Debt and development:
Beyond casual observation and commonsense

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There is a growing consensus that the emerging fiscal federal relations in India tend to constrain the States more than ever before. With the enactment of Fiscal Responsibility and Budget Management (FRBM) Act in 2003, the State Governments are under severe restrictions on deficit financing. The limits are also set for the freedom of the democratically elected State Government in setting their developmental agenda. The implementation of GST resulted in state governments foregoing their maneuverability and autonomy in taxation, which is the major source of their revenue. As elaborated in the issues of Kerala Economy, with the pandemic there has been a severe decline in the GST collection of all the States. As a result, the resource constrained State Governments are left with hardly any option other than borrowing for financing development.

Borrowing-induced debt and its implications for development has indeed attracted much scholarly attention both in the developed and developing countries. Empirical evidence is in abundance to indicate the public debt beyond a threshold level could have the dampening effect on growth. The threshold level, however, would vary from one country to another. Of late a discourse has emerged in Kerala focusing on borrowing, public debt and its fiscal implications on development. While such a discourse is highly desirable, much of it is based on casual empiricism. It is argued that Kerala's debt has been doubling on a five-yearly basis. What is more, the estimated per capita debt in Kerala is of the order of Rs 100,000 and a panic is being created in the minds of ordinary citizens. This article intends to set the stage for a more informed discussion on this important issue.

Public debt and private debt

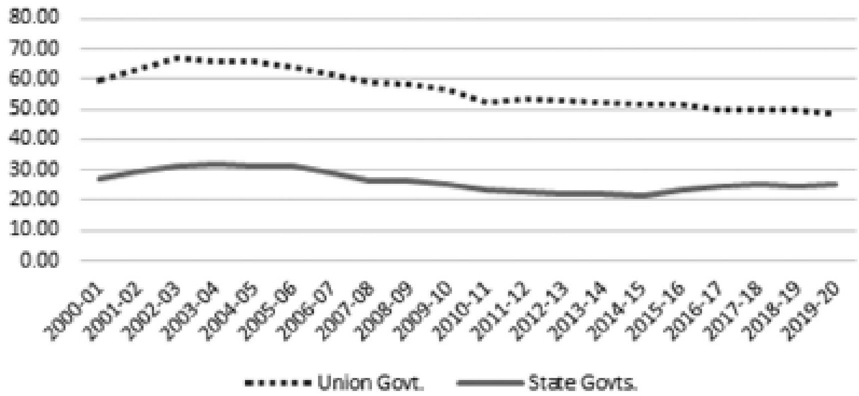
The conventional wisdom talks against borrowing during times of crisis as the future income sources are uncertain, adding up to the overall burden. Therefore, it is advised to "tighten your belt" during times of crisis. A household may cut back their expenditure during times of uncertainty. Common sense dictates that a government, either state or union, shall follow the same. But what is true of micro is rarely true of macro- the fallacy of composition error.

Hence, a prudent economic policy can never be framed by common sense and micro level evidence alone. The notion that a Government needs to cut back its spending as a policy response is called household fallacy (Farmer and Zabczyk,2018). They argue that the government is NOT like a household. Unlike households, the government can issue risk-free debt instruments to borrow money. Further, the potential revenue sources for a government are much diverse compared to an average household. Unlike households, the government invests in healthcare and education, something that increases the human capital stock. Yet another line of argument is that in case of domestic debt, interest payment is an income for the creditors in the economy, and its adverse impact would be limited provided the inflation is under control. For a government with a long-term development perspective, it might be advisable to borrow at present and invest by paying interest instead of making the future generation to pay for both inflation and interest rate.

FRBM: Centre and the states

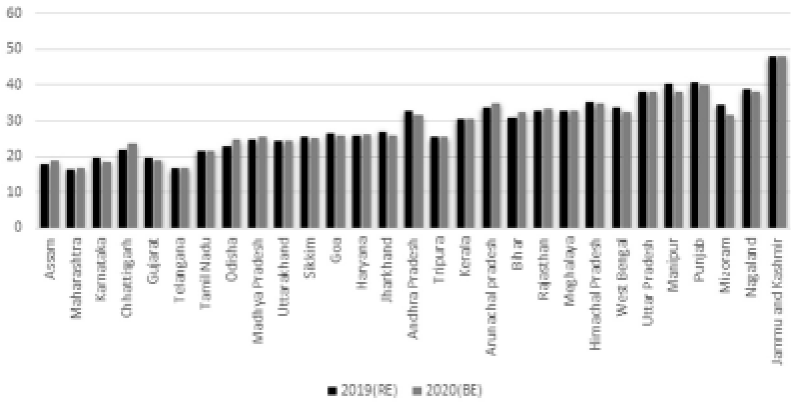
With the FRBM Act in place, the debt-to-GDP ratio for the center was to be brought down to 40 percent by 2024-25 as per the 2018-19 FRBM review committee recommendations. For the State Governments, regardless of their characteristics like stage of development, it has been pegged at 20 percent. Going by the available evidence, the FRBM has been effective in containing public debt. While the States in general are moving towards the FRBM commitment, the Center is lagging behind. In 2019-20, the Union government posted a debt to GDP ratio of 48.6 percent whereas the state governments had a debt-to-GDP ratio of only 24.92 percent.

