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Gujarat: The Issue of Debt Management

KEYWORDS

Dr.Sangita Agrawal

Faculty Member, Dept. of Business Economics Faculty of Commerce, M.S. University of Baroda

ABSTRACT *Public Debt forms a significant portion of the total credit available to the state economy and therefore, intimately connected with the working of the economy. The experience of the past two decades has shown that the Gujarat Government is passing through a high proportion of resource imbalances, which has led the state to high public Debt. This paper examines the position of Gujarat state with respect to - debt indicators, the issues pertaining to sustainability of debt and its restructuring program.*

Introduction

Gujarat is one of the most developed state in India. The state has able to manage a high growth in the nineties and it ranked first with 8.99 growth rate at constant 1993-94 prices among the states in the year two thousand. However, it cannot be characterized as a typical state. Like other states in India, Gujarat witnessed a secular deterioration in its fiscal health since the mid 1980's. In fact, in the initial years of 1980's, the state generated a revenue surplus of one percent of gross SDP. By 1987-88, however, the surplus had vanished. In subsequent years until 1993-94, there was gradual increase in deficit, but thereafter, it increased sharply, ranging between 3 to 5 percent of gross SDP. The situation further deteriorated in year 2001, when state reached a gross fiscal deficit of more than 5 percent of gross SDP.

Increase in deficit subsequently every year has led to large borrowings, which resulted into steady accumulation of debt. The debt dynamics turned more adverse in the nineties as public debt as percent of SDP witnessed rapid growth from 3.8 (1986-87) to 6.6 (2000) percent. The average annual growth rate of public debt has increased from 6.7 in the eighties to 41 percent in the years of two thousand. The RBI Report on State Finances [2001] pointed that 15 percent of the total expenditure of the Gujarat state in the year 2000 comprised of interest payment and debt servicing.

Debt by itself suggests an obligation or a liability and its presence in the economy, therefore, is not regarded desirable. According to Buchanan [1962] "Taxation covers the current expenditure of government while borrowings done to finance government expenditure which results in the creation of capital assets". However, the important role of public borrowing in economic development is relatively considered as the collapse of the principle of Laissez Faire and the rise of modern welfare states.

Keynes also believed that a large debt promotes economic stability and high levels of income and employment. According to them debt involves only a series of transfer payments that cancel out for the economy as a whole. That is what matters the State's economy in India. In context of a state, debt creation and management of debt is more important than raising debt to finance development.

Debt management refers to set of operations which are required to maintain the debt at the minimum cost. In a broader sense it would include all measures that affect the size and composition of the outstanding claims against the government. A definition by Abbott (1964) includes all the major component of debt management such as creation, administration and liquidation of public debt. According to him " By management of the debt is meant the choice of debt forms and the proportionate amounts of the different types used, the selection of the pattern of debt maturities, the amount of debt placed with the different class of holders, the decision to repay or refund maturing obligations, the refunding items offered, the treatment given to different classes of debt, and different types of bond holders, determination of the provisions attached to new bond holders, adaptation of new issues to the needs of the prospective holders, creation of new debt, and the relative weights given to all these matters in the government's general fiscal policy." The main issues in the management of public debt is to determine the total amount of issue of government securities, terms of issue and the timing of the issue and to maintain a healthy market in government securities.

The phenomenal increase in states debt has been a subject of debate in recent years especially in the Parliament and the State legislatures. Fiscal liability has created significant fiscal risk both at the centre and at the state, which include pay revision, increase in food subsidy in the wake of sharp increase in the prices of food grains, expenditure associated with electoral cycle and increase in capital inflows and its sterilization by the Reserve Bank.

Debt is refer as 'widening gyre' The dynamics of rising public debt and falling growth throw light on the theoretical and empirical basis for the idea of a vicious circle (a "widening gyre") of rising public debt, rising public deficit, falling ratio of private to total credit and falling growth.

It is also argued, that to accelerate growth, higher levels of public investment is required in critical social and economic infrastructure sectors by state governments. However, the financial position of most states is actually forcing a continuing squeeze on plan investment. Therefore states compel to borrow more to finance the plan.

