Available online at http://www.journalcra.com

International Journal of Current Research
Vol. 8, Issue, 01, pp.25758-25763, January, 2016

INTERNATIONAL JOURNAL OF CURRENT RESEARCH

ISSN: 0975-833X

RESEARCH ARTICLE

PUBLIC DEBT: ISSUES, CHALLENGES AND TRENDS IN INDIA

***Piyush Bhadani**

Assistant Professor, Maharaja Agrasen College Delhi University

ARTICLE INFO

Article History:
Received 14th October, 2015
Received in revised form
22nd November, 2015
Accepted 25th December, 2015
Published online 31st January, 2016

Key words:

Public Debt Fiscal Deficit, Primary Deficit Revenue, Deficit.

ABSTRACT

The present paper discusses the issues challenges and trends of public debt in India since 1980. It first explains the reason for public debt and then gives a brief overview on the concept of Public Debt. The paper analyses the theoretical perspective of the public debt in which the views of various authors on public debt have been explained. Further the paper looks at the trends of public debt and gross interest obligation of the government since 1981. It discusses how the government debt have been used and specifically focuses on decline in the recovery ratio over the years. Due to decline in recovery ratio there is either increase in fiscal deficit or decline in non interest expenditure of the government or a combination of both. Also the increased amount of public debt is not leading to increase in productive capacity of the government indicating the inefficient utilization of the funds borrowed either from internal of external source. Lastly the paper points out the areas where the government is lacking and the measures the government should take so that the funds can be used in an efficient manner.

Citation: **Piyush Bhadani, 2016.** "Public debt: Issues, Challenges and trends in India", *International Journal of Current Research,* 8, (01), 25758-25763.

INTRODUCTION

WHY DO GOVERNMENTS NEED TO BORROW?

The answer to the question that I am raising here is quite obvious and the reason for governments' borrowing is nothing else but "government deficit". The deficit of the government can be classified into three types:-

- REVENUE DEFICIT- Revenue deficit refers to the excess of revenue expenditure over revenue receipts.
- FISCAL DEFICIT-Fiscal deficit is the difference between the revenue receipts plus non-debt capital receipts and the total expenditure including loans, net of repayments. This indicates the total borrowing requirements of Government from all sources.
- PRIMARY DEFICIT-Primary deficit is measured by fiscal deficit less interest payments.

The Governments' borrowing also called Public Debt or National debt is the means of financing government operation but it is not the only source of financing. The other sources of financing deficit include tax revenue which includes direct tax as well as indirect tax and non tax revenue which includes income from Public Sector Undertakings, dividend paid to the government, interest received on loans given et-cetera. Government can also create money to monetize their debt, thereby removing the need to repay the debt and the interest. But in the light of low revenue and capital receipts in India public debt or public borrowing becomes an essential part of governments' obligation of meeting its expenditure for social and economic purposes. Debt is generally bridged by issuing bonds or treasury bills which are purchased by market participants like banks, insurance funds, pension funds and other institutions.

PUBLIC DEBT can be categorized as INTERNAL DEBT and EXTERNAL DEBT. Internal Debt for Government of India largely consists of fixed tenure and fixed coupon borrowings (dated securities and treasury bills) which are issued through auction. Maturity profile of existing debt could be classified into three categories, namely – short, medium and long term having maturity of less than 1 year, from one year up to 7 years and more than 7 years respectively. External Debt is a small proportion of the overall public debt of the Government of India. It is largely used for financing specific projects at the Central and State levels. States are not permitted to contract external debt directly and therefore in the existing system all external debt (even those not used for financing Central Govt. projects) are first contracted in the Consolidated Fund of India

****Corresponding author: Piyush Bhadani,***
Assistant professor, Maharaja Agrasen College Delhi University.

and then on-lent to States. Most of the external debt is from multilateral agencies such as IDA (International Development Association), IBRD (International Bank for Reconstruction and Development), ADB (Asian Development bank) etc. A small proportion of existing external debt comes from bilateral agencies. While calculating effective rate of interest for these loans, impact of exchange rate variation needs to be taken into account.