Figure 1. Debt to GDP ratio of the union and state goverments



Source: State Finances: A Study of Budget, 2020-21, RBI.

Figure .2 Debt to GDP ratio of Indian States



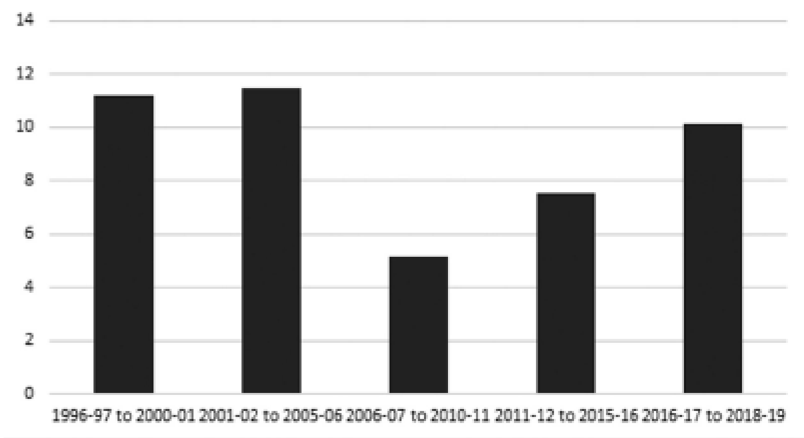
Source: State Finances: A Study of Budget, 2020-21, RBI.

Kerala's debt profile

Kerala's fiscal management during the COVID-19 pandemic was on the news headlines for various reasons. While the state received praise for its exemplary handling of the pandemic, serious concerns were raised regarding the state's fiscal position due to the welfare measures initiated during the pandemic. It was argued that Kerala's debt position would be worsened due to these measures.

Based on the casual observations of Kerala's debt profile, it is often argued that the state is highly debt ridden and that the stock of debt almost doubles every five years, that is, between each successive government. Nevertheless, these numbers are highly misleading because the discussion is based on nominal values. It would be better to look into the real growth in debt between successive periods (Figure 3). It is evident that in the post-FRBM era, there has been a decline in rate of growth of public debt. The recent increase in the growth rate needs to be seen in the context of adverse economic conditions arising out of two consecutive floods during 2018 and 2019.

Figure 3. Annual average growth rate in real debt stock



Source: Kerala State Budget Documents

At this juncture, a comparison of Kerala's debt position and interest payment commitment with other states may be in order. With a debt-to-GDP ratio of 30.8 percent in 2020, Kerala stands at the 17th position among 29 states, for which comparable data is available. Twelve states in India like UP, Andhra Pradesh, Punjab, Rajasthan, Himachal Pradesh, West Bengal, among others, are having higher debt-to-GDP ratio than Kerala. Further, as per the RBI estimates, Kerala's interest payment accounts for 2.1 percent of the GSDP as of 2019-20(RE) and among the 29 states, and holds the 20th position.

Kerala has high revenue expenditure compared to capital expenditure. Among revenue expenditure, both development and non-development revenue expenditure hold almost equal share (52.77 percent and 47.23 percent as of 2019-20(RE)). Salary to various government personnel is one major component of the development revenue expenditure. However, once they retire, their pension payments are listed under non-developmental expenditure. In other words, a higher non - development expenditure in the current period is the result of past development expenditure, which is at the core of Kerala's development experience. No wonder, Kerala's share of capital expenditure on total expenditure has been hovering around 10 percent for the last two decades. To ensure higher growth, we need to find alternative resources to mobilize capital.

The conventional wisdom talks about FDI as the route towards development. However, with FDI, the investments are made up of the sectors as per the funder's priority. The priorities of the state may take a backseat here. Instead of FDI, one should think of new ways of borrowing by tapping foreign financial markets with innovative debt instruments.

On the whole, it appears that public debt is neither good or bad. For those who have borrowed and managed debt appropriately, it has been an engine of growth while for others, it has sown the seeds of disaster. Many advanced economies hold significant amount of public debt. But they are not in crisis. In the case of the USA, the debt-to-GDP ratio is 135.7 percent, and the same for the UK is 117.3 percent. For Japan, it is 236.6 percent. At the same time, the Latin American debt crisis is still fresh in our memories. Hence, the discourse on debt management, debt utilization, investment capacity, cost overrun etc. would be highly rewarding.

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