State Level Debt–Deficit Dynamics: Emerging Issues

Article *in* Economic and Political Weekly · March 2017

Pinaki Chakraborty
National Institute of Public Finance and Policy

Manish Gupta
National Institute of Public Finance and Policy

State Level Debt–Deficit Dynamics
Emerging Issues

Lekha Chakraborty, Manish Gupta, Pinaki Chakraborty

An analysis of the debt and deficit of states based on the budget estimates of 2016–17 shows that almost half of them have a fiscal deficit target higher than the limit set in the Fiscal Responsibility and Budget Management Act. These states need to focus on the quality of expenditure and elimination of revenue deficit as per the framework proposed by the Fourteenth Finance Commission to enhance state-level capital spending.

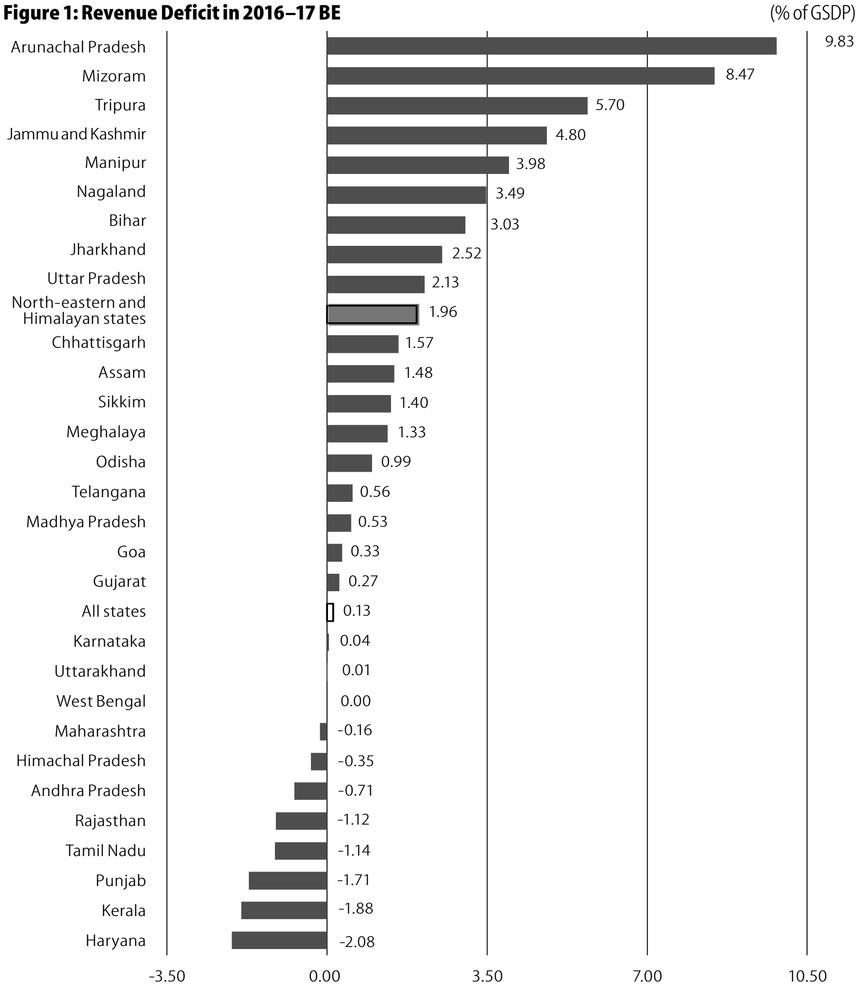
After the presentation of the report of the Fourteenth Finance Commission (FFC), the debt–deficit dynamics of states can be analysed in two ways—ex ante and ex post. The ex ante analysis involves identifying policy changes which can create an impact on debt and deficits through the very design of interventions. The introduction of Ujwal DISCOM Assurance Yojana (UDAY) scheme and increase in the borrowing powers of states to a maximum of 0.5% of the gross state domestic product (GSDP) by the FFC[1] are examples of such ex ante policy interventions that would have an impact on the debt and deficit of states.

On the other hand, ex post analysis captures the effect of interest rates, maturity composition of debt, inflation, and growth in real gross domestic product (GDP) on the changes in the pattern of the debt–GDP ratio. How much did the growth in GDP contribute to the changes in the debt–GDP ratio? What impact did inflation have on the size of the debt? Did high/low primary deficits (deficits net of interest) lead to an upward/downward bias in the debt–GDP ratio?

An ex post analysis is not feasible at the moment (based on 2016–17 budget estimates) as we do not have enough data points to answer these questions.[2] Alternatively, we have tried to analyse the emerging debt and deficit scenarios in states based on the 2016–17 budget estimates. We also examine the emerging debt–deficit scenario post-FFC, taking into consideration the flexibility for higher borrowing recommended by the FFC.

