SUMMARY, FINDINGS AND POLICY IMPLICATIONS

Growing public debt path presents major risks and challenges for both fiscal and monetary policy. When a country starts from an already high level of public debt, the probability that any macroeconomic shock will trigger unstable debt dynamics would be higher. This risk is increased when public debt is already on a steep upward trajectory, as it is now in several countries, such as Ireland, Italy, Greece, US, Portugal and Spain. Another major risk associated with high levels of public debt comes from potentially lower long-term growth. A higher level of public debt implies that a larger share of society’s resources is permanently being spent servicing the debt. This means that a government intent on maintaining a given level of public services and transfers must raise taxes as debt increases. Taxes distort resource allocation, and can lead to lower levels of growth.

The distortionary impact of taxes is normally further compounded by the crowding-out of productive private capital. In a closed economy, a higher level of public debt will eventually absorb a larger share of national wealth, pushing up real interest rates and causing an offsetting fall in the stock of private capital. This not only lowers the level of output but also results in reduced rate of capital accumulation and thus can lead to a persistent slowdown in the rate of economic growth. In an open economy, international financial markets can moderate these effects so long as foreign investors remain confident in a country’s ability to repay. But, even when private capital is not crowded out, larger borrowing from abroad means that domestic income is reduced by interest paid to foreigners, increasing the gap between GDP and GNP.
More importantly, the existence of a higher level of public debt is likely to reduce both the size and the effectiveness of any future fiscal response to an adverse shock. Since fiscal policy cannot play its stabilizing role, a more indebted economy will be more vulnerable to shocks. This was evident during the latest global financial crisis. Countries saddled with very high levels of public debt did not expand fiscal policy as much as other countries. And, although these countries benefited somewhat from the effects of foreign fiscal expansion, a larger domestic fiscal stimulus could have helped to reduce the severity of the recession actually experienced.

Traditionally, debt management policy was not considered a separate macroeconomic policy. It was always viewed as a part of either fiscal or monetary policies. Of late, there is a growing consensus among economists and practitioners that debt management should be treated as a separate macroeconomic policy with its own policy objectives and assignment of a separate policy instrument.

One of the key policy implications of debt management is that the initial debt to GDP ratio should be lower, or the desired primary surplus should be higher. The higher the risk premium charged and/or higher the vulnerability arising from poor debt structures, given greater vulnerability of emerging market economies.

In the Indian context, there are certain important gaps in analysis of debt sustainability. These include: lack of sustainability assessment of public debt in different scenarios, lack of a comprehensive debt sustainability assessment of debt held by the Government of India, lack of studies on assessment of sustainability of
debt in the light of FRBM Act 2003. There are also no empirical studies which have attempted to test the sustainability of debt.

The key focus of the present study is to partially fill the gaps identified above. Accordingly, the study attempts to examine the macro economic implications of growing Debt/GDP ratio and Fiscal Deficit (FD) of both central government and state government on government revenues and expenditure, and the manner in which the long term fiscal policy, especially the rule based fiscal monitoring through Fiscal Responsibility and Budget Management Act (FRBM) Act 2003 is executed / implemented in trying to bring in stability to the fiscal profile of the nation. The study also focuses on the role of medium term fiscal strategy in controlling the growing debt and fiscal deficits.

Against the backdrop of introduction of FRBM in 2003 and the subsequent amendments and changes brought out by the Union government, the study attempts a deeper analysis of fiscal effects of expenditure and revenue. Further, the sequential changes brought out by Government of India in its fiscal policy after the implementation of FRBM Act 2003 are also studied with respect to their impact on the public debt and other key macroeconomic parameters such as GDP growth and interest rates.

Additionally, the study has also examined the level of indebtedness of the Government of India from 1990-91 till the enactment of FRBM Act in 2003 and to study its impact on fiscal sustainability after 2003 until 2010, the current level of economic growth and inflation. Also, there is a need to study focuses specifically on the implementation of FRBM Act 2003 to reduce public debt in India.
The analysis pertains to the period 1990-91 to 2002-03 which is referred to as post liberalization phase, and that of post FRBM phase starting from 2003-04 to 2009-10. The study also analyses various fiscal policy changes and other economic reform measures during both the phases and their consequent effects on fiscal and debt sustainability during those periods.

