CHAPTER I

INTRODUCTION

The necessity of public borrowing or public debt has not been an issue of public debate with any government in the world. But what has become a topic of hot debate is the quantum of public debt that a government can sustain. Economists have different views on a satisfactory common limit of public debt. This is because the paradigm of the financial structure of each government differs widely and at the same time, the financial parameters remain volatile due to innumerable events of economic consequences happening every day. Therefore, even a tentative limit for debt could not be suggested before any government. However the recent economic crisis, faced by many countries, has raised the question in the minds of economists and rulers as to the quantum of debt which a country can afford and its probable consequences on the economy.

This world wide scenario seems to remain more or less the same in the Indian context as well. For instance, in India, a symptomatic debt trap appeared in 1991-92 in the form of fiscal imbalances having its root in a severe domestic inflation and balance of payment crisis.¹ This situation brought the economists to a table to find solution. Many researches have been done on the problem of public debt in India since then.

Another alarming trend in India is the growth of public debt of the state governments. A large part of the outstanding public debt belongs to the state governments, whose ever widening revenue deficit gap exerts tremendous pressures over both the State
and the national economy. Under the present circumstances of huge fiscal imbalance, there is an urgent need to study and analyze the public borrowings of the state governments.

Public borrowing is a recognized source of public finance for any government. Therefore, the Constitution of India, under Article 292 has empowered the Central Government to borrow funds against the consolidated fund of India. Though the Parliament has the powers to impose limits on such borrowings, it has not done so far. The state governments also have the power to raise loans under Article 293 of the Constitution. The power to set limits to state government borrowings has not been exercised by any state legislature so far. The Central Government can also give loans to the state governments on its own terms or it can provide guarantees in respect of loans raised by the state governments. The responsibility to manage the public debt of both the Central and state governments rests with the Reserve Bank of India.

1. State Governments and Public Debt

The state governments play a very important role in accelerating and sustaining the economic growth in India. According to the Indian Constitution, the state governments have important responsibilities in many sectors such as agricultural development, infrastructure, poverty alleviation, water supply and irrigation, public order, public health and sanitation etc. Moreover the states and the Centre have concurrent jurisdiction over several areas like education, family planning, electricity, economic planning, social planning, etc. Since the states have the responsibilities in a large number of areas their expenditures account for a substantial portion of the government expenditure in India.
The public expenditure of the States can be financed either by taxes or by borrowing. Quite often the state governments resort to both the means. The taxes are always there and so the borrowings. However the problem to debate upon is the level of taxation and the tax structure and the level of borrowing. A high level of taxation would mean a disincentive to growth because the people might be tempted either to evade the tax or not to make money as the government takes away a large portion of their earnings in order to invest for the benefit of the future generation. In contrast a high level of borrowing means taking away a large portion of private money for investment through debt instruments.

The success of the borrowings through debt instruments depends upon the willingness of the private sector to hold and absorb these instruments which in turn depend upon the nature of the debt instruments, reflected in the interest rate, maturity structure, credibility of the government etc. However, the expenditure of the government increases by leaps and bounds and hence the best and the easy method for any government is to borrow money from the public. It is in this context that debt financing assumes importance.

2. Burden Concept of Public Debt

Debt financing is, however, criticized on many grounds in classical economic analysis. According to the classical economists like Adam Smith and David Ricardo, private expenditure is productive and State expenditure is ‘unproductive’. They were of the view that taxes reduce current consumption but the internal borrowing reduces private capital formation.
But the modern view on public debt is quite different. Modern economists like Keynes and his followers view that increase in public debt through multiplier effect would raise the national income. They advised the government to borrow for all purposes so that effective demand in the economy may increase and output also may increase. Thus the government is always in between the devil and the deep sea because the government has to make a choice either to depend more on taxation or to depend heavily on public borrowings. A deficit in the government budget reflects the imbalance between expenditure and revenue. Deficits mean more borrowings which in turn contribute to higher market interest and increased rate of inflation.

