The Debt Dilemma: Saving the Burden on the Future Generation*

By Dr M Govinda Rao, Chief Economic Adviser, Brickwork Ratings

Elevated levels of India's fiscal deficit and public debt have been a matter of concern in India for a long time. Even before the pandemic, debt levels were among the highest in the developing world and emerging market economies. The pandemic pushed the envelope further and relative to the GDP, the fiscal deficit in FY21 increased to 13.3% and the aggregate public debt to 89.6%. As the economy recovered after the pandemic, the deficit and debt ratios have receded to 8.9% and 85.7%, respectively. The projections show that even without any serious disruptions to the economy, the debt level is unlikely to return to the pre-pandemic trajectory in the medium term. With elections to eight states slated to happen in 2023 and with the general elections slated in 2024, the electoral budget cycle could push the debt ratio further and there can be serious questions about its sustainability unless targeted interventions are made to reduce the debt burden, which may not be politically easy with elections on the horizon.

The debt-dynamics equation states that when there is no primary deficit (fiscal deficit in the year excluding the past legacy of interest payments), if the growth rate of GDP exceeds the effective interest rate paid on government bonds, the overall debt will decline. However, what is missed in these discussions is the distortions caused by financial repression to keep the interest rates on government borrowing low to reduce the cost. When the Statutory Liquidity Ratio (SLR) of the RBI mandates the banking system to hold 18% of their demand and time liabilities in government securities, and when the RBI intervenes in the market through open market operations around the time when the government borrowing is taken up, the interest rate on government borrowing is kept repressed. In such a situation, the debt may decline, but the distortions from the financial repression can adversely impact growth.

Thus, even when the sustainability of debt may not be threatened in the medium term, the costs of carrying high deficits and debt to the economy are heavy. First, on average, interest payments constitute over 5% of GDP and 25% of the revenue receipts, this is more than the government expenditure on education and healthcare put together. Large interest payments crowd out the much-needed expenditures on physical infrastructure and human development and emerging priorities to make the green transition. The issue is particularly concerning in the states of Punjab, Kerala, Rajasthan, and West Bengal. In Punjab, the Debt to GSDP ratio is 48.9%, in West Bengal, 37.6%, Rajasthan 35.4%, and in Kerala close to 33%. Second, high levels of debt make it difficult to calibrate counter-cyclical fiscal policy and constrain the ability of the government to respond to shocks. Third, the debt market in India is largely captive with mainly the commercial banks and insurance companies participating in it for meeting SLR requirements. With a cash reserve ratio

(CRR) of 4.5%. and SLR of 18% of net demand and time liabilities, and 40% of the credit by the commercial banks earmarked for the priority sector, the resources available for lending to the manufacturing sector are low driving up its cost of borrowing. The rating agencies keep the rating low when the deficits and debt are higher, and this enhances in cost of external commercial borrowing. Finally, today's borrowing is taxing tomorrow, and the burden of large deficits and debt will have to be borne by our future generation.

It is clear that, in the present fiscal environment, even achieving a consolidated debt-to-GDP ratio of 58.2% recommended by the 14th Finance Commission for 2019-20 would be unfeasible in the medium term. The Commission had recommended that the Union government should bring down its deficit relative to GDP from 43.6% in 2015-16 to 36.3%, and the States should maintain their deficit at about 22%. Even before the pandemic, the aggregate public debt had slipped to 74.3% in 2019-20, and the pandemic pushed it to 89.7% in 2020-21. With the nominal GDP recovering to grow at 18.5% in 2021-22 after the pandemic, the debt ratio declined only marginally to 85.7%. This implies that every individual in the country carries a debt burden of Rs 1,64,000 on his head. With the high primary deficit of 3.7% of GDP in 2022-23 and budgeted at over 3% in 2023-24, we will have to contend with elevated debt levels in the medium term.