Figure 1: Revenue Deficit in 2016–17 BE

(% of GSDP)

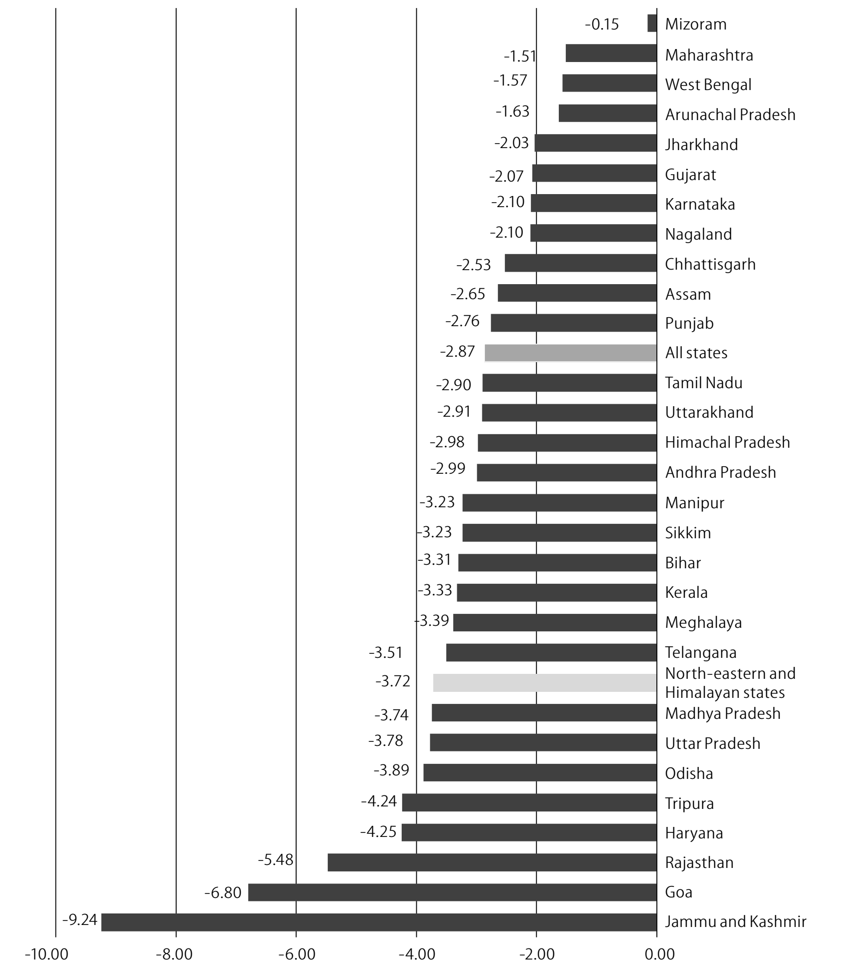


Source: 2016–17 Budget Documents of State Governments and Central Statistics Office (CSO), Government of India.

This article is a part of an ongoing larger study on intergovernmental fiscal relations in India, funded by the International Development Research Centre, Canada.

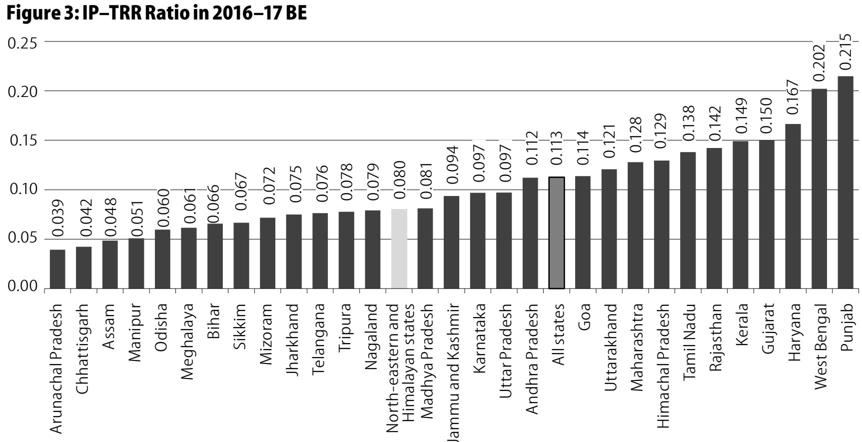
Lekha Chakraborty (*lekha.chakraborty@nipfp.org.in*), Manish Gupta (*manish.gupta@nipfp.org.in)* and Pinaki Chakraborty (*pinaki.chakraborty@nipfp.org. in*) are with the National Institute of Public Finance and Policy, New Delhi.