Borrowing from internal source does not change the total current amount that may be spent. When our government issues new bonds, the Indian bond buyers temporarily surrender their purchasing power which offsets the government's gain in purchasing power. People of the country do not gain or lose immediately through such transactions, although the use of these funds may affect the future Indian purchasing power. For example, if the government invests the borrowed funds in such a way that leads to overall reduction in the price level of the economy, the real future income may increase leading to increase in purchasing power. On the other hand if government borrows for deficit in revenue account, transfer payments defense expenditure et-cetera, funds may be diverted from investments and future purchasing power may fall. For example if a war is financed by bonds, lower rates of domestic capital formation may hinder standard of living for generations. Just as borrowing internally does not change total current purchasing power, repayment of internal debt does not simultaneously affect total Indian purchasing power. People who cash their bond receive purchasing power exactly equal to losses of purchasing power to taxpayers or the government. Also financing of deficit through internal debt leads to less inflation compared to financing of debt through monetization i.e. financing of public debt through printing money. When the government sells the bonds to foreign government or investors, India as a whole temporarily gains purchasing power. But, unless external borrowers permit repeated refinancing, external borrowing entails eventual external repayment. If the borrowed funds were used for investment goods that were sufficiently productive to cover the principal borrowed plus interest charges, the borrowers would still be ahead after repayment. On the other hand if the borrowed funds were used to finance consumption, then the repayment to the external lenders could entail net losses of purchasing power. But Public Borrowings do not come free of cost and the government has to pay the cost of borrowing in the form of interest payment. Currently in the union budget interest payment is the most important and increasing component of governments' non-planned expenditure. And we can say that there is a clear cut proportional relationship between public debt and interest payment. As the public debt increases the interest obligation of the government increases. This interest obligation becomes burden for the government if the borrowed funds are unable to recover the cost of borrowing due to unproductive utilisation of the funds. So financing of deficit through debt should be productive so that it does not lead to creation of unnecessary burden of interest payment and repayment for the government.

The Theoretical Perspective of Public Debt

Public debt is the debt owned by the central government of a country. It is one of the major sources of financing the deficit of the economy. But the crucial question is "does public debt create burden on the government?" In the light of this it is essential to define the nature of the burden of public debt.

1. According to Prof. Domar the burden of public debt should be defined as the ratio of the total debt to the total national income. If the total amount of national income remains constant and total amount of public debt increases year after year, the burden of the debt would increase. But if the national income also rises (with a rate higher than the rate of public debt) together with the increase in the amount of public debt then in spite of the increase in the amount of the public debt, the burden of public debt, defined as total amount of public debt divided by the total amount of national income will actually fall. In other words as the national income rises the total amount of tax collected by the state rises automatically, and thus larger and larger amount of public debt may actually impose lesser and lesser amounts of burden. Thus Domar argues that even if the absolute volume of public debt is increases, the burden of public debt will fall if the National Income is also increases more than the increase in the public debt.
2. To service the debt interest must be paid and taxes raised to finance these payments impose a burden on the economy. However it has been argued that, assuming that we are dealing with domestically held debt, taxing to pay interest merely transfers funds from one pocket to another and the state as whole does not suffer losses. But as we know taxes which must be imposed to finance this transfer carry a deadweight loss, just like the other taxes, and this definitely places a burden on the economy. The severity of the problem increases as the tax revenue (needed to service the debt) to GDP ratio increases.

Thus if we see the two different types of burden of the public debt it is quite evident that the increase in the amount of the public debt creates burden in the economy in the one or the other way. The burden of debt servicing is sacrosanct to public debt.

Furthermore, the relevant factors which should be taken into account in considering as to whether an internally held debt imposes a burden are as follows:-

1. The nature of the burden of the internally held public debt is different from the externally held public debt. In case of an externally held public debt the interest and the principal are required to be paid by the debtor countries to the creditor countries by means of export surplus and as such by the transfer of the real resources from the debtor to the creditor countries. On the other hand in the case of internally held public debt the resources held within the country but only require to be transferred from the taxpayers to the bondholders in the form of interest payments.
2. Dr Lerner is of the opinion that when unemployment is fought by deficit spending and due to this amount of public debt increases, the burden of the public debt should be weighed against the burden of unemployment which would be there if there is no deficit spending programme for employment generation. And if the policy makers take this

into account the burden of the public debt will much smaller and even nil or negative.

3. The existence of large amount of public debt may set in motion an inflationary tendency at any point of time. This is because the government bonds are near monies and any such policy of the government which will increase the interest rate on the bonds might trigger the conversion of the near monies in the true money by the bondholders. This makes the economy very much inflation sensitive. In fact a large public debt very much limits the possibility of a vigorous exercise of the central banking credit control techniques which might increase the rate of interest, since this might lead to a fall in the prices of the outstanding government securities and create disorderly conditions in the government securities market. This type of secondary burden of public debt should also be taken into account.
4. A large amount of public debt requires a corresponding large amount of tax collection for debt servicing and this may adversely affect work incentives, saving and risk taking propensities.