The issue is of critical importance and the fast pacing of fiscal consolidation imperative. Fortunately, after 6 years, GST has stabilized and has shown high growth potential. As the technology platform has stabilized, it is expected to maintain high buoyancy in the medium term. The technology has helped to improve tax administration and improved compliance. With cross-matching of GST returns with income tax returns, the compliance of income tax too is expected to improve and in the medium term, the aggregate tax-GDP ratio is likely to increase by 1.5 to 2 percentage points. In terms of policy interventions, this is the time to rethink the role of the State and vacate the activities which should really belong to the market rather than competing with it. At the Central level, even after much talk about disinvestment, the progress has been slow. Rather than dispensing with activities like telecom to the private sector, the government continues to pore money to BSNL and MTNL. MRNL. Equally disturbing are the employment melas to fill the so-called vacant posts which have been anyway found redundant. At the state level, it is important to guard against the return to the old pension scheme and indulging in large-scale giveaways for electoral reasons. Of course, redistribution is a legitimate government activity and that is best done through making cash transfers rather than subsidizing commodities and services. Giving subsidies alters relative prices resulting in unintended resource distortions. Equally important is the need to impose hard budget constraints by enforcing the FRBM rules in allowing the states to borrow and that squarely is in the domain of the Union government.

* Views are personal

Contacts:

Investors & Media Contact
+91 95133 99706
1-860-425-2742
investordesk@brickworkratings.com
media@brickworkratings.com

ABOUT BRICKWORK RATINGS

Brickwork Ratings (BWR) is India's home-grown credit rating agency built with the superior analytical prowess of the industry's most experienced credit analysts, bankers and regulators. Established in 2007, BWR aims to provide reliable credit ratings by creating new standards for assessing risk and by offering accurate and transparent ratings. BWR provides investors and lenders timely and in-depth research across the structured finance, public finance, financial institutions, project finance and corporate sectors. BWR has employed over 280 working professionals including credit analysts and credit market professionals across 8 offices in India. Our experienced analysts have published over 13,370 ratings across asset classes. BWR is committed to providing the investment community with products and services needed to make informed investment decisions. BWR is a registered credit rating agency by Securities and Exchange Board of India (SEBI) and a recognised External Credit Assessment Agency (ECAI) by the Reserve Bank of India (RBI) to carry out credit ratings in India. BWR is promoted by Canara Bank, India's leading public sector bank.

More information on Canara Bank is available for reference at www.canarabank.com

BWR Rating Criteria are available at https://www.brickworkratings.com/ratingscriteria.aspx Brickwork Ratings, a SEBI-registered credit rating agency, has also been accredited by the RBI, and it offers rating services for bank loan, NCD, commercial paper, bonds, securitised paper etc. BWR has Canara Bank, a nationalised bank, as its promoter and strategic partner. BWR has its corporate office in Bengaluru and a country-wide presence, with offices in Ahmedabad, Chandigarh, Chennai, Hyderabad, Kolkata, Mumbai and New Delhi, along with representatives in 150+ locations. BWR has rated debt instruments/bonds/bank loans, securitised paper of over ₹ 19,09,101 Cr. Additionally, fixed deposits and commercial papers, among others, worth over ₹ 84,580 Cr have been rated.

DISCLAIMER

 In issuing and maintaining its ratings, Brickwork Ratings relies on factual information it receives from issuers and underwriters and from other sources Brickwork Ratings believes to be credible. Brickwork Ratings conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Brickwork Ratings' factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Brickwork Ratings' ratings should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Brickwork Ratings relies on in connection with a rating will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Brickwork Ratings and to the market in offering documents and other reports. In issuing its ratings Brickwork Ratings must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

THE INFORMATION IN THIS REPORT IS PROVIDED "AS IS" WITHOUT ANY REPRESENTATION OR WARRANTY OF ANY KIND. A Brickwork Ratings rating is an opinion as to the creditworthiness of a security. This opinion is based on established criteria and methodologies that Brickwork Ratings is continuously evaluating and updating. Therefore, ratings are the collective work product of Brickwork Ratings and no individual, or group of individuals, is solely responsible for a rating. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Brickwork Ratings is not engaged in the offer or sale of any security. All Brickwork Ratings reports have shared authorship. Individuals identified in a Brickwork Ratings report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Brickwork Ratings rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time, for any reason in the sole discretion of Brickwork Ratings. Brickwork Ratings does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Neither Brickwork Ratings nor its affiliates, third party providers, as well as their directors, officers, shareholders, employees or agents (collectively, "BWR Reps") guarantee the accuracy, completeness or adequacy of the Report, and no BWR Reps shall have any liability for any errors, omissions, or interruptions therein, regardless of the cause, or for the results obtained from the use of any part of this publication. In no event shall any BWR Reps be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of any part of the Report even if advised of the possibility of such damages. Brickwork Ratings receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities.