Quickonomics

August 12, 2024

Reduced fiscal flexibility

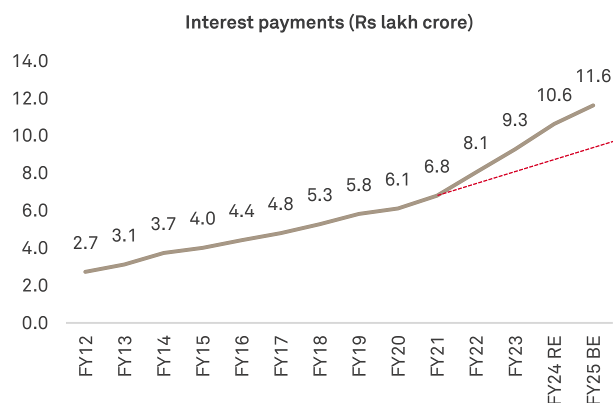
- The Centre's interest payments have risen notably after the pandemic, accounting for 3.6% of the gross domestic product (GDP) and 30.4% of the revenue expenditure in fiscal 2024
- Increased market borrowings in the aftermath of the pandemic, higher recourse to the National Small Savings Fund, along with the high borrowing cost of the past, have led to an increase in interest payments
- High interest payments mean reduced fiscal flexibility

While the Union government's progress down the fiscal consolidation path is well appreciated, it must be kept in mind that fiscal deficit/GDP ratio is still being normalised from the extraordinary high level it had reached in fiscal 2021 (9.2% of GDP), the Covid year, and remained high at 5.6% of GDP (FY24 PA).

In the five years before the pandemic, the Centre's fiscal deficit averaged 3.8% of GDP. Likewise, its debt-to-GDP ratio stood at 58.1% at the end of fiscal 2024, up from 47.7% before the pandemic, i.e. at fiscal 2020-end.

The elevated deficit and debt (and a couple of other factors, as we will see in subsequent sections), have led to an uptrend in the Centre's interest payments (Chart 1). After growing at 8.8% on average annually in the five pre-pandemic years (fiscal 2016 to 2020), interest payments surged 14.9%, on average, in the past four years (fiscals 2021-2024).

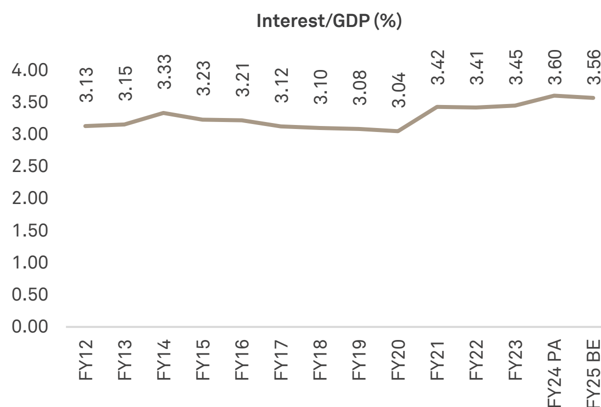
Chart 1: The ascent



Note: Red dotted line denotes how interest payments would have moved if they had followed the past trend
Source: Budget documents, CRISIL

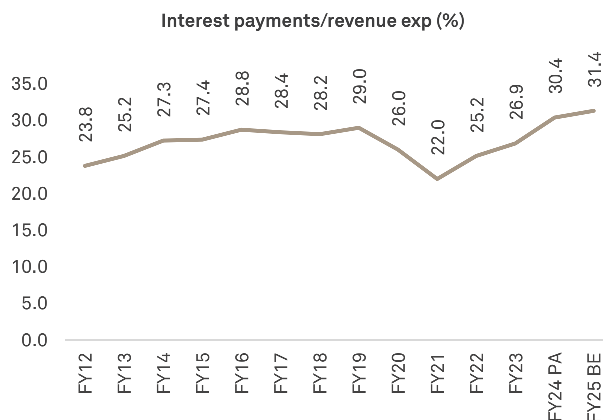
Looked at another way, interest payments, whose share in GDP was on a decline till fiscal 2020, started rising and reached 3.60% of GDP in fiscal 2024 (Chart 2). This also means they now account for over 30% of revenue expenditure, higher than in the past (Chart 3).

