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This is the third part in a special series by the Centre for New Economics Studies's InfoSphere team which aims to closely study and understand the macro-state of the Indian economy in a lead up to the next Union Budget. Read part one here and part two here.

In the previous part, we explored inflation and the increasing concern over rising food prices. Now, we turn our focus to the escalating debt crisis in India.

The International Monetary Fund (IMF) has recently raised concerns regarding India's rising public debt burden. This escalation coincides with a period marked by volatile inflation, subdued employment growth concentrated in the informal sector, and potential disruptions within the global supply chain. These factors collectively exert upward pressure on India's fiscal landscape.

India's economic growth trajectory exhibited relative weakness between 2016 and 2020. The imposition of lockdown measures in 2020 further exacerbated this trend, leading to a significant decline in the macro growth rate.

While a nominal recovery has materialised subsequent to the lifting of COVID-19 restrictions, the real growth rate remains subpar. Notably, the macro government debt-to-GDP ratio, which has been on an upward trend since 2015, experienced a substantial surge after 2018. This increase is further amplified by a declining GDP denominator, implying that even with stagnant borrowing levels, the net debt effect would still escalate.

India’s growth rate and debt to GDP (Source: InfoSphere)

As of March 2023, the central government’s debt stood at Rs 155.6 trillion, or 57.1% of the GDP, while the state governments’ debt was about 28% of the GDP. According to the finance ministry, India’s public debt-to-GDP ratio has remained around 81% from 2005-06 to 2022-23, slightly above the levels specified by the Fiscal Responsibility and Budget Management Act (FRBMA).

The 2018 amendment to the FRBMA set debt-GDP targets for the central government, state governments, and their combined accounts at 40%, 20%, and 60%, respectively. The COVID-19 pandemic significantly contributed to the current high debt-GDP ratio, leading to a major deterioration in debt levels across the board.

The question of India’s towering debt is closely tied to the growth of tax revenues outpacing expenditure. Encouragingly, this trend has been observed recently in both income tax and indirect taxes, particularly the Goods and Services Tax (GST). This improvement in tax revenue is partly due to the closure of several tax loopholes over the past few years.

For instance, long-term capital gains tax, which was previously non-existent, has been introduced. Profits from selling stocks or real estate are no longer fully tax-exempt as they once were. Additionally, the loophole in the Mauritius tax treaty was addressed a few years ago, further tightening the tax regime.

Despite these advancements, there is still significant work to be done to enhance India’s tax collection-to-GDP ratio, which currently stands at around 17%. This is notably three to four percentage points lower than the median for all emerging market economies, indicating that India is undertaxed in terms of direct taxes. Conversely, the indirect tax burden is rising, with the median GST rate remaining high at 18%. While efforts to increase direct tax revenues are crucial, addressing the high indirect tax rates is also necessary to balance the overall tax burden.

The IMF report cautions that under adverse circumstances, India’s general government debt, encompassing both central and state government liabilities, could reach a concerning 100% of GDP by fiscal 2028.

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The report emphasises the long-term risks associated with this projected debt path, highlighting the need for substantial investments to achieve India's climate change mitigation targets and enhance resilience against climate-related stresses and natural disasters. To address this critical financing gap, the IMF recommends exploring new and concessional financing avenues, fostering increased private sector investment, and potentially implementing carbon pricing mechanisms or equivalent alternatives.

In addition to managing public debt to prevent it from reaching unsustainable levels, India faces the challenge of improving its credit ratings. According to S&P Global Ratings, credit ratings are forward-looking opinions about the ability and willingness of debt issuers, including governments, to meet their financial obligations fully and on time.

High debt levels and substantial debt servicing costs negatively impact these ratings. Despite being recognised as the fastest-growing major economy and a 'bright spot' in the global economy, India's sovereign investment ratings have remained unchanged for a long period. Both Fitch Ratings and S&P Global Ratings have maintained India's credit rating at 'BBB-with a stable outlook,' the lowest investment-grade rating, since August 2006.

The forthcoming budget presents a pivotal opportunity to address this looming fiscal challenge. Beyond immediate concerns such as inflation and job creation, a long-term fiscal consolidation plan is imperative. This necessitates investigating alternative financing options, incentivising the private sector investment, and potentially implementing innovative solutions such as carbon pricing. Only by successfully navigating this fiscal tightrope can India ensure sustainable economic growth.

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