Shifting the Fiscal Anchor – India's Move from Fiscal Deficit to Debt-to-GDP Ratio

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Debt-to-GDP Ratio Latest News

- As the Finance Minister prepares to present her **ninth consecutive** Union Budget, India's fiscal framework is poised for a structural transition.
- From FY 2026–27, the Centre will operationally shift its **fiscal consolidation** target from the fiscal deficit to the debt-to-GDP ratio, aligning India's approach with global best practices.
- This Budget will, for the first time, spell out the fine print of this new fiscal anchor for a full financial year.

Expected Changes

- **Shift**: From earlier anchor of annual fiscal deficit target to the new anchor of medium-term debt-to-GDP ratio.
- **Rationale:** It provides greater flexibility to respond to economic shocks, enables gradual fiscal consolidation, and creates space for growth- and development-enhancing expenditure.

Key Projections and Targets (Debt Trajectory)

- The Centre has projected the debt-to-GDP ratio to decline to 50±1% by March 2031 from an estimated 56.1% in March 2026.
- Most economists estimate the Centre to peg it at 55% of the GDP for FY27 in the Budget.
- Achieving this trajectory implies a steady annual reduction of ~1 percentage point in the debt ratio.

Fiscal Deficit Implications

- A one percentage point reduction in the ratio every year would translate into a fiscal deficit of 4.2% of GDP in FY27.
- Even at this level, gross borrowings remain high due to –
    - Large repayment obligations.
    - Future liabilities such as implementation of the **8th Pay Commission.**

Role of Growth and Borrowings

- **Determinants of Debt-to-GDP ratio:**
    - Nominal GDP growth (denominator effect)
    - Government borrowing and repayment profile
    - Interest costs (likely to ease with softer monetary conditions)
- **Debt sustainability**: Improves faster with higher nominal growth even if fiscal deficits remain moderate.

Economic Survey 2025-26 – Validation of the Strategy

- India has reduced general government debt by around 7.1 percentage points since 2020.
- This is achieved while sustaining high public capital expenditure.
- The Survey endorses 50 ± 1% debt-to-GDP as a credible medium-term policy anchor.

General Government Debt and States' Role

- **Why States matter:**
    - General government debt, which refers to the debt of both states and the Centre, is the metric observed by global rating agencies to assess the fiscal health of the country.
    - While the Centre will detail its fiscal numbers linked to the debt-to-GDP ratio, the role of states in managing their public finances is seen facing greater scrutiny, as they account for a large share of total public debt.
- **Emerging view:**
    - States may need explicit, medium-term debt-to-GSDP glide paths.
    - Focus should shift from annual deficit targets to scenario-based debt trajectories.

Finance Commission and Federal Fiscal Architecture

- While the 16th Finance Commission recommendations (FY 2026–27 to 2030–31) are awaited, it will clarify –
  - **Tax devolution**
  - Revenue-sharing mechanisms
  - Possible fiscal parameters for states
- CEA V Anantha Nageswaran emphasised:
  - Need for empirical work and scenario analysis.
  - Avoid premature decisions on a uniform fiscal metric for states.

RBI's Concerns on State Finances

- RBI warns that high debt **crowds out** investment and growth.
- **For example**, while the debt of all states put together had declined to 28.1% of GDP by March 2024 from a peak of 31% as of March 2021, the figure is expected to rise to 29.2% by the end of the current fiscal.
- RBI urges highly leveraged states to adopt clear debt consolidation glide paths.

Rising State Borrowings

- States' borrowings have risen significantly in the last two decades.
- **For example**, in the first half of the current fiscal, states borrowed 21% more compared to the same period of 2024-25 and are slated to borrow Rs 5 lakh crore in the current quarter that ends on March 31.
- **Historical context:** Debt surge during 2015–20 partly due to UDAY power sector reforms, where states absorbed DISCOM debt.

Centre's Fiscal Position Going Ahead

- On the other hand, the Centre is set to meet its commitment to keep the fiscal deficit below **4.5%** of the GDP by FY26 despite tax cuts.
- Going ahead, while the government will get some fiscal breather with the debt-to-GDP ratio, the headwinds from the recent reductions in income tax and the Goods and Services Tax may weigh on the deficit projection.
- **FY27 expectations:** Debt target (~55% of GDP) and fiscal deficit (4.3–4.4% of GDP).

Challenges and Way Forward

- **Managing borrowings**: For example, high gross borrowings despite lower deficit targets. Institutionalise debt-to-GDP ratio as the primary fiscal anchor.
- **Ensuring states' fiscal discipline**: Without undermining cooperative federalism. Align state fiscal strategies with medium-term debt sustainability.
- **Balancing**: Development expenditure with long-term debt sustainability. Use scenario-based fiscal planning rather than rigid annual targets.
- **Uncertainty**: From future liabilities (Pay Commissions, welfare commitments). Leverage higher nominal GDP growth and lower interest costs to rebuild buffers. Strengthen Centre–State coordination post 16th Finance Commission.

Conclusion

- India’s shift from a fiscal deficit-centric framework to a debt-to-GDP-based fiscal anchor marks a maturation of its fiscal policy architecture.
- By prioritising long-term debt sustainability while preserving flexibility for growth-oriented spending, the new framework seeks to balance macroeconomic stability with developmental aspirations.
- However, its success will hinge on **robust nominal growth**, prudent borrowing, and active participation by states, making cooperative fiscal federalism more critical than ever.

Source: **IE**
