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Debt and Welfare In A World of Pandemics

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Drastic times call for radical measures. Falling tax revenues call for an increase in borrowings by the central government to help states. A failure to do so now could have a negative impact on the revival of economic growth in the future.

The success of public health efforts to deal with Covid-19 as well as the fate of economies across the world after the lockdown depends on the ability of governments to effectively generate resources. However, dramatic falls in economic activity have had a severe impact on the ability of economies to raise revenue through taxation. In the midst of the current unprecedented crisis, a large-scale programme of government borrowings has been touted as a possible step.

Yet this move is not without its problems. If governments borrow at high interest rates, but the growth of the economies remain low into the future, they might get stuck in a 'debt trap', where tax revenues may not be enough to even cover their annual interest payments. This is a serious concern for smaller and sub-national economies, which may not have the financial wherewithal to cope with the demands of the market.

What is required is a programme of sharing of the costs of debt: for larger, richer, economies to subsidise the costs of borrowing for smaller ones. And in a national economy, for the centre to share the costs of the provinces/states. In India, states have warned that high rates of interest may severely affect their ability to provide for public health. They have said that it is essential for the central government to borrow at lower rates and share resources with them. Similar proposals have already been tabled in the European Union (EU), with southern European countries like Spain and Italy calling for a programme of mutual sharing of debt burdens.

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Another measure that has been spoken about is for central banks to actively create money and lend to governments. Such measures may be inappropriate in a fast-growing economy, but must be explored as viable options in the current context of a steep fall in economic activity. In a demand-deficient economy this money creation and lending would have no inflationary pressures.

A global pandemic requires a unified response. The sharing of debt across partners provides for a significant way to combat the crisis. Yet the old demons of fiscal austerity have emerged once again, threatening to limit the ability of governments to effectively provide for public health and welfare.

The Economics of Debt

Government revenue can come from either income or borrowings. Income comes largely from taxation of market activity, while governments can borrow from private wealth-holders in financial markets.

The collapse of economic activity has seen tax revenues dry up. But even if income generation has reduced, there still exists a large stock of private wealth built up over the years, which governments can tap into. Borrowing thus allows governments access to resources that are not limited by the productive capacity of the economy.

However, a huge debt stock implies a large interest bill and this can limit the ability of governments to spend on developmental activities. Governments would have to ensure that their annual tax collections would be able to cover the interest payments due every year.

> Two factors would determine the sustainability of debt: the interest rate and the growth rate.

During the current pandemic, it is taken for granted that borrowing limits will be broken, as tax revenues fall and the need for funds increase. However, the accumulation of debt presents problems down the line: that of whether the accumulated stock of debt would be 'sustainable' or not.

Two factors would determine the sustainability of debt: the interest rate and the growth rate.

A simple definition of sustainability adopted by the mainstream is whether the ratio of debt to the Gross Domestic Product (GDP)—the debt ratio—stays constant. If the growth rate is higher than the interest rate, then even if the state expands borrowing, the debt ratio will *decrease*, for the increase in GDP will outstrip the increase in debt. If interest rates are higher than the growth rate, then any new borrowings will increase the debt ratio.

This highlights the problems faced by economies today. It is a given that growth rates will collapse for most states in the near future and that there is little they can do about it. While interest rates for developed economies remain low, those for smaller, poorer, economies are high. If economy A is one that investors would consider 'high-risk', or if economy A is not as attractive an investment destination as compared with economy B, the interest rate on debt contracted by economy A would be higher relative to economy B. Thus smaller economies can expect interest rates to be higher than growth rates, with worrying implications for debt sustainability. Likewise, the interest rates for the central government will remain low, while those for the states will be high.

Problem for States

The move towards fiscal discipline has implied limits on the ability of governments worldwide to borrow. However, in the midst of the pandemic, the Reserve Bank of India and the central government have loosened the restrictions of the Fiscal Responsibility and Budget Management Act (FRBM), which otherwise caps borrowings at 3% of the GDP. The EU too has loosened restrictions on the amount member-states can borrow from the market.

Yet the central question determining sustainability of borrowing programmes relates to the *terms* on which governments can borrow. In India, the interest rates for state government borrowings are higher than that of the central government. Similarly, countries in southern Europe have to borrow at higher rates as compared with richer northern economies like Germany and the Netherlands.

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The finance minister of Kerala, T M Thomas Isaac, made this problem abundantly clear. On a loan of Rs 6,000 crore for 15 years, Kerala had to pay a market interest rate of around 8.96%. With low to negative growth rates forecast for the future, such high-interest loans would put the states in debt traps.

Cutting back on borrowing does not represent a solution. The need is for the burden of debt to be shared amongst economies, with richer entities picking up the slack on behalf of weaker ones. In the case of India, since the states are at the forefront of combating the pandemic, an effective strategy of raising debt would be for the centre to borrow from markets at relatively lower rates and distribute it to states. In order to lessen the burden on the states, the centre could ensure that a portion of the borrowed funds is distributed as grants to states.

Or consider the case of 'coronabonds', discussed in the EU as a possible solution to the current problem. These are, simply put, special loans undertaken by EU nations which would be shared across all countries, implying that Italy could borrow at the same rate of interest as richer Germany. Such a proposal, the weaker countries like Spain and Italy argue, would enable poorer countries to access funds at lower, less punitive rates.

In both instances, this strategy essentially calls for a richer, stronger partner to shoulder some of the debt burden. Unfortunately, this does not seem to be in favour, globally or in India.