The statistical tools utilized for carrying out the empirical analysis of this study include: ratio analysis, trend analysis, regressions, recursive residual stability tests, unit roots and co-integration analysis. The datasets utilized for this study include the historical economic data on taxes, expenditure, revenue and public and external debt published by the Ministry of Finance, Government of India and the Reserve bank of India.

**Major Findings:**

The study considers the following debt convergent possibilities:

i. A country that runs higher primary budget surplus can have a higher initial debt stock and still manage to maintain long-term sustainability;

ii. A country with higher real growth rate can afford to have a lower budget surplus and still obtain sustainability; and

iii. A country that runs persistent primary budget deficits worsens its debt sustainability position.

The above debt convergence analysis is applied to public debt in India to ascertain the trend and level of debt position during the period 1989-90 to 2009-10 and it is found that possibility (ii) mentioned above is applicable to India as the average growth rate
of India during the past 10 years is around 8 per cent. In case of India, revenue deficit declined considerably during the past five years and resulted in ease of pressure on government expenditures.

This study had done an empirical analysis based on the modified Quintos model taking into account data on fiscal parameters (debt/GDP ratio, revenues, expenditure, interest payments, etc.) from the year 1990-91 to 2009-10 and tried to find out whether the variables revenue and expenditure are co-integrated or not. It was found to be co-integrated and also it is identified that debt is moderately sustainable in Indian case. Further, it is clearly established through the ratio as well as trend analysis that fiscal consolidation did take place consequent to the promulgation of FRBM Act, 2003. However, there were slippages during the past two years owing to fiscal stimulus measures initiated by the Government of India as a consequence of global financial crisis.

Some of this study’s conclusions are corroborated by the findings of Thirteenth Finance Commission (TFC) in their report which outlined the main trends in the Centre’s findings in recent years. The TFC’s analysis of these trends is given below:

i) The fiscal correction path, following the enactment of FRBM Act was more or less on track till 2007-08, after a pause in 2005-06. A number of developments, particularly the slowdown of the economy and its adverse impact on revenue growth, increasing commodity prices, anti-recessionary measures, farm loan waiver and implementation of the recommendations of the Sixth CPC, have resulted in a worsening, going beyond the reversal of the fiscal correction achieved till 2007-08.
ii) Despite deterioration in all fiscal indicators in 2008-09 and 2009-10, the debt-GDP ratio remained stable, or even declined marginally. This was because of the growth of nominal GDP remaining higher than the average nominal interest rate.

iii) Though the tax-GDP ratio has come down in 2008-09, it is still higher than the level reached in 2004-05. The fall in the aggregate tax-GDP ratio in 2008-09 would have been sharper but for buoyant revenues from corporation tax and service tax. There has been a continuous increase in the tax-GDP ratios of these taxes till 2008-09. While the tax-GDP ratio in respect of corporation tax is expected to be maintained even in 2009-10, that of service tax is expected to witness a marginal fall. With buoyant revenues from corporation tax, revenue from direct taxes has, for the first time, overtaken that from indirect taxes in 2007-08.

iv) Total expenditure of the Centre relative to GDP witnessed a significant contraction between 2003-04 and 2006-07, after which it started rising again, despite moderation in capital expenditure. Rising revenue expenditure, particularly in 2008-09 and 2009-10, contributed to growth in total expenditure. Within revenue expenditure there was sharp increase in expenditure on pay and allowances, as well as subsidies.

v) Resumption of the path of fiscal correction is crucial to achieving a sustainable fiscal situation at the Centre. Though softening of international oil prices has provided some relief, reverting to the high growth path and a strategy to exit from the expansionary fiscal stance put in place as a countercyclical measure will hold the key to fiscal correction. In recent years, off-budget liabilities of the Centre have assumed alarming proportions. In 2008-09, off-budget bonds
issued to oil marketing and fertilizer companies amounted to Rs. 95,942 crore or 1.80 per cent of GDP.