The growth in debt means government is making large investment in the economy. Unfortunately, the increase in debt which the state has, is not due to large investment but due to increase in current expenditure. The state is increasingly being dependent on central government and market borrowings. In order to understand the implications of borrowings, this paper enumerates the issues of debt management of Gujarat state. Its trend and structure, problems related with debt Sustainability and the role of centre in debt restructuring program of Gujarat Finance for the period 1980-2008.

Methodology

The study uses the annual data obtained by the various RBI bulletin on state finances and Gujarat State Domestic product, GOG Publications. The study tries to explain the public debt in terms of both levels as well as growth rate. Various indicator of public debt is also estimated in order to understand the nature and magnitude of public debt. To get a

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comparative idea about the whole fiscal situation, All States in general compared with Gujarat.

Trend and Structure of Public Debt of Gujarat State

The Federal type of Indian public finance provides for borrowing by both the Central Government and the State governments either independently or collectively. State government does not have complete freedom with regard to public borrowing. Previous consent of the central government is necessary for the state to float new loans. Central government exercises control over the borrowing policy of the states in order to prevent unsound borrowing and to safeguard the credit structure of the states. The responsibility of managing the states' debt rests with the Reserve Bank of India. Being the manager of the debt of the centre and the states, the Reserve Bank of India is in a position to coordinate the debt policies of the centre and the states, keeping in view the monetary and fiscal policies in general.

The total debt of Gujarat indicates an upward trend as shown in the Table-1. It was Rs.1178Cr. in 1980, increased to Rs.6230Cr. in 1990 and to Rs.29786Cr. in 2000. The total increase from 1980 to 2000 indicates an increase of 25.28 percent. In 2005, there was a reduction in total public debt to Rs.10690Cr. then, again it evinced the upward trend. This pin points the excessive dependence of the state government on the centre for obtaining loans and other sources of the debt. Similarly the total debt of All states also showed an upward trend with Rs.24254Cr in 1980 and Rs.498092Cr in 2000 indicating an increase of 20.53 percent.

Table-1 Total Outstanding Liabilities (as on 31 March) and its Composition

	Gujarat				All states			
Year	Public debt (Rs. Cr.)	Internal Debt	Loans & adv	Provident Fund	Public debt (Rs. Cr.)	Internal Debt	Loans & adv	Provident Fund
1980	1178	23.93	64.94	11.12	24254	18.31	71.41	10.27
1985	2751	14.61	74.44	10.94	52281	15.45	72.38	12.16
1990	6230	11.52	79.42	9.05	108203	17.18	68.25	14.56
1995	11128	13.48	75.21	11.29	212224	20.36	61.96	17.67
2000	29786	39.35	51.04	9.60	498092	36.42	45.09	18.48
2005	10690	88.43	2.75	8.80	148873	70.29	3.8	25.86
2008 (B.E)	11922	86.20	3.55	10.23	220269	72.12	6.69	20.90

Source:- Handbook of Statistics on State Government Finances, RBI, 2004

Various State Finance Report of RBI

Note:- the total debt of Gujarat in 2005 the NSSF is Rs29773Cr and in 2008 it isRs. 38192Cr. The NSSF was earlier collected by centre and states in the ratio of 20:80.from 2002-03 the entire net collections given to the states fund.

The RBI classification of total debt consists of internal debt. loans and advances from the centre and total provident fund. It is worth to note that the relative importance of composition of total debt had changed. During the period 1980 to 2000 the contribution of loans and advances is as high as 70 percent while the share of internal debt and provident fund is 23 and 11 percent. In the year 2005 the share of internal debt had increased to 80 percent while the contribution of provident fund and loans and advances to 8 and 2 percent. Similar kind of trend was observed with All States.

The fall in the contribution of loan and advances from 70 percent in 1980 to 3 percent in 2008 was due to the fall in plan loans from the centre. As per the recommendations of Twelfth Finance Commission the government provides plan loans only, and that too, in the case of an externally aided project.

Secondly it being noticed that within the component of internal debt there is an increase in the share of special securities issued to NSSF. NSSF is the most expensive source of financing. Annually, the NSSF component in total debt is increasing at a rate of 6 percent and it constitutes 57 percent of the outstanding debt.

