary processes setting in slowly, following the 2003 FRBM legislation⁶. An example of such improvement is the first clear definition⁷ of Central Government Debt in the FRBM Act, 2018. Apart from all outstanding liabilities against the Consolidated Fund of India, it must also include the financial liabilities of any entity owned or controlled by the CG, which the government is to repay or service from the annual financial statement, since they further the objectives of the CG. These borrowings, classified as Extra Budgetary and other Resources, comprising CG fully serviced bonds and NSSF loans, are being added to the fiscal deficit from the 2021 budget onwards. Borrowings of central public sector enterprises made for their routine business activity are not counted as CG liabilities, but the large debt of the Food Corporation of India to meet government food subsidies is.

Since all borrowings to further government objectives are now brought under the FRBM they will also decrease steadily on the specified adjustment path, barring further global shocks. There is considerable reform in government expenditure, with price controls and market interventions being replaced by direct benefit transfers and explicit subsidies. Banks have reformed and strengthened in many ways and become less dependent on the government. State governments are also being incentivized to reform (see, for example 15th FC recommendations) and improve accounting processes. Successive rounds of reform have begun to make a dent in state suppression of electricity prices since

⁶ Rules accompanying the 2003 FRBM Act required the Centre to reduce the fiscal deficit to 3 per cent of GDP and, eliminate revenue deficit by March 31, 2008. There was also a ceiling on guarantees. But the ceilings could be exceeded during "national security or national calamity or such other exceptional grounds as the Central Government may specify". Moreover, deviations from the FRBM Act were possible with the permission of Parliament. Monetary financing was banned, but there are no restrictions on OMOs (Goyal, 2011). The FRBM was revised in 2018, following the post GFC relaxation, with a focus on a debt reduction path. It is expected to be revised again following the Covid19 shock.

⁷ The debt series currently available those from the RBI marginally exceed those from the Finance Ministry. We use the RBI figures.

distribution losses become subsidies of the governments. Therefore non-transparent additions to public debt will continue to reduce. Moreover, there is good progress on attempts to monetize large poorly performing government assets, accumulated in the planning period, and use them to retire government debt or transform expenditure in more productive directions.

The distinction between a temporary and a permanent rise in government expenditure, however, needs to be made. Goyal (2011) introduced a dynamic debt equation in a DSGE open economy model used for monetary policy. In response to shocks to subsistence consumption the model throws up a large increase in debt. The rise is more if debt levels are already high, and if there is higher growth. The model captures the exact Indian fiscal response during the 2000s high growth period and during the financial crisis. While deficits can finance a temporary rise a permanent rise requires taxation to rise. Monetary accommodation reduces debt levels but can increase instability if there is a permanent rise in government expenditure. Therefore fiscal institutions that can act as a restraint on non-tax financed expenditure creep need to be strengthened. Indian tax GDP ratios remain on the lower side⁸ given the large expenditure on physical and social infrastructure required. But the past decade has seen extensive tax reform as well as more comprehensive databases that can be used to reduce informalisation and tax evasion thus increasing the tax base.

Fiscal consolidation after the 2003 FRBM Act was upset by global shocks. But it also suffered from a poor appreciation of the snowball effect. Pro-cyclical rise in government spending in the 2000s high growth period was followed by over-stimulus in response to the GFC and then over-tightening after both fiscal and current account deficits widened and outflows were threatened in 2011. This made the volatility of $g-r$ much higher than that of PD . Over 1981-82 to 2019-20 the standard deviation of PD was only 1.6 compared to 6 for $g-r$.

⁸ The 15th FC estimates this at 19% of GDP compared to above 30% in most AEs. Tax ratios in most EMs are also higher.

Over 2004-11 g much exceeded r , but the PD as well as off-balance sheet items rose. Even so, the CG debt ratio fell 20% to 53.5. Over 2012-19 $g-r$ fell. High r itself reduced g ⁹. Therefore despite the PD falling due to strenuous fiscal consolidation efforts and a much lower rise in off-balance sheet items, CG debt ratio fell only 4.5%. Interest payments to GDP ratio that fell from 4.5 to 3 in 2011 stagnated around that level since.

Therefore high growth in the first period was squandered in pro-cyclical profligacy. In the second period, over-tightening of macroeconomic policy reduced the snowball effect.