**Implications:**

After analyzing the nature of existing debt stock and suggesting a debt reduction roadmap for the Government over the medium term, it is necessary to look at issues related to debt sustainability debate around the globe. While assessing the health of economy, public debt is always an important parameter in the matrix of economic theory. The discussions on the optimum level of public debt in any economy, whether developed or developing, have generated large interests among various stakeholder groups and individuals.

Year 2008 represents a watershed in the policy design for public finance management. Economies across the globe have undertaken massive fiscal out from the adverse impact of global economic meltdown relatively fast, but it cannot be construed that it was not affected during the crisis period. During 2008-09 and 2009-10, various fiscal and monetary measures were undertaken to insulate Indian economy from the adverse impact of global expansionary measures to mitigate the adverse impact of global economic slowdown. While this shift in policy had helped global economy to move towards recovery, the future outlook for the global economic growth is still not the same as it was before the advent of the financial crisis in 2007.

While implementing the expansionary fiscal policy during 2008 and 2009, most of the countries have contracted very high level of debt in order to provide stimuli to protect
their economies and to finance higher level of public expenditure with lower revenues. This in turn has resulted in significant increase in the level of public debt and liabilities as percent of GDP for most of the countries. This has made the debate on sustainable public debt level all the more relevant in the present context and this issue has become the fulcrum of discussion for designing future fiscal policy.

During the period of financial crisis, the decoupling theory has been called into question. Emerging market economies felt the impact of this crisis and the degree of adverse effect on a particular country was the function of existing policies in that country. Indian economy has come out from the adverse impact of global economic meltdown relatively fast, but it cannot be construed that it was not affected during the crisis period.

During 2008-09 and 2009-10, various fiscal and monetary measures were undertaken to insulate Indian economy from the adverse impact of global slowdown. These measures resulted in the reversal of fiscal consolidation trend witnessed during the period 2004-05 to 2007-08. While Central Government debt as percentage of GDP improved during this period from 53.4 per cent to 46.2 per cent, the same has deteriorated to 50.5 per cent of GDP at the end of 2009-10. Similarly, the consolidated debt of general government improved from 79.3 percent of GDP in 2004-05 to 68.7 percent in 2007-08 and subsequently worsened to 73 percent in 2009-10. This reversal in trend has generated worries about the sustainability of government debt in India. At the same time, the developments in Euro Zone have further intensified the debate on the sustainability issues.
The present crisis in Euro Zone has brought into focus that sustainability analysis in classical terms may not be the sole tool to gauge the fiscal health of the country. Some of the important parameters for determining the stability and vulnerability level of public debt for example could be maturity profile, composition, carrying cost, external or domestic investor base along with savings rate, potential and realized tax to GDP ratio, etc.

In the case of India, the gradually declining level of general government debt estimated over the medium term does answer the sustainability issue positively. At the same time the following characteristics of existing debt stock and economic parameters put India in a distinct category when compared to the developed as well as other emerging market economies.

This study also treats the clear disconnect between the theoretical work that has been done on fiscal sustainability and assessment of fiscal sustainability in practice. In particular, country work undertaken by the IMF and others generally pays less attention to the PVBC, focusing instead on indicators of sustainability that are not grounded in theory. Our study has reinforced the limitations of PVBC approach - most notably some fiscal policies that in no obvious sense appear unsustainable can satisfy the PVBC while some other fiscal policies appear sustainable but do not satisfy the PVBC.

The measures of sustainability have considerable intuitive appeal though the measures are highly inconclusive and arbitrary. One advantage of the IMF approach to assessing fiscal sustainability in the context of a broader medium-term
macroeconomic scenario is that debt targets that are not sufficiently ambitious will usually be revealed by weakness in one or more key macroeconomic measures.

Finally, the link between fiscal and external sustainability warrants further consideration, with a view to developing an integrated analytical framework that combines both aspects of sustainability and from which fully consistent indicators of fiscal and external sustainability can be derived.