Chart 2: A step-up in interest payments...



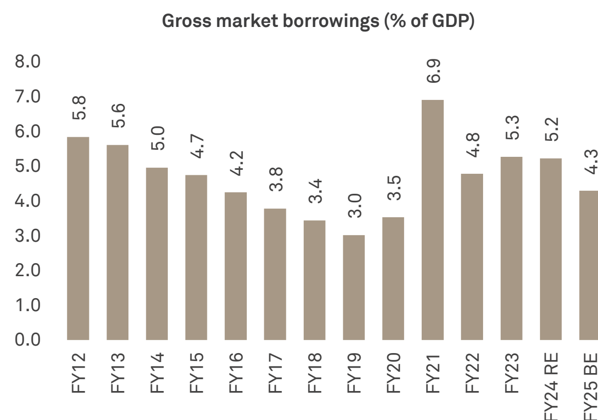
Source: Budget documents, CRISIL

Chart 3: ...taking up a large part of revex



Source: Budget documents, CRISIL

Chart 5: ...also, as a proportion of GDP



Source: Budget documents, CRISIL

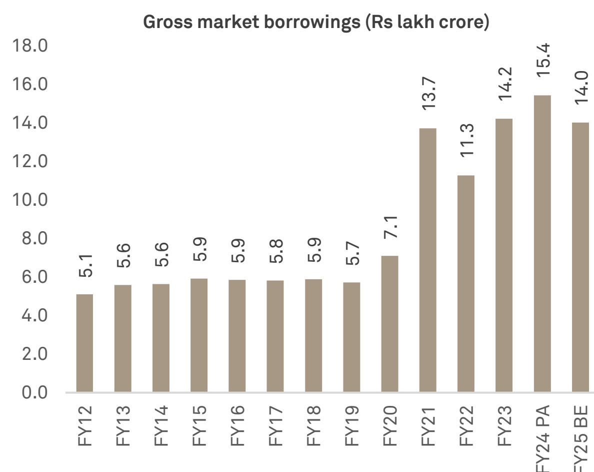
Three reasons why interest payments have gone up

1. **Higher market borrowings:** Interest payments are a function of how much the government borrows and at what rate of interest. Gross market borrowings have shot up since fiscal 2021 (Chart 4). While some reduction in borrowings is budgeted in fiscal 2025, they remain notably above the trend in gross terms and in relation to nominal GDP (Chart 5).

2. **High cost of borrowing:** A dominant part of the interest payment in a particular year is a function of the interest rate at which the debt was issued in the past. As can be seen in Chart 6, the government's weighted average cost of borrowing was high pre-Covid, at 7.34%, on average, in the immediately preceding five years (fiscal 2016 to fiscal 2020) - and above 8% before that - which partly accounts for higher interest payments in recent years.

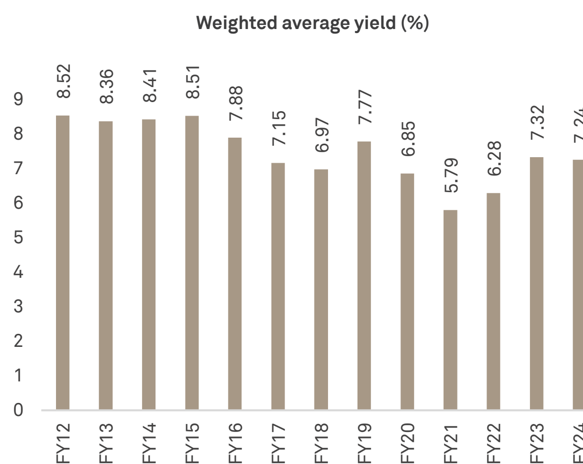
   While the cost of borrowing fell during the pandemic years, it firmed up again in the last two years (Chart 6). This, along with increased market borrowing compared with the past, suggests pressure on interest payments could remain in the near future.

Chart 4: Market borrowings stabilise after surging...