Thirdly, the states government also resorted to market borrowing for raising revenues. Borrowings from financial institution like NABARD, LIC has increased after 2002.

It also seems that the declined in the share of Small Savings and Provident Fund are attributed to the fact that they are basically used as a gap filling instrument and as a last resort.

This indicates that the state is increasingly dependent on the central government and other instruments to finance its expenditure.

To the some extent during the period (1995-2002) the Government of Gujarat also provided guarantees to the large number of sectors as per the provisions of the Gujarat govt, Guarantees Act 1963. (Amended 1988). The government charged guarantees fees in the range of 0.25 percent to 2 percent. The total amount received by way of fees amounted to Rs 22.42Cr in 1995-96 which had increased to Rs. 90Cr. in 2002-03. However, in comparisons to the outstanding amount of guarantees, the fees collected appeared to be low. Being a contingent liability, different probabilities of default are attached to be fixed in relation to the risk involved. The sinking fund could be used to service any default occurring.

Though Guarantees are not debts, yet, in the eventuality of default, they have the potential to drain resources from an apparently sound fiscal system.

Sustainability of Debt

The mounting debt and the debt servicing liabilities of the states are an important indicator of debt sustainability. Sustainability of debt can be defined as the ability to maintain a constant debt/GDP ratio over a period of time. [Prasad, 2004] As such there is no unique definition of sustainability of public debt yet; a comparative analysis of the growth of public debt along with the growth of SDP can partly serve the purpose. For the economy as a whole, the necessary condition for sustainability requires rate of real interest to be less than or equal to the rate of real economic growth. Debt indicators in terms of revenue receipt and as percentage of SDP are depicted in Table -2.

TableV-12- Debt Indicators I

Year	Debt GR Rate	Gr. Of RR	Debt as % SDP	Per capita Debt
1980-1990	19.45	15.13	3.51	Rs. 121
1991-2000	22.91	13.69	3.23	Rs.383
2001-2008	14.16*	14.94	6.17	Rs.1510
1980-2008	19.18*	14.99	4.14	Rs.594

Handbook of Statistics on State Government Finances, RBI, 2004,Various State Finance Report of RBI

*note- does not include the NSSF.

The following observations are made from the Table -2

(i) Table-2 indicates that the state is increasingly being dependent on the central government. This dependency is reflected by the debt ratio in terms of revenue receipts, its growth rate and as percentage of SDP. The rate of growth of revenue receipts was less than the rate of growth of debt over a period of 1980 to 2008. During 1980-90 the rate of growth of debt was 19.45 while the rate of growth of revenue receipts was 15.13. This difference was widened by 9 percent in the nineties. In the years of two thousand, if we include the NSSF the rate of debt was 28 percent while the rate of growth of revenue receipts was 14 percent. The point is that the growth rate of debt indicates an increase every decade and is soaring high and high. While the growth rate of revenue receipts was stagnant to 13 and 14 percent.

(ii) Debt in proportion to gross SDP also witnessed an upward trend. It was 3.51 percent in the eighties increases to

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3.23 percent in the nineties and 6.17 percent in the years of two thousand. The per capita debt burden was indicating an increase of Rs.121 to Rs. 1510. Thus the present trend indicates that the state is facing a steady accumulation of debt and in the near future it might face the situation of debt trap.

(iii) The debt position of the state government depended not only on the absolute level of their outstanding liabilities but also on the various indicators which determine the sustainability of debt. Ratio of Interest payments to revenue receipts, ratio of interest receipts to capital receipts and Debt-SDP ratio is also an important indicator of debt sustainability. It seems from the Table-3 that all these indicators with interest payments show an upward trend.

(iv) The excess of interest payment will hold the capital formation and thus the income of the state. The rising interest earnings of the government offset to a great extent the burden of interest payment. Table-3 shows that the interest payments of Gujarat are continuously increasing from Rs.68.6Cr. to Rs.8159Cr. indicating an increase of 118.9 percent.