There is another debate which is quite essential to discuss if we are discussing public debt at this length. The debate is "whether the system of financing a project by means of public debt shifts the burden to the future generation." There are different views regarding this some of them are as follows:-

1. Ricardo-Pigou thesis- They have discussed the mechanism of burden transfer through reduced capital formation. To understand the argument behind this we assume that investment adjusts itself automatically to the level of savings forthcoming at the full-employment level of income. In such a given framework the transfer of any resources from private to public use leaves the private sector with fewer resources. But the resources withdrawal from the private sector may be from the consumption or from capital formation. If the withdrawal is from consumption, the welfare of the current generation, measured by consumption, is reduced and the income of the future generation is unaffected. But if the withdrawal is from capital formation, the consumption of the present generation is untouched and while the future generation will inherit a smaller capital stock and thus enjoy a lower income. So in this sense future generation is burdened. Further if we assume that tax finance comes from consumption while loan finance comes from savings (hence under the assumption saving equals investment, from investment) it then follows that loan finance burdens future generation.
2. Buchanan thesis- He holds the opinion that financing of project by the government by means of borrowing does shift the burden to the future generation. According to him, the concept of burden should be interpreted in terms of the individual attitudes towards their economic well-being rather than rather than changes in the private sector outputs and real income because of the inheritance by the future generation of a larger or smaller amount of capital instruments. Buchanan argues that during the period in which the project is financed and borrowing takes place, no burden of any kind is created. The individuals who give loans to the government voluntarily exchange liquid funds for less liquid government bonds instead of using the funds for acquiring consumption and/or investment goods. Since this is done voluntarily by the individuals concerned, they do not feel themselves to be any worse off. When, however, bonds are repaid in the future generation, funds are taken from the taxpayers and given to the bondholders in return for the bonds. As a result the taxpayers feel themselves to be worse off, but the bondholders are not better off since they have now merely changed bonds for cash. But in the latter generations the taxpayers are worse off since tax is a compulsory payment. As a result the society as a whole becomes worse off in the latter generations. In this sense burden is shifted to the future generation.
3. Musgrave thesis of intergenerational equity- Musgrave argues that if the funds borrowed are spent as capital expenditure then the benefit will extend to the future, then burden transfer should be called for as matter of intergenerational equity. Thus it is rationale to divide the budget into a current and capital component, with the former tax and latter loan financed. He constructs a case in which regardless of the reaction of generation 1 to tax finance or loan finance, loan finance always divides the cost among generations and tax finance can never do so. In this sense loan financing does shift the burden to generations to come.

Trends of public debt and interest payment in India

There is no doubt that public debt in India has grown rather rapidly since 1980s. During the 80s the combined debt of the central government and the state government grew at the rate of 18% per annum, as against the GDP growth rate of 14% (both at current prices). As a result the public debt to GDP ratio increased from 50% in 1980-81 to 75% in 1990-1991. During this period i.e.1980-90, increase in internal debt was faster than external public debt. Between 1980-81 and 1990-91, the internal debt as percent of GDP grew from 22.7% to 28.8% where as the external debt as percent of GDP declined from 8.3% to 5.9%. Then 1990-91 onwards internal debt as percent of GDP started falling till 1997-98 and reached 25.7%, thereafter it increased to its highest level of 41.4% in 2003-04 and again it started falling to reach 36.4% in 2009-10.As a result of the concerted efforts to restore fiscal balance through tax reforms, expenditure management, institutional reforms and financial sector reforms in the first half of the 1990s, there was significant reduction in the magnitude of fiscal deficit and the proportion of debt relative to GDP during the period 1991 to 1997.However, during the period 1997 to 2003, there was a reversal in the trend of fiscal consolidation, and the cumulative impact of industrial slowdown, fifth pay commission award, and a lower than expected revenue buoyancy culminated in fiscal deterioration. On the other hand if we see the trend in the external debt as a percent GDP, it has declined throughout the last three decades and reached to its minimum of 1.7% in the year 2003-04.This shows that the share of internal public debt in the total public debt has increased compared to external public debt throughout the last three decades. Although the share of external public debt in the total public debt has decline, it is still a major cause of concern for the increasing public debt as the pressure created by the debt service on balance of payment with respect to a countries' external public debt account leads to decline in the foreign exchange reserves of the country. The total external public debt of the country grew from Rs. 11,298 crore in 80-81 to Rs. 1,34,083 crore in 2009-10. As far as internal debt is concerned, the central government's outstanding internal debt rose from Rs. 30,864crore in 1980-81 to 23,49,148 crore in 2009-10. The interest payment on the public debt is the major component of government's non-plan expenditure and during the last three decades interest payment on internal as well as external debt as a proportion of GDP has increased from 1.9% in 1980-81 to 3.3% in 2009-10.The gross interest obligations with respect to the centre's internal debt have become rather high during the course of the last three decades.