Figure 2: Fiscal Deficit in 2016–17 BE (% of GSDP)



Source: 2016–17 Budget Documents of State Governments and CSO, Government of India.

Figure 3: IP–TRR Ratio in 2016–17 BE



Source: 2016-17 Budget documents of State Governments and CSO, Government of India.

Deficit and Interest Payment: Statewise Analysis

Statewise revenue deficit, fiscal deficit, and interest payment to revenue receipts (IP/RR) ratio are presented in Figure 1 (p 24) and Figures 2 and 3. As is evident from Figure 1, eight states are expected to have a revenue deficit in 2016–17 (budget estimates). These states are Maharashtra, Himachal Pradesh, Andhra Pradesh, Rajasthan, Tamil Nadu, Punjab, Kerala, and Haryana. However, the combined revenue account of all states is expected to be in surplus. With regard to the fiscal deficit, all states' combined deficit is expected to be below 3% of GSDP as mandated under the Fiscal Responsibility and Budget Management (FRBM) Act. However, 14 states have budgeted to show fiscal deficits above 3% of GSDP. States budgeted to have a fiscal deficit of more than 4% of GSDP are Tripura, Haryana, Rajasthan, Goa, and Jammu and Kashmir.

If we consider IP/RR, it is the highest in Punjab, followed by West Bengal, Haryana, Gujarat, and Kerala, with an interest outgo of more than 15% of revenue receipts (Figure 3). There are seven states with average ratio of 11.3% (other than those above 15%). There are 17 states with below 10% IP/RR ratio, including some of the major states like Karnataka, Uttar Pradesh, Madhya Pradesh, Bihar, Odisha, and Assam. The outstanding debt to GSDP ratio for all states is estimated at 22.7%. For Northeastern and Himalayan states, this ratio is expected to be around 28% (Figure 4).

Enhanced Debt Limit and Eligibility

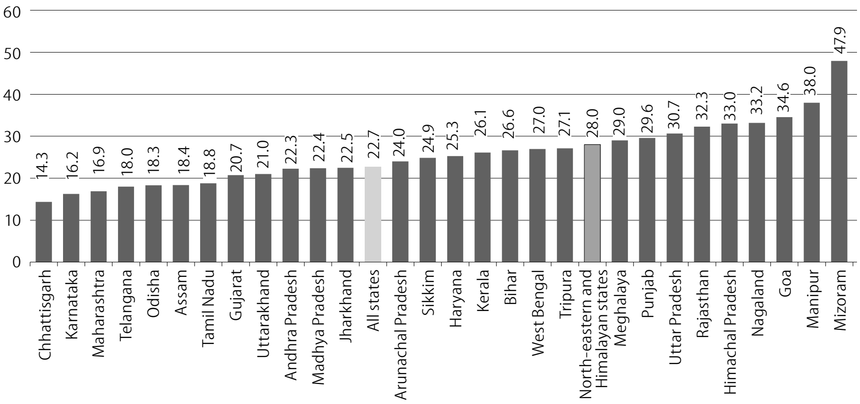
The FRBM Act mandates that subnational governments in India maintain a zero revenue deficit or revenue surplus and a fiscal deficit threshold of 3% of GSDP. The FFC envisaged that the quality of deficits is as significant as the levels. The FFC prescribed the following conditions for enhanced borrowing limits of states:

(i) Fiscal deficit of all states will be anchored to an annual limit of 3% of GSDP. The states will be eligible for flexibility of 0.25% over and above this for any given year, for which the borrowing limits are to be fixed if their debt–GSDP ratio is less than or equal to 25% in the preceding year.

(ii) States will be further eligible for an additional borrowing limit of 0.25% of GSDP in a given year for which the borrowing limits are to be fixed if the interest payments are less than or equal to 10% of the revenue receipts in the preceding year.

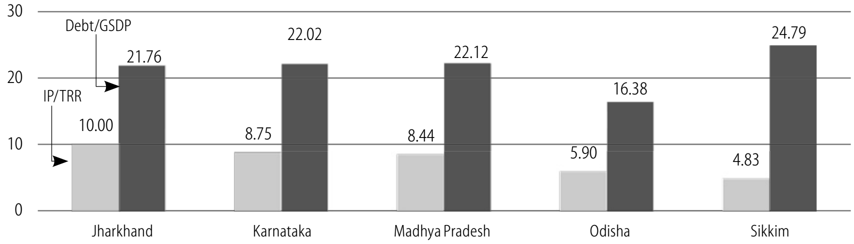
(iii) The two options under these flexibility provisions can be availed of by a state either separately, if any of the above

Figure 4: Outstanding Liabilities in 2016–17BE (% of GSDP)



Source: 2016–17 Budget Documents of State Governments and CSO, Government of India.