Table-3 Debt Indicator II

Year	Interest payment (Rs. Cr)	Ratio of I.P / RR	Ratio of I P/CR	Debt/ SDP
1980	68.6	0.06	0.19	0.15
1985	187.5	0.09	0.27	0.29
1990	531.5	0.15	0.24	0.49
1995	1328.1	0.15	0.52	0.15
2000	3131.4	0.19	0.28	0.27
2005	6143	0.24	0.49	0.32
2008(B.E)	8159	0.21	0.79	--

Source:-Handbook of Statistics on State Government Finances, RBI, 2004

Various State Finance Report of RBI

(v) Secondly, when the interest burden in relation to revenue receipts is more, then the problem is more serious because increase in interest leads to high revenue deficit. Table-3 evinces that the ratio of interest payment to revenue receipts increased from 0.06 to 0.21 during the period 1980-2008. The increase in this ratio indicates a wide resources gap between receipts and expenditure. It also indicates the amount of tax absorbed by debt.

(vi) Thirdly, the ratio of public debt to state income is also considered an important indicator of the manageability of public debt. The debt-income ratio shows the magnitude of burden of growing public indebtedness of the Gujarat state. Table-3 evinces that the debt income ratio had increased from 0.15 in the eighties to 0.49 in the nineties. In the year 2005 it was 0.32, thus, the increase in this ratio indicates that the fiscal health of the state was deteriorating.

(vii) Similarly, if the ratio of capital receipts to debt is increasing, it indicates more receipts from the debt and less for assets creation. On the other hand if the rate of growth of public debt is accompanied by corresponding increase in the rate of asset creation, the burden of public debt would not be that burdensome. If the borrowed funds are used for asset creating public projects, the income of the nation is bound to rise along with the rise in the government's obligation. TableV-13 evinces that the ratio of capital receipts to debt has increased from 0.19 in the eighties to 0.79 in the years of two thousand. The increase in this ratio indicates that, the borrowings of the government had increased due to an increase in the revenue expenditure and not of the capital receipts.

Thus the public debt of the Gujarat government evinces an upward trend and if timely action is not taken, then, it will affect the state economic development. The income creating effect of public debt makes the burden of public debt less burdensome. But the point is that considerable part of receipts was made to meet the debt obligations. Since revenue receipts had not witnessed any noticeable increase, the high gap between fiscal resources against fiscal liabilities4 will create a negative trend for Gujarat Government. It would be very difficult for Gujarat to obtain loans and advance from centre and other national and international financial institutions also.

In the light of the above, let's examine the role of the Planning Commission and the Reserve Bank of India with respect to Gujarat state.

Role of Finance Commission and Debt Restructuring Program for Gujarat

Various methods of debt redemption had been used by the centre and the state to improve the fiscal health. During the period 1980-88 enormity of the problem of debt was not as serious as today. The Seventh and Eighth Finance Commission were more concerned about the central loans given to states and they suggested appropriate measures to deal with non-plan capital gap. They recommended that the burden of non-plan budgets of the state could reduced by a large scale write-off of the states debt to the centre. The Report of the study team on Centre-State Relations of the Administrative Reform Commission also supported the write-off of a bulk of the states' debt on the ground that this would open up satisfactory creditor-debtor relationship between the centre and Gujarat state on a long term basis.

(i) During the period 1990-91, the growth rate of debt was increased to 22 percent and state wants that the centre should take some major steps to reduce its outstanding liabilities. The Gujarat Government in its memorandum to Ninth Finance Commission suggested:

- A debt relief to state in proportion to 70-30 of the plan assistance could be given.
- It also made a suggestion that the entire external assistance received from externally aided project (ADB) should be exclusively passed to the state for implementing projects.
- The loans given to states on account of drought should be written off.
- The repayment of public debts has became the second largest item of revenue expenditure next to salaries and wages, so the Commission should write off a part of the outstanding loans on a selective basis. Loans given by the centre for meeting the expenditure on natural calamities and for socially desirable but financially unremunerative schemes such as command area development, modernization of police force, schemes of border area development etc could be considered for write-off as the assets if created out of such loans cannot yield financial returns which are adequate for repayment of such loans.
- The state government also urged the Finance Commission to consider favorably the recommendations of the Rangrajan Committee on small savings to reverse the declining trend in the net small savings collections.

However, the approach of the Ninth Finance Commission was not encouraging. The Commission worked out the loan portion in such a way that it can be contributed from the source of grant portion. Secondly, in case of externally aided projects the Commission made a recommendation to pass the grant fully, but later on it was withheld by the centre.

(ii) The growth of debt was mounting with all states, as out of 24 states 17 states were facing the severe problem of outstanding liabilities. Looking to this the TFC recommended various debt relief measures to states. These include:-

(a) Debt write-off scheme - Under the debt-restructuring programme recommended by the TFC, states has been given a debt relief scheme linked to the achievement in reducing revenue deficit. Gujarat has also passed the Fiscal Responsibility Legislation to avail this benefit. Gujarat would get a benefit of debt-write off of Rs.2615 Cr. in the year 2005-2010, if the state achieves the fiscal target. The total debt write off schemes which were availed by the state in proportion to transfer is 10.22 percent which

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was the highest among the non special category states.

(b) Debt Swap Scheme- The centre has introduced the debt swap scheme from 2002 to enable the states to substitute their high cost loans by fresh low cost loans. In fresh loans the rate of interest are reduced from 10.5 to 9 percent per annum. As per recommendations of the Commission, the Gujarat Government has taken various measures of debt swap schemes. The average cost of debt was 12.10 percent in 2001 is expected to rise further. An amount of Rs.1744.42Cr bearing interest rate at 14.5 percent of the centre government was swapped in 2002-03. In the year 2004-05 an amount of Rs.3798.88Cr. bearing interest in the range of 13.5 percent were swapped.

(c) Sinking Fund- Under this method, the aggregate burden of public debt is least felt, as the burden of taxing the people to repay the debts is spread evenly over the period of the accumulation of fund. Due to increase in the central loans in nineties, the government of Gujarat has used the first time Sinking Fund method and on the advice of the Finance Commission converted the past debt into fresh debt at a normal rate of interest. The Sinking Fund is also known as the depreciation fund in which annual contributions are made for amortization of loans on the basis of government loans. It has been constituted for the repayment of loans from the Government of India, which are repayable in lump on the expiry of a prescribed period. The Tenth Finance Commission has also recommended to the states the use of sinking fund to overcome debt problem.

(d) The Tenth Finance Commission has also introduced two schemes related with debt relief. The first could be availed if the state succeeded in increasing the last three years average revenue mobilization. The second is linked to the retirement of debt by divestment of public sector undertakings. The Tenth Finance Commission had also given debt relief to state whose interest payment exceeds 17 percent of revenue expenditure or with high fiscal stress.

(iii) Gujarat government emphasized the debt issue in its memorandum to the Eleventh Finance Commission. The memorandum suggested for lowering of interest rate on loans advanced to the states. It argued that inspite of prudent debt management policy Gujarat is facing a problem of debt accumulation and possibility of debt trap. The state has to sacrifice the capital expenditure because of the increase in the interest rate (6.5). It is appropriate that the Commission examines this issue holistically and takes some measures positively. However the Eleventh Finance Commission continued with those schemes which they availed during the Tenth Finance Commission.

(iv) The problem of state indebtedness is more complicated as most of the funds are used for non-plan purposes, financing relief expenditure, cleaning overdrafts and in those activities which do not yield immediate revenue. It is found that a very small portion of the total loans is used for directly remunerative investment projects. Largely, it has been used for non productive areas or in building up capital assets which yield return in the long run. Due to increase in non-plan total expenditure in almost all the states, the Twelfth Finance Commission recommended a Debt Relief Facility in place of Fiscal reform Facility. Under this scheme the Commission has recommended that the central loans to the states will be contracted for the period of two years i.e till March, 2004 and outstanding on March 2005. However, to avail this scheme the state should enact the Fiscal Responsibility legislation in their state.

(v) Special Scheme of Debt Relief Write – off: linked to reduction of revenue deficit of the state has also been introduced. In case of Gujarat, the write-off will be given if the revenue deficit goes below the base year figure which is calculated for three years (2001-2004). For the purpose of determining the scale at which relief will be provided, the repayment due by the state during the period 2005-10, to the base year figure of revenue deficit has been worked out. If the revenue deficit level deteriorates, then the performance in the subsequent year will be measured for not that particular year but for the previous year also.