A great deal of controversy arises on the appropriateness of debt financing by a government. It is argued that more amount of debt would mean a more debt obligation to the future generations. There is a contrary argument that the public debt helps only to rotate that money, which is largely held by the citizens of the country. In other words, debt reduces the tax burden to the general public and at the same time transfers more income to the holders of the debt instruments, in the future. Naturally the burden of debt, the payment of the principal and interest, falls on the future generations.

Some economists are of the view that this burden must be borne by the present generation because the money generated is spent for the immediate benefit of that generation. On the other hand, some other economists argue that the burden of debt implies nothing but foregone private consumption in the current period itself. It also implies a complete voluntary sacrifice of consumption on the part of private units which is compensated by future consumption with the additional payments of interest on government securities. A greater borrowing means more public investment, more growth
and more income for the masses. Therefore, the future generations can condone the public debt incurred by their forefathers by which they continue to benefit. A low burden of debt means less welfare for the future tax payers. However, the level of public debt and the rate of interest there on are always a matter of controversy among economists.

3. Public Debt in India

As in the case of any government in the world, public debt has been a major part of public finance in India. India’s public debt consists of the debt incurred by both the Centre and the state governments. The public debt of the Central Government consists of internal debt and external debt. Internal debt consists of market loans, floating loans such as ways and means advances, treasury deposit receipts and treasury bills, special floating loans and other obligations. Other sources include funds raised from small savings, term deposits, provident funds, reserve funds and deposits. External debt includes all sorts of debts obtained from external agencies and governments on various terms and conditions.

The combined debt of the Centre and the state governments in 1980-81 was Rs. 69,552 crores (Appendix 1). It rose to Rs.3,68,824 crores in 1990-91 and to Rs. 14,84,106 crores in 2000-01. In 2006-07 the combined debt galloped to Rs. 31,90,698 crores. It means a rise of 351.45 per cent in the eighties, 252.5 per cent in the nineties and 114.99 per cent during the last seven years. Such a growth rate in the government debt has special impact upon the economy which makes it all the more important to study its sustainability.

The growth in the public debt is caused by the growth in public expenditure over and above public revenue. The growth of the public expenditure is inexorably linked to
political compulsions and is not always based on priority of productive schemes and projects.

There has been a continuous and a sharp rise in the public debt of the Central Government since independence. In 1950-51, the total amount of debt of the Central Government was Rs. 2,865 crores. In 1980-81 it rose to Rs.59,749 crores. In 1990-91 it grew to Rs.3,14,558 crores and in 2000-01 to Rs.11,68,541 crores and reached to Rs.25,38,596 crores in 2006-07. It shows an absolute growth rate of 348.86 percent during the eighties, 224.59 percent during the nineties and 117.24 percent in between 2000-01 and 2006-07.

There is a growing concern about the level of indebtedness of the Central Government and debt sustainability (Appendix 2). The Debt-GDP ratio is a good indicator of the health level of public debt. The Debt-GDP ratio was 41.1 per cent in 1980-81 and slightly rose to 55.31 per cent in 1990-91. However, there was a major upward movement in the coming years and the figure reached an all time high of 63.89 per cent in 2004-05 and started decreasing slightly and reached 61.23 per cent in 2006-07. This is certainly an alarming growth which is an indication towards the probable future problems for the economy and its growth.

The ever increasing public debt is the outcome of the mismatch between expenditure and revenue. If the uncontrolled, unproductive and inefficient spending spree continues and if the government is sluggish in further resource mobilization, the future growth of the economy will be definitely impaired.
4. Public Debt of the State Governments

The deterioration in the finances of the state governments in India has been more worse than that of the Central Government. Many of the state governments resorted to borrowing in order to meet their public expenditure without attempting to raise public revenue. This resulted in mounting the debt of the state governments and critically impairing the economy. In the year 1980-81, the total liabilities of the States together amounted to Rs. 26,783 crores and this figure rose to Rs. 1,28,155 crores in 1990-91. In 2000-01, it was Rs. 5, 94,147 crores and in the last seven years the total debt grew as high as Rs. 12,50,819 crores. The percentage growth of the States debt during the eighties and nineties is 310.14 per cent and 297.59 per cent respectively and that of the last seven years, it is 110.52 per cent.

