Emerging Issues in State Finances Post-Fourteenth Finance Commission:

State level Debt-Deficit Dynamics: Emerging Issues

NIPFP

POLICY NOTE

LEKHA CHAKRABORTY
MANISH GUPTA &
PINAKI CHAKRABORTY

Post-Fourteenth Finance Commission (FFC), debt-deficit dynamics can be analyzed in two ways: ex-ante and ex-post. Ex-ante analysis involves identifying policy changes which can create an impact on debt and deficits through the very design of the intervention. The introduction of UDAY scheme and increase in borrowing powers of states to 0.5 per cent of GSDP designed by FFC are examples of such ex-ante policy interventions that would have an impact on 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 GDP to the changes in the pattern of debt/GDP ratio. How much did growth in GDP contribute to the changes in the debt-GDP ratio? What impact inflation had on the size of debt? Did high/low primary deficits (deficits-net-of interest) led to upward/downward bias in debt-GDP ratio? Ex-post analysis is not feasible at the moment (based on 2016-17 BE), as we do not have enough data points to answer these questions[1]. Alternatively, we tried to analyse emerging debt and deficit scenarios in states based on 2016-17 BE. We

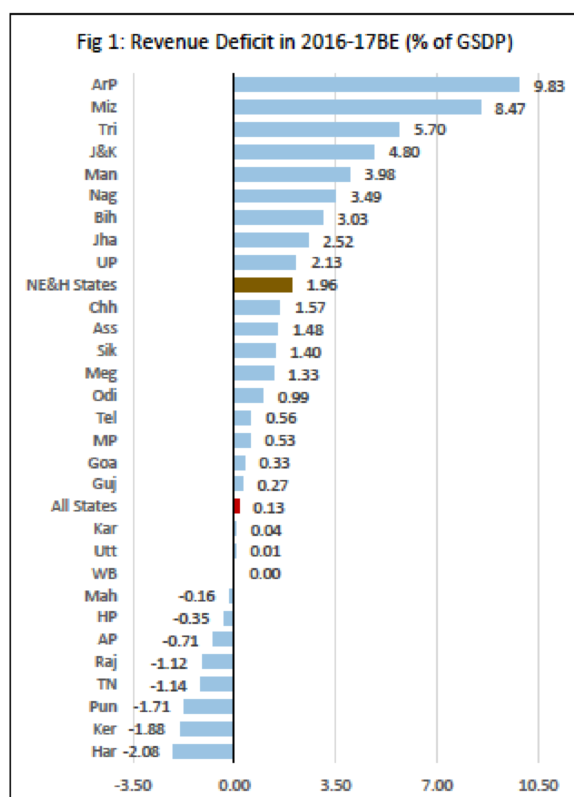


Fig 1: Revenue Deficit in 2016-17BE (% of GSDP)

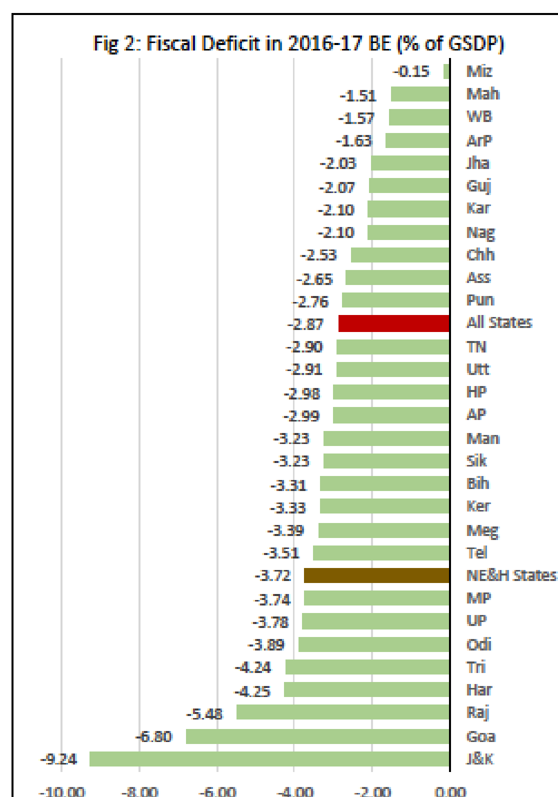


Fig 2: Fiscal Deficit in 2016-17 BE (% of GSDP)

[1]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 paper at the moment .

National Institute of Public Finance and Policy, New Delhi. IDRC project on 'Intergovernmental Fiscal Transfers in India'.

also examine emerging debt-deficit scenario post-FFC taking into consideration flexibility for higher borrowing recommended by FFC.

Deficit and Interest Payment: State wise Analysis

State-wise revenue deficit, fiscal deficit and interest payment to revenue receipts ratio are presented in Figure 1, 2 and 3. As evident from Figure 1, eight states are expected to have revenue deficit in 2016-17 (BE). These states are Maharashtra, Himachal Pradesh, Andhra Pradesh, Rajasthan, Tamil Nadu, Punjab, Kerala and Haryana. However, all states combined revenue account is expected to be in surplus. With regard to fiscal deficit, all state combined deficit is expected to be below 3 per cent of GSDP as mandated under the Fiscal Responsibility Act (FRA). However, 14 states have budgeted to have fiscal deficit above 3 per cent of GSDP. States budgeted to have fiscal deficit more than 4 per cent of GSDP are Tripura, Haryana, Rajasthan, Goa and Jammu & Kashmir.

If we consider interest payment to revenue

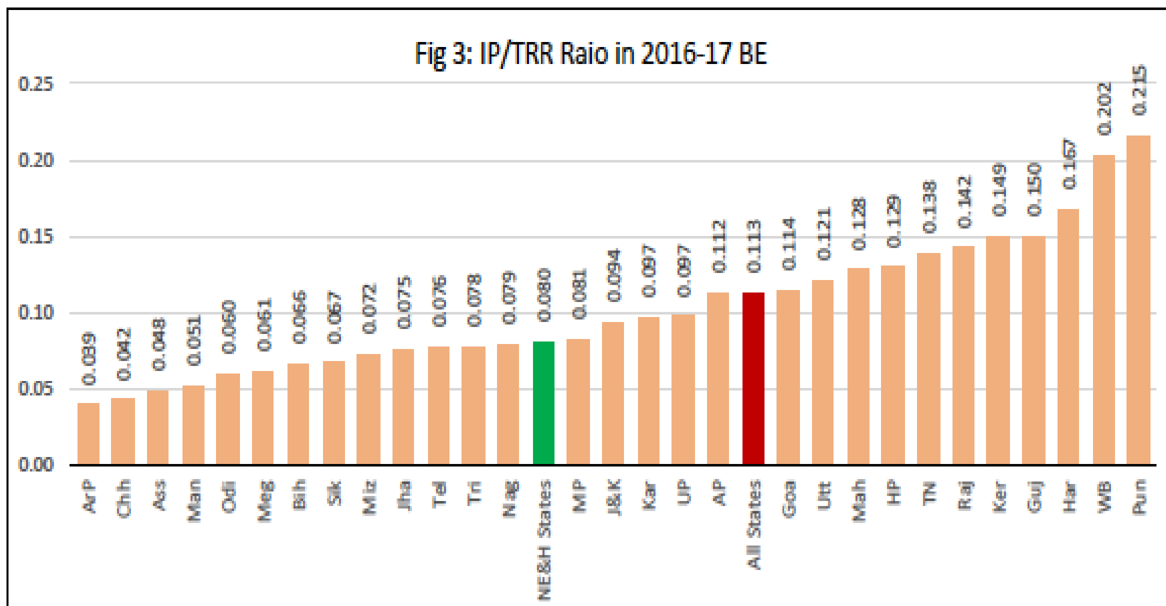


Fig 3: IP/TRR Raio in 2016-17 BE

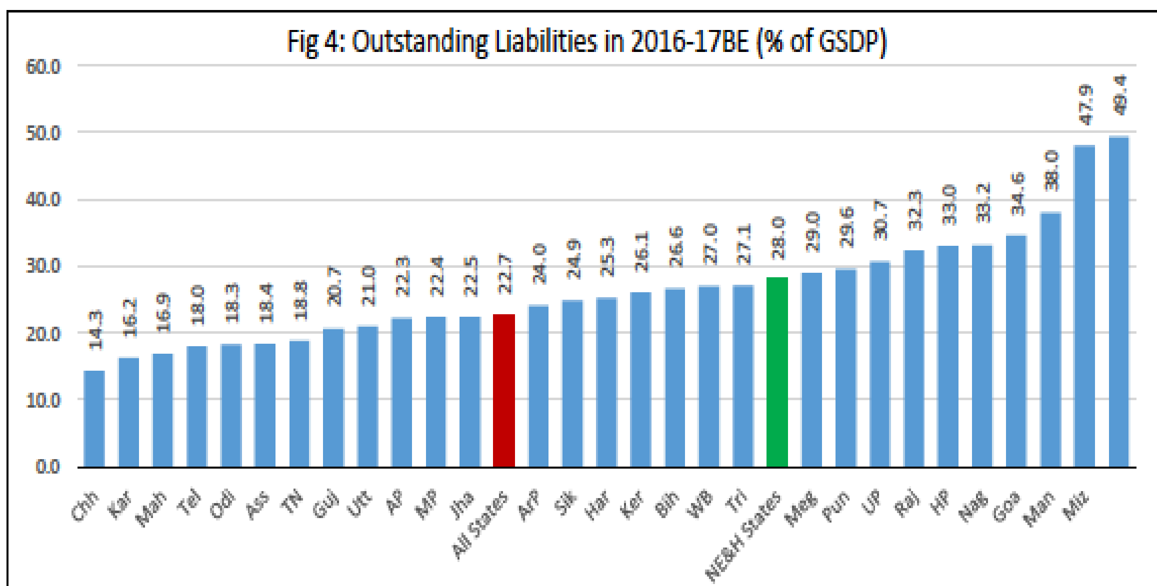


Fig 4: Outstanding Liabilities in 2016-17BE (% of GSDP)

receipts ratio (IP/RR), it is highest in Punjab, followed by West Bengal Haryana, Gujarat, and Kerala with an interest outgo of more than 15 per cent of revenue receipts (Figure 3). States with above all state average ratio of 11.3 per cent (other than those above 15 per cent) are 7. States with below 10 per cent IP/RR ratio are 17 including some of the major states like Karnataka, Uttar Pradesh, Madhya Pradesh Bihar, Odisha and Assam. Outstanding debt to GSDP ratio for all states is estimated at 22.7 per cent. For the North Eastern and Himalayan states this ratio is expected to be around 28 per cent (Figure 4).

Enhanced Debt Limit and Eligibility

FRA mandates that subnational governments in India maintain zero revenue deficit or revenue surplus and a fiscal deficit threshold of 3 per cent of GSDP. The FFC envisaged that the quality of deficits is equally significant as the levels. 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 per cent of GSDP. The States will be eligible for flexibility of 0.25 per cent 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 per cent in the preceding year.

ii. States will be further eligible for an additional borrowing limit of 0.25 per cent 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 per cent of the revenue receipts in the preceding year.

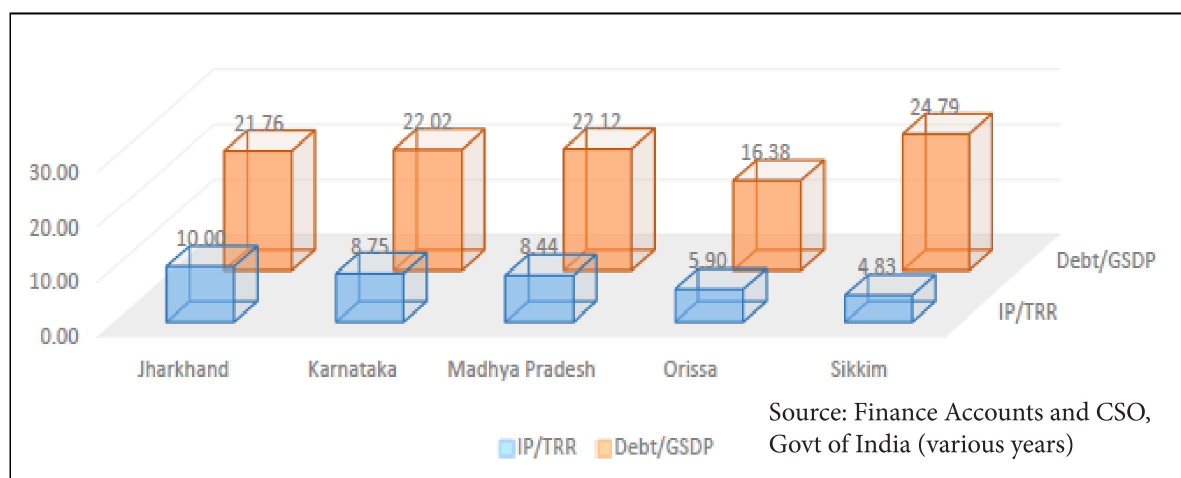
iii. The two options under these flexibility provisions can be availed of by a State either separately, if any of the above criteria is fulfilled, or simultaneously if both the above stated criteria are fulfilled. Thus, a State can have a maximum fiscal deficit-GSDP limit of 3.5 per cent in any given 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.

We examine the eligibility of states for additional borrowing powers based on FFC condition in the first year of assessment, i.e., 2015-16. Enhanced market borrowing of states for 2015-16 is analysed based on the four criteria proposed by FFC. A two-step methodology is followed for identifying the states for enhanced borrowing procedure:

Step 1: Identify the states within the fiscal deficit upper-bound of 3 per cent of GSDP and with no revenue deficit.

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 CSO, Govt of India (various years)

Step 2: Within the subset find out states with interest payments-to-revenue receipts-ratio below 10 per cent; and debt-to-GSDP-ratio below 25 per cent.

The analysis of outstanding debt and deficits of all States ex-post to 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 FRA thresholds of deficits and the criteria of outstanding debt to GSDP below 25 per cent and IR/RR ratio below 10 per cent (Figure 5). Therefore, they are eligible for enhanced debt procedure suggested by FC to 0.50. Gujarat, Meghalaya and Uttarakhand were eligible for 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 out of this enhanced borrowing facility. As per the information obtained from Ministry of Finance, Government of India, in 2016-17, six states have become eligible for enhanced borrowing limit.

To conclude, we need to emphasise that all states revenue account is expected to have a revenue deficit in 2015-16 (RE). Revenue surplus estimated at 0.13 per cent of GSDP in 2016-17 (BE) may slip into revenue deficit if there is a revenue short fall or increase in revenue expenditure more than what is budgeted. Since almost half of the states have a fiscal deficit target higher than FRA limit in 2016-17 (BE), fiscal consolidation at the state level under new framework of borrowing proposed by FFC should focus on quality of expenditure and elimination of revenue deficit. One major concern that emerges out of this analysis is that some of the major states (in terms of GSDP) are expected to slip into revenue deficit in 2016-17 BE. The rationale of the new framework of borrowing is to provide fiscally prudent states with additional borrowing for higher capital expenditure. As per FFC's assessment, state level capital outlay during its award period is expected to increase from 3.83 per cent of GDP in 2015-16 to 4.61 per cent 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.

References

Fourteenth Finance Commission (2014), FFC Report, FFC, New Delhi.

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