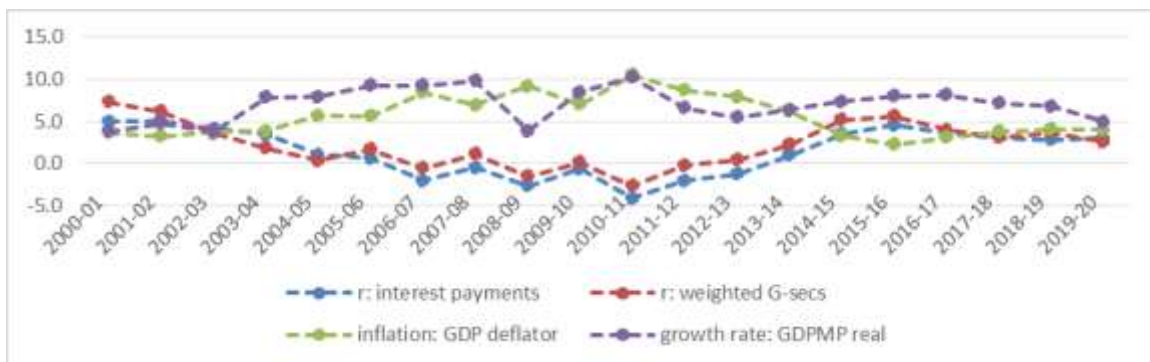


Figure 3: Inflation, real interest and growth rates

Figure 3 showing movements in the relevant real interest, inflation and growth rates over the period helps appreciate the pro-cyclicality. Real rates were low when inflation rates were high in the 2000s and high when inflation was low after 2014. Shocks to growth rates were not smoothed. The average interest rate the government paid on its debt was lower than the weighted average interest rate on G-secs in most periods. Real interest rates on government debt peaked in the early 2000s and in 2014-16 when policy rates were raised. Real rates were negative from the mid-2000s to 2013, when inflation was also high.

The lessons for post-Covid19 adjustment are to avoid pro-cyclicality as well persistent non-tax financed rise in spending, while maximizing the snowball effect. The latter requires that countercyclical policy smooth shocks to reduce volatility and prevent large

⁹ The average levels of $g-r$ and PD in the first period were 10.2 and 1.2. In the second period they were 4.9 and 0.7 respectively.

jumps in real interest rates thus reducing variation in $g-r$. Important among domestic policies that reduce volatility are reforms and shift in government expenditures towards those that raise productivity. Spikes in domestic interest rates, excessive volatility of exchange rates and real over- or under-valuation and should be avoided. Reforms must avoid shocking the system, even as they remove supply-side bottlenecks that create volatility¹⁰.

Analyzing possible adjustment scenarios gives additional lessons in the next section.

4. Post Covid19 debt adjustment scenarios in India

Higher post Covid19 deficits are expected to raise the CG debt GDP ratio to about 66%, back to the peak levels of the early 2000s before FRBM, from the 2019 low of 50. The 2021 budget papers give the FD as 9.5 for 2020-21, and budget it as 6.8 for the next year. The PDs are 5.9 and 3.1 respectively.

As we have seen, the real debt ratio increases with the excess of the real interest rate (r) over the rate of growth (g), plus the primary deficit ratio (PD). Growth in 2021-22 is expected to touch double digits on base effects and low r . The FD should rise as part of countercyclical policy to recover and exceed 2019-20 income levels after negative growth in 2020-21. Reform, combined with expenditure on high multiplier, growth and employment enhancing items, will raise potential growth making higher growth sustainable.

As growth is established and revenue rises, however, the PD must begin to fall. Avoiding the mistakes of 2000s (excess liberality) and 2010s (excess consolidation), with appropriate values of high g , low r ($r-g=-5$) and reducing PD, will allow the 66% debt ratio in 2021 to be back at 50 by 2027-28—in six years compared to the 25 years it took

¹⁰ That is one reason, in the second wave of the pandemic, local containment imposed less income loss compared to the national lockdown in the first wave. It gave more degrees of freedom aligned to local conditions, while reducing infections. Diversity reduces the impact of a shock. The national lockdown had much lower death rates and spread. But the rapid 2021 spread occurred because unlocks were taken too far under the assumption the pandemic had been contained. And new variants, unfortunately, were even more infectious. Unlocks can also be graded and diverse and be reversed at the first sign of a rise in numbers.

earlier. It will be at 54 below the 15FC guidance of 56 in 2025-26. It can fall further to reach the 2018 FRBM target of 40 by 2030-31, 5 years behind the 2018 FRBM path.

