Chapter 7

Summary and Conclusions

This study examined selected issues related to the accumulation of domestic debt of the central government for the period between 1974-75 and 1998-99. The issues that we examined were related to the key questions of internal debt management and long run sustainability of debt. The study examined the profile of debt, its structure, ownership pattern, maturity and term structure of interest rate. It also brought out the factors behind the growth of debt, examined the intensity of debt burden, analysed the rationale behind and the impact of interest rate policy reform on government finance and empirically tested the long run sustainability of debt.

The profile of the central government debt as evolved over time showed that there had been a sharp increase in the debt-GDP ratio during the 1980s compared to 1970s, and this increasing trend had been arrested during the 1990s. We also observed that the structure of debt had undergone a significant change over the years. With the increase in the share of high cost debt, viz., market borrowing, small savings and provident funds in total outstanding debt, the debt structure became more expensive over the years. On the other hand, the share of Treasury bills declined sharply from around 19 per cent in the second half of 1970s to 2.28 percent in 1999. The alteration of debt structure towards high cost debt instruments signifies a higher burden of debt and added strain of debt servicing on government finance. Even though the stock of debt in relation to GDP did not exhibit an increasing trend during the 1990s, a shift of debt structure towards high cost debt continued to put higher pressure of debt burden on government finance.

One of the principal objectives of financial sector reforms was to delink monetary and fiscal operations by providing greater autonomy to Central bank by way of reducing considerably the scope of the government in monetising deficits. The analysis revealed that between 1974-75 and 1993-94, the share of monetised debt fluctuated in the range of 20 to 28 per cent, except for 1977-78, when it declined to 17.14 per cent. However, the share of monetised debt started declining steadily during the late 1990s, and in 1998-99 it was 16.60 per cent of the total debt. This decline indicates government's reduced dependence on Reserve Bank of India to finance the fiscal deficit.
Apart from controlling the structure of debt, the control of the distribution of ownership and maturity pattern of debt is also an integral part of debt management policy. In recent years, the internal debt management policy aimed at shortening the average maturity period of debt. Our analysis showed that the share of long-term government debt declined from 57.25 per cent in 1975 to 18.19 per cent in 1999. In order to alter the maturity structure of debt, rates of interest assigned on short-term securities were higher than the long-term securities in the late 1980s and early 1990s. The preferential shift of investors towards shorter dated securities, at high interest rate, created greater pressure of debt burden on government finance, and also the government confronted with frequent repayment obligations. The Reserve Bank of India admitted that ‘the frequent bunching of securities for redemption, and the frequent rolling over of short term issues together posed the problem of Central bank in the management of liquidity’ (Report on Currency and Finance: 1998-99, p.V-10). The econometric investigation of the term structure of interest rate in Hsiao’s autoregressive frame work of causality detection, based on monthly data on short and long dated government securities, for the period between April 1992 and March 2000, revealed that short term interest rates causes the long term interest rates in the government securities market. This finding has important implications for debt management because as the short rates induce long rates, if the Reserve Bank of India continues to play at the shorter end of the market and if the short rates are very high, the overall interest rate structure may become higher adding more strain on debt management and in government finances.

Our analysis of the changing structure of the ownership pattern of debt revealed that the major subscribers of government securities were Reserve Bank of India and commercial banks. However, there has been alteration of the government securities holding away from Reserve Bank of India to commercial banks. The latter’s holding of government securities showed a steady increase from 27.93 per cent in 1974-75 to 71.90 per cent in 1993-94 and then on it declined to 58.92 per cent in 1998-99. The share of Life Insurance Corporation’s holding also increased steadily in recent years.

One of the principal objectives of interest rate deregulation was to create an investor’s base for government securities outside the captive market. However, the structure of ownership pattern revealed that primary market in government securities continues to be
dominated by the captive investors like commercial banks and Life Insurance Corporation. The concentration of debt market in the hands of few large investors introduces an element of rigidity in the downward adjustment of interest rate. As there are hardly any alternative players to absorb government securities other than commercial banks, their choice regarding further subscription would obviously depend on the attractiveness of return on other competing assets. Thus, to attract investors including banks, the government may have to mobilise more resources at higher rates of interest.

The increase in the volume of debt during 1980s coupled with a shift towards a high cost debt structure, contributed to the sharp increase in interest payment. Interest payment emerged as one of the fastest growing expenditure in the government account. Between 1974-75 and 1998-99, when the total expenditure grew at a trend growth rate of 15.60 per cent, interest payment grew at the rate of 20.85 per cent per annum. The share of revenue earning that had to be set aside to meet the interest burden increased from around 16 per cent in 1974-75 to more than 52 per cent in 1998-99. The comparison of assets and liabilities position of the central government revealed that total outstanding capital investment in the form of capital outlay and net lending was higher then the outstanding liabilities till 1982. However, from 1983 onwards, liabilities exceeded assets and that gap continued to widen. Decline in capital investment in the form of capital outlay and net lending adversely affected the recovery in the form of interest earning, dividends and profits. The decline in recovery when netted against the gross interest burden of the central government showed a steep increase. The net interest burden, which was only 22.68 per cent of the gross interest burden in 1974-75, increased to 61.38 per cent in 1998-99.

