**Financing State Expenditure in the Post GST Era: Masala Bonds**

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By Nikhil Damodaran[[1]](#footnote-1), Aarjav Nair and Shraavan Varma

Like the farm laws which impinge on the constitutionally [mandated state list](https://thewire.in/agriculture/agriculture-marketing-reforms-federalism), transforming the indirect taxes to a Goods and Service Tax is fundamentally centralizing revenue generation. The short lived experience of transferring GST revenue to states has been [marred](https://indianexpress.com/article/business/economy/four-cms-write-to-pm-fm-on-gst-centre-ought-to-borrow-6579607/) by [controversy](https://scroll.in/article/971657/with-the-centre-refusing-to-pay-compensation-to-states-is-gst-nearing-an-end), with most states complaining of [delays in devolution](https://www.hindustantimes.com/india-news/centre-committed-to-pay-full-gst-compensation-to-states-but-states-must-borrow/story-entp4iQ9RP3pqUZhtIfAPI.html) (transfer of revenue share from center to state governments). But development cannot stop and more importantly decentralized mechanisms to counter the pandemic cannot stop either. To generate revenues independent of devolution, the Kerala government utilized its Kerala Infrastructure Investment Fund Board (KIIFB) to borrow in the international market by selling rupee denominated bonds. This frees up resources for the state government to finance its fight against the pandemic without compromising on its infrastructural investments. We analyze at the pros and cons of this financial strategy by the state of Kerala to understand the *‘new’ Kerala model of development*.

*What are these rupee denominated bonds?*

On the 18th of October 2013, the then chief economic advisor to the union ministry of finance Raghuram Rajan announced that certain [domestic entities](https://cleartax.in/s/masala-bonds#:~:text=Masala%20Bonds%20are%20rupee%2Ddenominated,entities%20can%20issue%20these%20bonds.) (corporates, body corporate and Indian bank) in India can issue bonds [denominated in the Indian rupee](https://indianexpress.com/article/explained/explained-what-are-masala-bonds-where-can-these-be-issued-5734218/) to be sold in international markets. This was not previously allowed. To issue bonds in the domestic currency to international investors implied that surprise movements in exchange rate would not hurt the borrower. This meant that these bonds would not increase risk posed by exchange rate movements. A major caveat was whether there would be adequate demand for bonds issued by local body corporates in the first place.

If there is sufficient demand for these bonds, it would imply an increased demand for the Indian rupee much like a global demand for the Chinese renminbi. If we can imagine a scenario in which the supply of bonds increases, it could potentially cause a surge in the demand for Indian rupee and [prevent depreciation](https://www.businesstoday.in/current/economy-politics/masala-bonds-norms-modi-govt-prevent-rupee-fall/story/282482.html) of the currency. It could open up yet another channel for India’s interaction with the globalized world economy.

Soon after Rajan’s announcement, the International Financial Corporation (IFC), an entity of the World Bank Group [issued 10bn INR in November 2014](https://www.ifc.org/wps/wcm/connect/news_ext_content/ifc_external_corporate_site/news+and+events/news/ifc+issued+first+masala+bonds+in+london+to+attract+international+investment+for+infrastructure+in+india) and dubbed it as “[Masala](https://indianexpress.com/article/explained/masala-bonds-in-indias-new-cash-and-curry-push/) (Spice) Bonds” which evoked popular representations of the Indian cuisine. The first issue raised bonds of [3 different maturities](https://www.ifc.org/wps/wcm/connect/news_ext_content/ifc_external_corporate_site/news+and+events/news/ifc+issues+historic+15-year+masala+bond+in+london) with the 10 year one promising a return of 6.3%.[[2]](#footnote-2)

*Kerala’s use of Masala Bonds*

On May 1st, 2019 the Kerala Infrastructure Investment Fund Board (KIIFB) floated the [first ever sub-sovereign masala bond](https://indiaincgroup.com/kerala-joins-the-global-masala-bond-drive-india-global-business/) at the London stock exchange to finance its infrastructure projects and free up the state government’s resources for other crucial developmental programs. These bonds joined an increasingly crowded market with 49 such previous issues at the London stock exchange. However, with a coupon rate of 9.72 percent, the KIIFB bonds attracted attention. The KIIFB initially issued INR 21,500 Mn in rupee denominated bonds and managed to raise INR 23,232.64 Mn.[[3]](#footnote-3) With the issue of these bonds, the capital provided by these bonds ensured the capacity to rebuild crucial public infrastructure, which was damaged after the devastating Kerala floods (August 2019). In hindsight, the timing of accessing international markets was spot on. But what other reasons made it plausibly prudent to borrow money from the international markets?