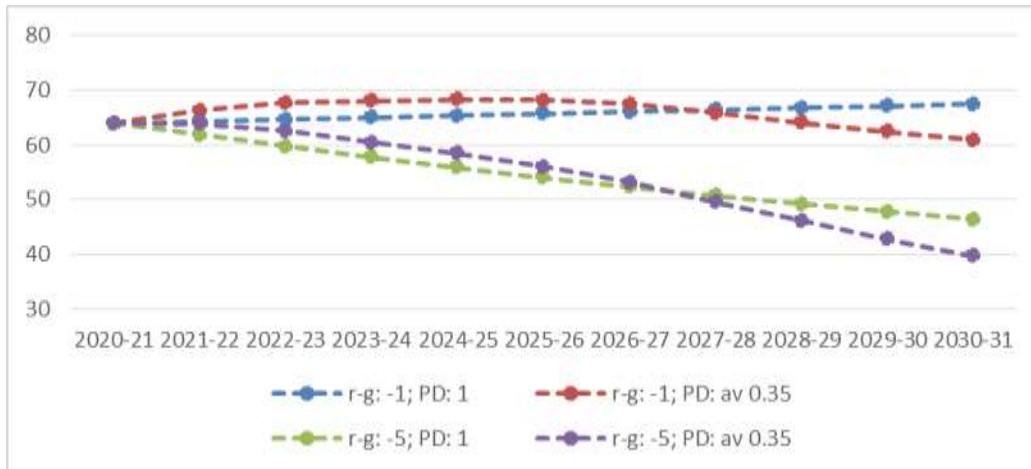


Figure 4: Post Covid19 debt adjustment scenarios

Alternate scenarios and their assumptions are shown in Figure 4. Of the 4 paths shown there, the top 2 have a small r-g gap of -1. The top line has a realistic post Covid19 PD of 3 reducing gradually and becoming a surplus of -1 in 2026-27, with an average value of 0.35. This allows deficits to be countercyclical. The intersecting line has a PD of 1 throughout the ten years. Although CG debt falls faster initially on this path the countercyclical deficit path does better in the longer-run and has a debt ratio lower by about 7% of GDP in 2030-31. Debt ratios, however, are still in the 60s.

The other two lines, with r-g= -5 deliver a much faster fall in debt ratios, which reach the 40s by the end of the decade. The scenario with counter-cyclical deficits again does better in the long-run.

The lessons for policy therefore are that counter-cyclical deficits actually help long-run consolidation. But the greatest debt reduction comes from maintaining a low real interest rate, which itself keeps growth high. This requires countercyclical variation in nominal rates with inflation. A smooth reduction in debt will prevent a rise in risk premiums that can raise nominal and real interest rates. As debt comes down and real rates remain low,

the share of interest payments in the budget will fall, releasing government revenue for more productive expenditure in a virtuous cycle.

What happens after the adjustment to 40% debt is complete? In the steady-state when b is not changing our formula (4) reduces to $b = PD/g-r$. Assuming policy is able to stabilize the real growth rate between 6 and 7% and the real interest rate remains between 1 and 2%, average $g-r$ will be about 5%. This implies the PD can be positive at 2%. Thus there will be room for a countercyclical rise if required. If g falls so should r , thus keeping the gap intact. If inflation rises the nominal interest rate should rise by more or less depending on the change in r required to keep it at the natural rate.

5. Conclusion

India shows a credible fall in PD after the FRBM was introduced. Off budget items have also been falling in the 2010s. Although the $g-r$ gap was positive pro-cyclical macroeconomic policy meant this was highly variable. Over twenty years the standard deviation of $g-r$ was more than 3 times that of PD. If policy becomes counter-cyclical and acts to smooth shocks average $g-r$ can be at around 5. A counter-cyclical PD will contribute to the smoothing as well as help reduce debt most efficiently, so that space is available for adequate fiscal response to future shocks. Reducing debt in the medium-term is consistent with a Covid19 fiscal boost.

The focus on structural debt reduction in successive FRBMs encouraged policy to be pro-cyclical. This unfortunately delayed the reduction in debt. In EMs debt ratios do tend to rise in high growth phases because of the many pressures to spend. Some institutional restraint is, therefore, required. But it should not be so strong as to remove the possibility of counter-cyclical stabilization. The 15th FC has allowed a range for the FD of 0.5 in a year. The Inter-governmental Group set up to redraft the FRBM, could consider expanding the range to 1%, with reaching the top of the range in a year conditional on quarterly growth being below trend. Escape clauses should allow a more substantial rise in FDs if there is a large shock.

With greater transparency and improved budgeting practices off-budget items should continue to reduce steadily. Improvements in fiscal institutions will help. A fiscal council can begin by serving as an information centre and aid capacity building in states. This was the experience in Europe.

Countercyclical fiscal policy brings down the level of debt and deficits in good times. An FRBM that allows countercyclical deficits would be more credible. It would enable better fiscal and monetary coordination and outcomes. A passive monetary policy can accommodate an active fiscal policy during a crisis, as long as they switch positions in the longer term. Monetary accommodation can help reduce debt servicing costs to the extent rise in expenditure is temporary. Any persistent rise in government expenditure must come from a rise in taxation. As the RBI gained greater independence in post-reform India, both tended to be active, which harmed growth. Monetary tightening sought to compensate for fiscal giveaways.

Better fiscal practices as well as counter-cyclical expenditure can help harvest the large snowball effect available in EMs. Both the excess liberality in the 2000s that wasted and the excess consolidation in the 2010s that reduced $g-r$ and the snowball effect must be avoided. We show it will be possible then to reduce the debt ratio as much in six years, as was earlier accomplished in 25 years and reach the FRBM target by 2030-31, 5 years behind the 2018 FRBM path. As debt reduction creates fiscal space, the probability of spikes in risk premium that raise interest rates is lowered.

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