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While in India the central government has indicated an expanded programme of borrowing, state governments are still constrained in the amount they can borrow. The RBI has increased limits on short-term borrowings. However, this is not enough. There are no indications that the centre will be expanding borrowing on the states' behalf.

State governments have asked for relaxation of FRBM limits, and an increase in the amount of funds they can borrow from markets. But increasing access to capital markets would not ease the pressure on states, as they might be forced to borrow at punishing interest rates. What is required is assistance from the central government, with its greater capacity to bear the burden of borrowings.

Across the globe, the EU is wracked by internal debate on the subject of shared debt, with richer countries like the Netherlands, Austria, and Germany opposing the idea of shared debt, and countries like Spain, France, and Italy insisting on it. The opposing countries refuse to have their tax-payers—in their own words—subsidise the debt of foreign economies. They claim that the lower rates might incentivise weaker economies to borrow more, leaving the richer countries with the responsibility of repaying part of a loan that they did not undertake themselves.

Monetising the Deficit

Even if a relatively richer and economically more advantaged entity like the central government were to borrow from markets, it is not a magic bullet. The effect on bond markets of a massive programme of government borrowing in a time of pandemic is ambiguous.

On the one hand, interest rates might rise when the market sees a huge increase in the demand for funds by government, as lenders would have the upper hand over a desperate borrower. On the other, with the private sector failing, private wealth holders would be desperate to stock up on assets that provide *some* positive returns. They may therefore might be more than willing to lend to the government. This could reduce interest rates.

While RBI actions have led to a reduction in interest rates on long-term government bonds, the private sector does not seem to be enthused about the prospect of lending to the government. Most banks have chosen to park their excess money with the RBI, rather than purchase government bonds.

Such a situation calls for the active intervention of the RBI. In normal times, the central bank introduces money into the economy by trading bonds and other securities with the private sector. Governments borrow money by selling securities to the private financial sector. The effective interest rate that governments borrow at, therefore, is determined by the private sector’s willingness to hold government debt.

> A *general* rise in prices caused by demand outstripping supply may not occur even if the RBI monetises the deficit, simply because there is no reason to believe the economy might hit previous levels of growth in the near future.

In today’s crisis, a powerful option to raise funds is for the RBI to print money and directly finance the government’s needs, a move termed as the Reserve Bank 'monetising' the deficit. Monetising the deficit would imply bypassing the private sector altogether: the RBI would print money and directly purchase long-term bonds from the government.

While some may balk at the idea of the RBI lending freely to the government, it must be kept in mind that central banks have in the past undertaken similar programmes to lend to the private sector. Under the Quantitative Easing programme, beginning in 2008, the United States’ Federal Reserve printed money and purchased long-term and distressed assets from banks, in an attempt to clean up their balance sheets and get them to lend again after the financial crisis. Any monetisation of the deficit in India can be thought of as quantitative easing for the government. Such a move would ensure a flow of resources to the government without interest rates rising.

The exact modalities of such a situation would have to be worked out legislatively, for the RBI is legally not allowed to purchase securities directly from the government. Moreover, while the RBI has intervened in markets to reduce interest rates, it has so far abstained from directly lending to the government. This hesitancy might prove expensive for the Indian economy, especially given that other central banks, such as the Bank of England, have begun to directly lend to the United Kingdom government.

Such schemes are not without critics. The objections to expanded borrowing rest on two factors: the dangers of inflation and the sustainability of debt.

The (Potential) Problems of Inflation and Sustainability

Consider inflation. It is claimed that if the RBI were to monetise the deficit, the creation of a significant amount of new money would lead to inflationary pressures in the economy, if not immediately, then eventually. However, in an economy where demand has collapsed, there is little danger of inflation, since no one would be demanding new goods. Under Quantitative Easing, the Federal Reserve purchased nearly $3.6 trillion dollars of new assets between 2008 and 2014. This led to significant increases in the money supply, yet inflation rates remain subdued till today.

Any inflation in India in the near future is likely to come from disruptions to agricultural supply chains during the first six weeks of the lockdown. However, this form of inflation can be solved by government interventions to ensure that supply chains are quickly restored. A *general* rise in prices caused by demand outstripping supply may not occur even if the RBI monetises the deficit, simply because there is no reason to believe the economy might hit previous levels of growth in the near future.

The other concern is that excessive government borrowing would result in a huge stock of debt, which would render India an unattractive investment destination. The fear is that a high stock of debt today implies higher taxes in the future, leading to curtailed economic activity.

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This argument does not take into account the expansionary potential of government spending, which may well stabilise the pandemic-wracked economy and create additional employment. Moreover, it is yet uncertain whether it is a high *level* of debt (as a proportion of GDP) that dooms an economy to failure, or whether *changes* in the debt ratio serve better as predictors of economic failure (IMF 2012).

A national economy is different from a private economic entity. A highly indebted firm must cut down on borrowings during a depressed market situation, as it would then be hard to increase revenue. But a national government can intervene in myriad ways to ensure the economy maintains a healthy rate of growth in the future. Of course, a future of robust growth rates may be very long in coming. The point is that unlike a firm, a government *can* maintain a long-term economic horizon and carry debt for long without going 'bankrupt'.

Moreover, to restrain borrowings now in the hope that private investment may pick up in the future is an extremely risky gamble. There is no way to be sure that private investment will be forthcoming in a world where the coronavirus is ever-present.

Drastic times call for radical measures. In the wake of collapsing growth rates, we must experiment with measures to combat a truly terrifying, dangerous threat. The inability of governments to shoulder burdens on behalf of weaker partners and to experiment with new measures to raise resources might prove to be very expensive for the economy.

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