*Reasons for Floating Masala Bonds*

First, with the onset of Goods and Services Tax (GST) in 2017, there were massive revenue shortfalls and a reduced space for effective fiscal autonomy – the states had to depend on the GST Council for revenue to fund their investment projects. To add to troubles, by May 2019 Kerala had witnessed multiple natural disasters – recurring floods and a wave of the Nipah epidemic. Additionally, citing a [force majeure](https://www.indiatoday.in/news-analysis/story/gst-compensation-row-act-of-god-nirmala-sitharaman-1716047-2020-08-28)the devolution of GST revenues to states from the center is behind schedule. Interestingly, the central finance ministry had [suggested](https://indianexpress.com/article/business/economy/four-cms-write-to-pm-fm-on-gst-centre-ought-to-borrow-6579607/) that states indulge in borrowing to make up for the loss of revenue. For the state of Kerala, KIIFB provided a viable alternative to generate additional revenue with a nod from the [Reserve Bank of India](https://www.newindianexpress.com/states/kerala/2020/dec/21/only-no-objection-givento-kerala-infrastructure-investment-fund-boards-masala-bond-issuance-rbi-2238940.html).

Second, domestic borrowing for states was costlier than accessing the international market. For instance, the Indian bond market had securities issued at coupon rates of up to 10.15%.[[4]](#footnote-4) By exploiting the international bonds market even at a rate of 9.72%, KIIFB bonds were accessing cheaper financing options. Despite this the KIIFB bonds were the 6th highest coupon rate among international currency denominated bonds and the highest ‘Masala’ Bond.[[5]](#footnote-5) So not only was international borrowing more lucrative, but it also ensured a faster flow of revenue.

Further, there were institutional and [legal concerns](https://www.thehindu.com/news/national/kerala/ldf-governments-masala-bonds-unconstitutional-says-chennithala/article27142493.ece) about the issuance of these bonds. The concern was a violation of [Article 293](https://www.pgurus.com/on-the-constitutional-validity-of-masala-bonds-by-kerala-governments-board-in-the-global-market/) of the Indian constitution in which, if such loans have direct or indirect effect on the Federal government, then they are deemed illegal. However, the extent to which such international borrowings would indirectly affect the Federal government is a question of macroeconomic uncertainty. For instance: if the KIIFB bonds are more lucrative than the ones issued by the Federal government, then it could cause investors to prefer them over the ones issued by central government. Whether this could happen, only time will tell. However, according to RBI, any corporate and Indian bank registered under the Indian Companies Act 2013 is eligible to issue Rupee denominated bonds overseas.

*Sustainability of Debt and Other Concerns*

While the option of international borrowings opens an independent source of revenue, it could potentially lead to rupee appreciation. If there are many rupee denominated bonds in the market, then international investors would require more rupee to purchase these bonds causing the rupee to appreciate. However, at least in the initial phases of issue, masala bonds do not threaten to dominate investor portfolios and hence might not pose a significant threat to rupee appreciation. It appears that these international borrowings could fill the temporary revenue shortfalls and absorb the delays in devolution. However, will these borrowings be sustainable?

There are two key factors which could give us some indication of sustainability of debt. First, past economic performance and projected performance in the coming years during which the debt will be active. In 2019-20, Kerala’s gross state domestic product is estimated to increase by around 12%.[[6]](#footnote-6) Based on sectoral performance during 2017-18, agriculture, manufacturing and services contributed to 13%, 24% and 63% of the GSDP and these sectors grew by 10.9%, 9.1% and 10.8%, respectively.[[7]](#footnote-7) If these sectors improve their performance in line with the aggregate projections, then the size of the cake gets bigger.

Does this alone ensure that Kerala could sustain its debt? No. The second factor is the cost of servicing total debt (old, accumulated debt as well as the new domestic and international borrowings). This points to how the states utilize their income. Assuming that the state continues with its development expenditures, it would need these funds to sustain its public investment and free up resources. Part of its income also goes to servicing its prior debt commitments. In 2018-19, the ratio of its internal debt to total revenue for Kerala was the 5th highest amongst the 29 states for which data was available, with an average debt of 34%.[[8]](#footnote-8) However, with borrowings from the international market, the composition of its total debt gets altered and so does its ability to repay based on a lower interest from the international market.

Further, the Kerala ministry of finance explained that their sustainability plans include a strategy for repayment of these bonds. They claim to allocate the petrol cess and up to 50 percent of the motor vehicle tax towards repayment of the KIIFB bonds. In the financial year 2017-18, revenue from petrol cess stood at 0.1 mn rupee with no change in the last 18 years.[[9]](#footnote-9) This is likely to stay around the same number. This implies that repayment burden will largely be led by motor vehicle tax which stood at 471.1 mn rupees, which witnessed an annual increase of 13.2%. So, it is likely that these determine the extent to which Kerala could rely on international borrowings. These strategies are likely to maintain investor confidence and ensure that these channels of borrowing could become sources of temporary revenue.

If the ‘new’ Kerala model of financing its expenditure becomes a success story, it would usher in a new era of federalism. It would certainly help the states maintain their autonomy and focus on decentralized development. At the outset, this experiment is too small to have a sizeable impact on the federal government. It could potentially pave way for other states to follow suit and fuel their urge to break out of the shackles of centralization of finances.

1. Nikhil Damodaran is an assistant professor, Aarjav Nair and Shraavan Varma are students at the School of Government and Public Policy, OP Jindal Global Univeristy. [↑](#footnote-ref-1)
2. [Specialist bonds list](https://www.londonstockexchange.com/reports?tab=specialist-bonds&lang=en). (n.d.). Retrieved January 23, 2021, from <https://www.londonstockexchange.com/search?searchtype=all&amp;q=specialist+bonds> [↑](#footnote-ref-2)
3. KIIFB is a double BB rated bond and hence had to offer a 9.72% return on its bond in order to cover the risk associated with investment in KIIFB bonds. Specialist bonds list. (n.d.). Retrieved January 23, 2021, from <https://www.londonstockexchange.com/search?searchtype=all&amp;q=specialist+bonds> [↑](#footnote-ref-3)
4. Andhra Pradesh Power Finance Corporation Ltd 10.32% bond yield, coupon rate, A+ credit rated bond. (n.d.). Retrieved January 23, 2021, from <https://www.indmoney.com/bonds/INE847E08DR1/andhra-pradesh-power-finance-corporation-ltd-1032-bond-yield> [↑](#footnote-ref-4)
5. Specialist bonds list. (n.d.). Retrieved January 23, 2021, from <https://www.londonstockexchange.com/search?searchtype=all&amp;q=specialist+bonds> [↑](#footnote-ref-5)
6. E-States Database. (n.d.). Retrieved January 23, 2021, from <https://www.rbi.org.in/Scripts/AnnualPublications.aspx?head=State+Finances+%3A+A+Study+of+Budgets> [↑](#footnote-ref-6)
7. Economic Review Page. (n.d.). Retrieved January 23, 2021, from <https://kerala.gov.in/economic-review> [↑](#footnote-ref-7)
8. The value has been calculated with the data available from the E-States Database from the RBI's Datasheets, computing an average of the values from 1990-91 to 2018-19. E-States Database. (n.d.). Retrieved January 23, 2021, from <https://www.rbi.org.in/Scripts/AnnualPublications.aspx?head=State+Finances+%3A+A+Study+of+Budgets> [↑](#footnote-ref-8)
9. Isaac says KIIFB is no ponzi game, government funds enough to pay debts. (n.d.). Retrieved January 23, 2021, from https://www.onmanorama.com/news/business/2019/11/04/thomas-isaac-kerala-kiifb-ponzi-game-government-funds.html [↑](#footnote-ref-9)