All the four southern states, Tamil Nadu, Karnataka, Andhra Pradesh and Kerala, have a more or less similar economic profile. Therefore, the Debt-GDP ratio of these states can provide a better comparison about their debt position. In 1997-98, Tamil Nadu had a Debt-GDP ratio of 15.7 per cent, Andhra Pradesh and Karnataka had a ratio of 20.8 per cent and 18.1 per cent respectively. In contrast, Kerala had a Debt-GDP ratio of 26 per cent. In 2001-02, Kerala had a ratio of 34.8 per cent while the other states kept this ratio below 30 per cent. In 2006-07, Kerala’s ratio rose to 37.6 per cent. On the other hand, the other states continued to keep their Debt-GDP ratio around 30 per cent. Moreover, Kerala’s Debt GDP ratio has been much higher than the ratio of all the states in India all the years since 1997-98. (Table 4.4)

The poor Debt-GDP ratio of Kerala is certainly a cause for worry even now and this is likely to lead the State to more financial difficulties, from which it may not be able
to recover. Hence, it is an urgent need of the hour to point out the malaise gripping the State for which this study is being undertaken.

5. Importance of the Study

Since the formation of the State of Kerala in 1956, various governments have been guided by the principle of a welfare State. Welfare schemes never give any return in the short run. Moreover, it is not an easy task to measure the returns in the long run as well. A welfare State naturally invests a great part of its revenue on social investments whose returns remains relatively immeasurable.

The overemphasis of the State government on welfare schemes has increased the debt burden since the revenue could never overcome the ever increasing expenditures in the social sector. This situation has brought about a greater burden on the State finances. Therefore, the Government of Kerala had to resort to more public borrowings to fill the deficit gap. Consequently the growth of the State’s public debt and the servicing of these debts caused serious strains on its budget.

The situation is more apparent since the mid-nineties. From Rs.1,041.58 crore in 1980-81 the total debt obligation of the state rose to Rs. 8,820.87 crore in 1994-95 and thereafter it galloped to Rs. 49,875.18 crore in 2006-07. Similarly in comparison of Debt-GSDP ratio of the four south Indian States, the Kerala’s Debt-GSDP ratio was the highest.

The report of the Comptroller and Auditor General of India says that the ambitious plan expenditure heightened the borrowings and put further strain on the financial condition of the State Government. Further, the report notes that the decline in
the ratio of tax receipts to the Gross State Domestic Product in successive years showed poor tax compliance and the unwillingness of the Government to meet the deficits from its own sources. “Consequently, the State's financial condition slid to a situation of fiscal stress, lost its flexibility to meet the increasing expenditure and became vulnerable to fluctuations of outside sources,” says the report.4

The gravity of the situation is seen better exposed in many of the official financial documents of the State as well. The White Paper on State finances of Kerala (June 2001) opened with the observation that “The State is facing an acute financial crisis”5 and went on to say that “the government is unable to pay cash on cheques issued or make payments on items already included in the budget document”.6 Similarly, in the audit report for the year ending March 31, 2003, the Comptroller and Auditor General (CAG) expressed grave concern about the growing public debt of the State Government. The CAG remarked that “the State was gradually getting into a debt trap.”7

All these show that the public debt of Kerala is ever increasing in alarming proportions. Therefore it is very urgent to take up creative steps in addressing the central issue of public debt management as a vital development imperative. Hence the phenomenon of the growth of public debt and associated debt management issues invariably become the central focus and in that context the present study is undertaken.

The importance of the present study further arises from the fact that so far no research on financial management perspective of the growth and structure of Kerala’s public debt for the period from 1980-81 to 2006-07 has been attempted.
6. Objectives of the Study

The following are the broad objectives of the study:

1. To study the growth pattern and trends of change in the public borrowings of the Government of Kerala.

2. To analyse the variables influencing the growth of public borrowings in Kerala.

3. To analyse the cost of debt vis-a-vis public borrowings.

4. To analyse the mobilization and redemption of various components of Public Borrowings.

7. Methodology

This study is based on secondary data. The data for the study have been primarily collected from the Finance Accounts of the Government of Kerala, published by the Comptroller and Auditor General of India. The other sources of the data are Reserve Bank of India Bulletins, Reserve Bank of India Report on Currency and Finance, Finance Commission Reports, Economic Reviews published by the Government of Kerala, Budget Documents of the Government of Kerala, Economic Surveys of the Government of India and the ‘Hand book of State Finances on Indian Economy’.