(vi) New Policy of Central Loans:- The Commission had recommended a new policy of Central loans to states. According to this scheme, the centre should release only the grant portion (30 %) of central assistance for state plan and leave it to the state to raise loan portion (70%) from other sources. The central government should not act intermediary for future lending and the states have to manage themselves and approach the market directly.

(vii) The Twelfth Finance Commission also recommended that the external assistance may be transferred to states on the same terms and conditions as attached to such assistance by external funding agencies.

(viii) The Commission also recommended that states should set-up Guarantee Redemption Fund through earmarked guarantee fees.

An overview of the measures taken by respective Commission suggests that centre has made the states more dependent during the Seventh to Ninth Finance Commission. However, Tenth Finance Commission approach made the state more dependent on the market instead on government. The situation on the whole has not improved but become worse.

State Indebtedness is becoming more complicated as the government is raising fund from the market through state owned enterprise under the state government guarantees. Basu & Ghosh [2005] opined that excessive guarantees discourage proper credit risk assessment by the financial institution, which may pose a moral hazard problem with the public enterprise. However, the RBI recently appointed a Technical Committee on State Government Guarantees for prescribing a limit on guarantees. It has also introduced new regulations requiring that bank and other financial institutions assign 20 percent risk weighting to state government bonds or advances outside the States' formal borrowing programme.

Another concern is the small saving collection and provident fund. This has contributed to the large extent, the accumulation of debt particularly in states like Gujarat as the dependency on loans from the centre has declined. In future a high debt-servicing burden reduces the maneuverability of fiscal policies of state.

Conclusion

(i) The debt of the Gujarat state government showing an upward trend and the growth rate of debt accounts to 19.18 percent during the period 1980-2008.

(ii) In proportion to SDP it accounts 4.14 percent in the period 1980-2008. The maximum increase in public debt was evinced in the decade of the nineties and early years of two thousand. In the year of 2003 and in the subsequent years a fall in debt was observed because of the stringent measures taken up by the Gujarat State government on the recommendation of Twelfth Finance Commission and through the central government policy.

(iii) The major reasons attributed to growing debt of Gujarat state are:-
   a) The policy of the Commission with regards to transfer of resources. This has weakened the general financial position of the state, which in turn had led to the increasing indebtedness.
   b) The central government policy about loans to the state in the early nineties.
   c) Lapses on the part of the Gujarat state government which led to increase in non-plan expenditure

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d) Increase in interest payments on market loans.
e) Growing contribution of NSSF for financing the debt.

(iv) Some experts feel that first, the policy of the central government about loans to the state needs necessary changes. Secondly, the State had not made adequate efforts in the past to balance their budgets and avoid the deficit, inspite of the emphasis laid by the Commission.

(v) Technically, there should be some uniform and definite procedure and a ceiling on state debt should be imposed. The establishment of loan council (Article 293) besides National Loan Council should be set up to supervise and control loan utilization. The state should minimize the incidence of overdraft if possible.

(vi) Regular scrutiny and proper evaluations of the utilization of borrowed funds by the state itself is the ultimate solution to solve the debt position of the state.

(vii) The concept of cooperative federalism between the centre and the state should be encouraged as it is done in America.

(viii) The pattern of utilization of funds by the state governments can perhaps be corrected in future so that more of the borrowed funds are utilized for building assets and thus capital formation.

(ix) There is a need to look at the problem of the indebtedness of the states on a more rational basis. State must have a constant dialogue with the centre in order to asses the non-plan capital gap. State should reduce their expenditure on capital building asset and where investment is of long term nature, to control the excessive guarantees to reduce future debt burden and explore the other sources of tax and non tax revenue. Besides this there is a need to bring a change in the attitude and policy of the central government towards the interest of the state.

(x) Last and the foremost need to solve the problem of state debt are to strengthen the resources base of Gujarat state. This requires some changes in the relevant articles of the constitution for giving more adequate sources of finance to the state to match their development needs and aspirations.

Briefly, we can conclude that the present constitutional arrangement in regard to borrowing with stagnated source of revenue and increasing social and developmental activities has worsened the problem of debt.

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