PUBLIC DEBT IN INDIA-- GOOD OR BAD?

In the Indian context, we can access the burden of public debt in terms of gross interest obligation because it is not essential that the return to all investments financed by the funds raised from public borrowing is high enough to overlap the gross interest obligation. The funds raised from borrowing from public to finance revenue account deficit does not earn any return and moreover the interest obligations on such loans are required to be raised from other sources. So the deficit in the revenue account is the worst form of deficit as the funds raised to finance this deficit don't earn any interest, as a result the expenditure on the other social commitments by the government suffer. But there are ventures which are financed by public borrowing yield returns, and that too in the form of interest receipts, profits and dividends. In 1980-81 as much as 84.3% of the interest paid on the total public debt of the centre was recovered as interest receipts, dividends and profits. The corresponding figure for 1990-91 and 1992-93 are worked out to be 44.5 % and 50% respectively. Thus during this decade that is 1980-90 the net interest outgo has been quite phenomenal and thus the recovery ratio (defined as receipts on account of interest, dividend and profits divided by interest payment on borrowing) has declined substantially. Deployment of funds by the government for the purposes which are not directly remunerative, in the sense of yielding interest dividends or profits, could still be quite productive to the economy as a whole in the sense of improving its efficiency of production or adding to its productive capacity through improved economic and social infrastructure. In that case one could legitimately expect the public investments to reflect themselves in higher growth of national income and correspondingly in better revenue receipts of the government especially tax receipts. But if we see in the recent past even though the total public debt is touching the sky, the increase in the central government receipt as well as tax receipt has been far below the increase in its gross interest obligation. So while the productive impact of large proportion of public expenditure cannot be ruled out, the fact cannot be overlooked that it had failed to reflect itself in sufficiently enhanced revenues of the Indian government. If direct returns from government investments do not expand as public date mounts and if at the same time government revenues do not expand sufficiently, the higher relative burden of the net interest outgo can mean either reduced non-interest government spending or larger fiscal deficit or a combination of both. In the process a sort of vicious circle can get into motion with higher deficit leading to larger borrowing which causes still higher deficits because of the larger net outgo in the form of interests. The crucial factors responsible for this vicious circle are a mix of inadequate recovery ratio and insufficient revenue mobilization. And that's what is happening in our country and in order to reduce the fiscal deficit the government is reducing the non-interest government spending which to some extend is a compromise on the social and economic obligations of the government. So in the Indian context, where the government is not able to use its public debt in a productive manner and at the same time is unable to raise sufficient tax revenue to meet its interest obligation, Public Debt can be considered to be bad.

WHERE DOES THE GOVERNMENT LACK?

One of the major problem that any policy maker does not take into account is the wide spread presence of the Black Economy in the country. If we want any of the fiscal policy instrument to affect the economy in a real sense so that all sections of the society gets the benefit of such policy change, its very essential for a policy maker to consider the existence of Black Economy in the overall economy. We cannot understand the Indian Economy without taking into account the black economy. The continuous rise in the fiscal deficit of the government, which is leading to higher borrowing by the central government, can be curtailed if we take measures to reduce the size of the black economy which is almost 50% of GDP right now. Due to the presence of the black economy fiscal policy faces two problems, i) Government is not able to collect enough tax, so less revenue receipts are generated leading to higher borrowing by the government. Since government has social obligations as well they have to borrow to fulfill their commitments. But if Black economy would have been taken into account, the government would have increased the revenue collection. The shortage of resources is the result of black economy. ii) Even if the money is allotted, full amount is not used for the development.

WHAT NEEDS TO BE DONE?

Explore ways and means of mobilizing additional current revenue, larger tax revenue will reduce government's deficit on revenue account as well as its fiscal deficit. Larger recoveries in the form of interest receipts, dividend and profit will reduce the net outgo on account of interest on public debt. Also there is a need to take into account the black economy in the country. If we try to reduce its size more and more funds will be available for investment which will ultimately lead to overall growth of the economy. As a result tax collection of the government will increase and will undermine the need of borrowing by the government. In this instance, it would be appropriate to refer to the 1944 paper written by E.D. Domar. In this paper Domar demonstrate that "the problem of debt burden is essentially a problem of growing national income increase." Domar shows the taxation required to finance the interest liabilities of a government on its public debt will not impose a particularly unbearable burden on the economy if the national income of the country is growing. What is necessary to ensure, according to Domar, is that government expenditures are productive in a sense that it contributes to the expansion of national income in general. So Domar asserts that in response to the increasing public debt the policy makers should not stop or reduce public borrowing but should review the existing allocation of government expenditure and make sure that the maximum possible proportion of these expenditures is incurred in areas and in manner that contributes to the growth of national income.