The analysis of data is carried out by taking individually the main and sub-components of the public debt of the Government of Kerala,. The major components of public debt consist of Internal Debt (ID), Loans and Advances from the Central Government (LACG) and Small Savings and Provident Fund (SSPF). The following components of debt of the State have been studied in detail.
1) **Internal Debt (ID):** It consists of Market Loans floated by the Government, Ways and Means Advances from the RBI, Special Securities issued to NSS fund of Central Government and Other Internal Debts.

2) **Loans and Advances from the Central Government (LACG):** Loans for States/Union territory plan schemes, Non-Plan loans, Loans for Central Plan Schemes, Loans for Centrally sponsored plan schemes and pre 1979-80/1984-85 loans are the major components of LACG.

3) **Loans from Small Savings and Provident Fund (SSPF):** This includes Small Savings Fund, State Provided Fund, Trust and Endowments and Insurance and Pension funds.

The data and information related to the above are statistically analyzed, using ratios, percentages, averages, Compound Growth Rate, Average Annual Growth Rate, Polynomial trend graphs, Standard deviation, Coefficient of variation, Correlation and Regression analysis.

**8. Period of the study**

The period of study mainly covers twenty seven years from the fiscal year 1980-81 to 2006-07 (Sixth, Seventh, Eighth, Ninth and Tenth Five Year Plan Periods). Though the period of study has been limited as above, the data and relevant information pertaining to the past several years have been analysed wherever required and found useful for solid inferences.
9. Chapterisation

The report of the study has been presented in five chapters as given below.

Chapter 1: Introduction

The first and introductory chapter includes deliberations about public borrowings, importance of the study, objectives, methodology and limitations of the study.

Chapter 2: Literature Review

This chapter is intended to throw light on the theoretical issues related to public debt and also to present a brief and summarized review of the literature related to the topic of public debt, from different perspectives.

Chapter 3: Conceptual Framework

This chapter consists of definitions for all the specific terms and concepts which have been extensively used in the report. Appropriate explanations also have been provided wherever required. The method of analysis also has been explained in this chapter.

Chapter 4: Analysis and Findings

This chapter contains the analysis and interpretation of the data and related information relating to the public debt of the State of Kerala. Different analytical tools have been extensively used in this chapter along with tables and charts, to make a microscopic analysis of the data relevant for the period under study.

Chapter 5: Conclusions and Suggestions

The fifth and final chapter of the thesis contains the summary of important findings, conclusions and solid suggestions useful for the improvement of the fiscal conditions of
the State. In addition to the findings and suggestions, the major areas where urgent academic attention is required in the form of further research, has also been highlighted in the last part of the thesis.

10. Limitations of the Study

1. The study excludes the ‘other obligations’ of the State government such as the balances at the credit of ‘earmarked and other funds’ and certain deposits that have not been invested but are merged in the general cash balance of the government as these amounts constitute only a negligible part of the total debt.

2. The study also does not take into account the ‘contingent liabilities’ which are nothing but guarantees provided by the government for the borrowings by the public sector units. They can become debt obligations only in the event of default by the borrowing public sector institutions. Since such possible future liabilities do not exert pressure on State finances, the exclusion of these items from the study will not affect the validity of the results and conclusions of this study.

3. In spite of the researchers’ sincere efforts to ensure the arithmetical accuracy of the mass data used for the study, mild clerical errors might have crept in the analytical part of the study. The researcher however hopes that these minor discrepancies, if any, would not have any significant impact on the results obtained.

4. In some years the government merged, reclassified or removed some minor heads of accounts which made it impossible to analyze the data based on such minor heads. Therefore only the major heads have been taken in to account for tabulation purposes.
References:


4 Comptroller and Auditor General of India Report 2003


6 Ibid, P.3.