Figure 5: First Year Ex Post to FFC—Final States with Combined Eligibility for Enhanced Debt Procedure for 2015–16 (parameters fixed for 2013–14)



Source: Finance Accounts and Budget Documents of States (various years) and CSO, Government of India.

criteria is fulfilled, or simultaneously if both the above stated criteria are fulfilled. Thus, a state can have a maximum fiscal deficit–GSDP limit of 3.5% in any given year.

(iv) The flexibility in availing the additional limit under either of the two options or both will be available to a state only if there is no revenue deficit in the year in which borrowing limits are to be fixed and the immediately preceding year (Finance Commission of India 2015).

We examine the eligibility of states for additional borrowing powers based on the FFC condition in the first year of assessment, that is 2015–16. The enhanced market borrowing of states for 2015–16 is analysed based on the four criteria proposed by the FFC. A two-step methodology is followed for identifying the states eligible for an enhanced borrowing procedure. Step one is to identify the states within the fiscal deficit upper bound of 3% of GSDP and with no revenue deficit. Step two is to find out that states are within the subset with IP/RR ratio below 10% and debt-to-GSDP ratio below 25%.

The analysis of outstanding debt and deficits of all states ex post to the FFC period in the first year of assessment (2015–16) revealed that only five states—Jharkhand, Karnataka, Madhya Pradesh, Odisha, and Sikkim—have successfully managed the FRBM thresholds of deficits and the criteria of outstanding debt to GSDP below 25% and IR/RR ratio below 10% (Figure 5). Therefore, they are eligible for the enhanced debt procedure as suggested by the FFC to 0.5% of GSDP. Gujarat, Meghalaya, and Uttarakhand were eligible for a partial enhanced borrowing procedure, as either of the IR/RR or debt/GSDP was maintained within the stipulated limits. As this recommendation was implemented from the fiscal year 2016–17, these states did not benefit from this enhanced borrowing facility. As per information obtained from the Ministry of Finance, in 2016–17, only six states have become eligible for enhanced borrowing limit.

Conclusions

To conclude, we need to emphasise that all states' revenue account is expected to have a deficit in 2015–16 (revised estimates). The revenue surplus, estimated at 0.13% of GSDP in 2016–17 (budget estimates), may slip into a revenue deficit if there is a revenue shortfall or increase in revenue expenditure more than what is budgeted. Since almost half of the states have fiscal deficits target higher than the FRBM limit in 2016–17 (budget estimates), fiscal consolidation at the state level under the new framework of borrowing proposed by the FFC should focus on the quality of expenditure and elimination of revenue deficit. A major concern emerging out of this analysis is that some of the major states (in terms of GSDP) are expected to slip into revenue deficits as per the 2016–17 budget estimates. The rationale of the new framework of borrowing is to provide fiscally prudent states with additional borrowing for higher capital expenditure. According to the FFC's assessment, state-level capital outlay during its award period is expected to increase from 3.83% of GDP in 2015–16 to 4.61% of GDP in 2019–20. The success of this enhanced borrowing would be judged both by the increase in the number of states qualifying for this facility and by the increase in capital expenditure at the state level.

NOTES

1 FFC has provided flexibility to states for higher borrowing under following conditions: states should have no revenue deficit, fiscal deficit should not be more than 3% of GDP, interest payment to revenue receipt ratio below 10% and debt to GSDP ratio below 25%.

2 The ex post analytical framework of debt–deficit dynamics is also within the intertemporal (the intertemporal budget constraint equation, $B_t/Y_t = (\tilde{r}_{t-1,t} - \pi_{t-1,t} - g_{t-1,t})\ B_{t-1}/Y_{t-1} + def_t/Y_t + B_{t-1}/Y_{t-1}$ which accounts for how a nominal interest rate $\tilde{r}_{t-1,t}$, net inflation $\pi_{t-1,t}$, net growth in real GDP $g_{t-1,t}$, and the net-of-interest deficit debt combine to determine the evolution of the government debt–GDP ratio; where Y_t is real GDP at t and B_t is the real value of government debt) budget constraint equation (Hall and Sargent 2010), which is beyond the scope of the article at the moment.

REFERENCES

Budget Documents of State Governments (2016–17 and 2015–16): "Finance Accounts of State Governments," (various years), Comptroller and Auditor General of India, New Delhi.

Finance Commission of India (2015): "Report of the Fourteenth Finance Commission," Government of India.

Hall and Sargent (2010): "Interest Rate Risk and Other Determinants of Post-WWII US, Government Debt/GDP Dynamics," NBER Working Paper 15702.