The nature of fiscal policy estimated revealed that it was more or less expansionary in nature. Thus, in aggregate sense, expansionary fiscal policy was responsible for the increase in fiscal deficit and debt. However, the disaggregated analysis of the revenue and expenditure pattern of the government revealed that the nature of fiscal expansion had been different in different periods. The study found that during 1970s there had been a steady increase in the government expenditure in both revenue and capital account. Till the late 1970s, some surplus was also generated in the revenue account to
finance capital expenditure. But from 1979-80 onwards, central government plunged into large revenue account deficit and the revenue account gap further widened during the 1980s and 1990s. The fiscal expansion during the 1980s and early 1990s was reflected in the widening of fiscal and revenue deficit. The nature of fiscal expansion till the mid 1980s was characterised by rapid increase in the revenue and capital expenditure.

However, there was a fiscal contraction from 1993-94 onwards. In the latter half of the 1990s, though fiscal deficit was contained, the revenue deficit gap continued to widen. During the 1990s, the controlling of fiscal expansion was achieved by a drastic cut in capital expenditure, the main discretionary component of government expenditure. The capital expenditure, which increased from 5.79 to 7.03 per cent of GDP between 1980-81 and 1986-87, had come down to 3.52 per cent of GDP by the end of 1998-99. As total expenditure became increasingly skewed towards revenue expenditure, the share of productive capital expenditure, viz., capital outlay and net lending showed a marked decline. The unbridled growth of revenue expenditure was mainly due to the increase in the committed liabilities of the central government. As mentioned, one of the fastest growing expenditure in revenue account was interest payment. The other major component of expenditure was defence. The combined share of interest payment and defence expenditure in total expenditure increased from 38.72 per cent in the second half of 1970s to 49.83 percent in the last half of 1990s. During the same period, their combined share in non-developmental expenditure increased from 70.82 per cent to 77.99 per cent.

The increase in the revenue expenditure was not supported by the corresponding increase in revenue mobilisation. The problem of revenue mobilisation got further compounded as the tax reform measures introduced since 1991 failed to achieve its desired objectives. The tax reform measures, which aimed at simplifying the tax structure, reduced both direct and indirect taxes across the board. The study found that, since the tax reform, though direct tax buoyancy had increased, the buoyancies of indirect taxes declined below unity. Reduction in rates of indirect taxes resulted in the net revenue loss for the government. As a result, the overall tax-GDP ratio showed a marked decline during this period.
The government having failed to contain the revenue deficit, due to the rapid growth of revenue expenditure and the decline in revenue mobilisation, increasing proportion of fiscal deficit was diverted to finance the revenue deficit. As revenue expenditure is current consumption expenditure in nature, and also not productive strictly in commercial sense, use of borrowed resources to finance such expenditure may prove to be unsustainable in the long run. From the point of view of sustainability there is an urgent need to contain the revenue deficit and bring a compositional shift in government expenditure away from revenue expenditure to productive capital expenditure.

Apart from this, it should also be mentioned that the sustainability of debt depends on the movement of the 'adjustment factor', viz., the real rate of growth minus the real rate of interest. The study noted that compared to 1970s, the real GDP growth was higher during the late 1980s and in 1990s. Despite higher GDP growth, sharp increase in the real rate of interest, reduced the gap between real rate of growth and real rate of interest. The increase in rates of interest on government securities was the outcome of the interest rate policy reform undertaken in the early 1990s. The study found that the interest rate policy reform, which aimed at creating investors' base for government securities outside the captive market by assigning attractive rates of interest on government securities, has failed to achieve its objectives. Given the high rates of return on government securities, the captive investors, especially banks started investing in government securities above their SLR requirements. The other objective of interest rate policy reform was to reduce the monetisation of deficit and thus creation of reserve money into the system. The analysis revealed that, though the monetisation of deficit declined significantly during the 1990s due to the doing away with the automatic monetisation of deficit through adhoc Treasury bills, the reserve money did not show a substantial decline due to the huge increase in the foreign exchange reserves in the post liberalisation period.