Conclusion

The necessity for governments to borrow in order to finance a deficit budget has led to the development of various forms of public debt, which are now a central feature of all capital markets. Governments may owe public debt in the form of bonds, notes, bills, and the like, which require specified payments to the holders at designated times. For the most part, public debt differs from private debt only in that it is an obligation of government rather than of private individuals or corporations. If we talk about the advantages and disadvantages of the public debt, it has both. The productive utilization of the public debt can lead to capital formation, increase in national income and hence increased revenue collection, employment generation and overall growth of the economy. But if the funds are not utilized properly then the increasing amount of public debt and the corresponding rise in net interest payment is a serious issue to worry because the more the burden of interest payment will increase the more the available amount of other necessary expenditure by the government will decline. Such other expenditures are sacrosanct for the economic and social obligation of the government. In a sense reducing the expenditure on other commitments for reducing public debt may well amount to reneging on its obligation with may destabilize the economy as a whole.

REFERENCES

Economic Survey 1980-81 to 2010-11: http://indiabudget.nic.in/

India's external debt: A Status Report 2011-12 Government Of India ministry of Finance department OF Economic Affairs external Debt Management Unit.

Indian Public Finance Statistics 2004-05 to 2011-12 http://finmin.nic.in

Musgrave R.A. and Musgrave P.B: "Public Finance in Theory and Practice" Chapter-32.Gulati I.S,

Reddy Y.V.: Fiscal Policy and Economic Reforms, Working Paper 2008-53 May 2008, National Institute of Public Finance and Policy.

Tackling the Growing Burden of Public Debt, Economic and Political weekly May 1 1993.

APPENDIX

Table 1. Internal and External Public Debt of Government of India (in Rs. Crore)

Years	Internal debt	External debt
1980-81	30864	11298
1990-91	154004	31525
1991-92	172750	36948
1992-93	199100	42269
1993-94	245712	47345
1994-95	266467	50929
1995-96	307869	51249
1996-97	344476	54238
1997-98	388998	55332
1998-99	459696	57255
1999-2000	714254	58437
2000-2001	803698	65945
2001-2002	913061	71546
2002-2003	1020698	59612
2003-2004	1141706	46124
2004-2005	1275971	60878
2005-2006	1389758	94243
2006-2007	1544975	102716
2007-2008	1808359	112031
2008-2009	2028549	123046
2009-2010	2349148	134083

SOURCES- Economic survey document, Indian Public Finance Statistics

Table 2. Internal and External Public Debt of Government of India (as % 6f GDP)

Years	Internal debt (as percent of GDP)	External debt (as percent of GDP)
1980-81	22.7	8.3
1990-91	28.8	5.9
1991-92	28.1	6.0
1992-93	28.2	6.0
1993-94	30.3	5.8
1994-95	27.9	5.3
1995-96	26.0	4.3
1996-97	25.3	4.0
1997-98	25.7	3.7
1998-99	26.4	3.3
1999-2000	36.9	3.0
2000-2001	38.2	3.2
2001-2002	40.0	3.1
2002-2003	41.3	2.4
2003-2004	41.4	1.7
2004-2005	40.5	1.9
2005-2006	38.7	2.6
2006-2007	37.4	2.5
2007-2008	36.3	2.2
2008-2009	36.3	2.2
2009-2010	36.4	2.1

SOURCES- Economic survey document, Indian Public Finance Statistics

Table 3. Interest payment by government of India

Years	Interest payment (in Rs. Crore)	Interest payment (as percent of GDP)
1980-81	2604	1.9
1990-91	21498	4.0
1991-92	26596	4.3
1992-93	31075	4.4
1993-94	36741	4.5
1994-95	44060	4.6
1995-96	50048	4.2
1996-97	59478	4.4
1997-98	65637	4.3
1998-99	77882	4.5
1999-2000	90249	4.7
2000-2001	99314	4.8
2001-2002	107460	4.7
2002-2003	117804	4.8
2003-2004	107460	4.5
2004-2005	126934	4.0
2005-2006	132630	3.7
2006-2007	150272	3.6
2007-2008	171030	3.6
2008-2009	192204	3.4
2009-2010	213093	3.3

SOURCES- Economic survey document, Indian Public Finance Statistics

****