Source: Budget documents, CRISIL

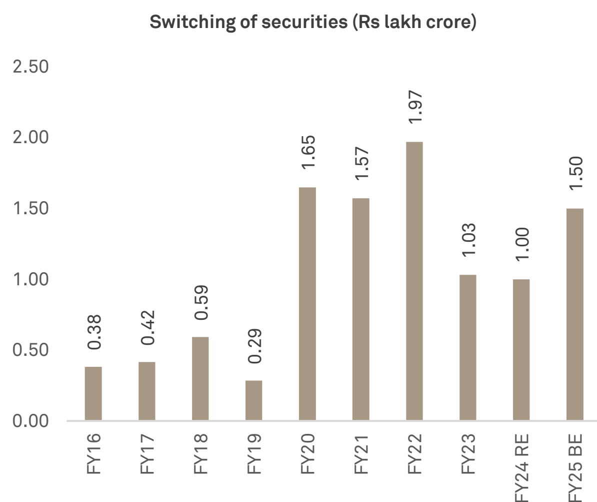
Chart 6: Cost of borrowing has risen again



Source: RBI, Budget documents, CRISIL

In another noteworthy phenomenon, to reduce the pressure on fiscal deficit, the government has increased the quantum of switching operations considerably since fiscal 2020 (Chart 7). Through switches, the government exchanges securities nearing redemption with longer dated ones. While this reduces the government's immediate expenditure, and hence the fiscal deficit, it increases the future debt burden and leads to an added interest payment load over the years.

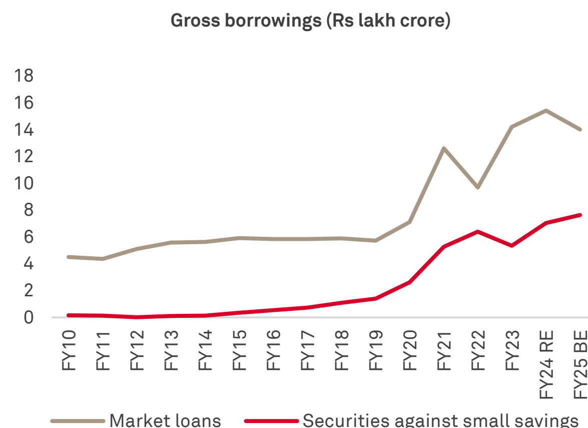
Chart 7: Increase in switching operations



Source: Budget documents, CRISIL

3. **Greater recourse to small savings funds:** In recent years, the government has also been borrowing from National Small Savings Fund (NSSF) in large amounts (Chart 8) to keep market borrowings from rising too much. The government typically pays a higher rate of interest on these compared with market borrowings. For instance, during fiscal 2024, as against the weighted average yield of 7.24% on market borrowings, the government had to pay an interest rate of 7.6% on NSSF borrowings. This, therefore, also seems to be adding to the interest payment burden of the government.

Chart 8: Borrowings from NSSF also on the rise



Source: Budget documents, CRISIL

The way forward

At 3.6% of GDP or 30.4% of revenue expenditure (in fiscal 2024), the central government's interest payments are reducing its fiscal flexibility. To put it in context, interest payments exceeded the budgetary capex of 3.2% in fiscal 2024.

The government has done a stellar job in bringing down the fiscal deficit much faster than expected and made fiscal accounts transparent.

For further reduction in the fiscal deficit, government revenues (tax or non-tax) need to continue improving.

In fiscal 2025, gross market borrowings are budgeted to fall after rising in the previous two years as the Centre benefited handsomely from non-tax revenue (one-off upside due to the RBI dividend). This immediately reflected in some moderation in interest payments (3.56% of GDP BE for fiscal 2025 vs 3.60% in fiscal 2024). It also softened government bond yields or the cost of borrowing for the government.

Apart from such occasional one-off boost to government revenues, sustaining high growth in the economy is a pre-condition for increased tax collections and for reducing indebtedness and debt service burden on a durable basis.

Concurrently, the Centre needs to run a tight fiscal ship to bring down its debt levels to pre-pandemic levels and finally to the aspiration level of 40% as suggested by the FRBM Review Committee in 2017.

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