The rationale behind government moving towards market related rates of interest was also to improve banks profitability on its investment in government securities. The idea was that higher profitability of banks in turn should reduce the interest rates spread by automatic upward revision of deposit rates and downward revision of the lending rates. The upward revision of deposit rate was expected to induce financialisation of savings.
The decline in the spread during the late 1990s was mainly due to the decline in the lending rates. However, the deposit rate also declined from 12.50 percent in 1995-96 to 10 percent in 1998-99. If higher interest rate is an inducement for financialisation of savings, these findings indicate that declining deposit rates would have a negative impact on financial savings. The study noted an increasing trend in the share of financial savings in total savings since mid 1970s. However, the share of financial savings in total savings declined from 50.40 percent in 1993-94 to 43.81 percent in 1997-98, thought it reached at 51.51 percent in 1998-99. Despite higher profits by the banks on investment in government securities, their earning expenditure ratio also remained more or less constant during the period of study.

The study analysed the issue of sustainability of debt. The existing literature on fiscal sustainability in Indian context reached near unanimous conclusion that current trajectory of debt growth is unsustainable. However, the present study is of the view that the issue of debt sustainability should not be treated in isolation. Instead a holistic approach should be taken to see what role fiscal policy serves for the economy. If the role of fiscal policy is growth promoting and a fiscal expansion is growth enhancing, then cut in government expenditure across the board to achieve fiscal contraction may adversely affect growth. In order to examine the relationship between fiscal policy and economic activity, we estimated the ‘fiscal policy stance’ and index of economic activity, namely the ‘output gap’. The econometric investigation of the relationship between the two revealed that there existed a long run stable equilibrium relationship between the two and the causality test revealed that a feedback mechanism operated between ‘fiscal policy stance’ and ‘output gap’. This result implies that the fiscal policy in India is contracyclical in nature.

As the fiscal policy is intimately linked with the economic activity, the question of debt sustainability should be viewed as a problem of the growth of national income. As argued by Domar (1944), if the national income grows and the debt sustainability condition is not violated, the tax rate required to be imposed to service the debt servicing charges would remain within a manageable limit. In the present context, we have examined the question of debt sustainability in a comparative static framework based on the debt sustainability principle suggested by Domar. Imputing the key
parameter values in the budget constraint, namely, GDP growth, rate of interest on government borrowing, effective rate of lending by the government, nominal income elasticity of revenue and nominal income elasticity of non-interest expenditure, we arrived at the future profile of debt-GDP ratio and other key fiscal indicators. The future profile of debt-GDP ratio showed an increase from 49.82 per cent in 1998-99 to 62.55 per cent in 2009-10. The corresponding interest burden as a percentage of GDP increased from 4.43 per cent to 6.52 per cent of GDP. As a percentage of revenue receipts the interest burden increased from 52.09 per cent in 1998-99 to 99.61 per cent in 2009-10.

Despite the moderate increase in the debt-GDP ratio, at the terminal year of projection, the corresponding increase in the debt burden seems to be exhausting the entire revenue resources of the central government. Thus, in this context, sustainability of debt not only imply containing the debt-GDP ratio but also containing the debt-servicing obligation of the government within a manageable limit. Even if the debt-GDP ratio not reaching the upper bound, if the revenue resources get exhausted to service the debt, the situation would be considered as unsustainable.

Our analysis revealed that burden of debt servicing has been rising continuously over the years and it was as high as 52.09 per cent of the total revenues in 1998-99. Thus, there is an urgent need to reduce the burden of debt servicing so that the share of revenues that had to be set aside to meet debt servicing obligation declines. As mentioned earlier, one of the major reasons for the sharp increase in the interest payment was increase in the rates of interest on government securities across all maturities after financial liberalisation.

We examined, how the future fiscal profile of the central government would emerge if rate of interest on government borrowing declines. In fact, if the nominal interest rate is reduced to 8 per cent to have real rate of interest of 3 per cent (assumed rate of inflation is 5 per cent), the future fiscal profile improves significantly. In this case, the debt-GDP ratio only increases from 49.82 to 51.19 per cent during the projection period. The corresponding increase in the share of interest payment in total revenue receipts is also
from 52.09 per cent 59.08 per cent. Thus, a lower interest rate regime would help in improving the fiscal profile significantly.

On the basis of the above findings, it can be concluded that the sharp increase in debt servicing obligation in recent years has not only been contributed by the growing volume of debt, but also due to the sharp increase in the rates of interest on government securities across all maturities. As the increasing trend of debt-GDP ratio is arrested during the 1990s, attempt should also be made to create a macroeconomic environment conducive for a low interest rate regime so that the future debt-servicing obligation reduces at least in medium term. The critical importance of low interest rate regime is also brought out in our sustainability exercise. Decline in the rates of interest in government securities would reduce the burden of debt serving implying the release of resources for developmental expenditure. In recent years, in the face of declining tax effort of the central government, attempts should also be made for higher revenue mobilisation so that tax-GDP ratio increases. As the revenue mobilisation is intimately linked with the rate of growth of the economy, effort should be made to alter the government expenditure pattern in such a way that it promotes growth. As the sustainability of debt depends on the rate of growth of the economy and the rate of interest, a higher growth and a lower interest rate regime will bring in fiscal sustainability.