Sub-national debt dynamics and implications for fiscal policy

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Overview

- Context
- Subnational debt projections
- Implications for fiscal management
- International experiences

Sub-national debt levels converged and fell before the pandemic but have diverged and increased since then

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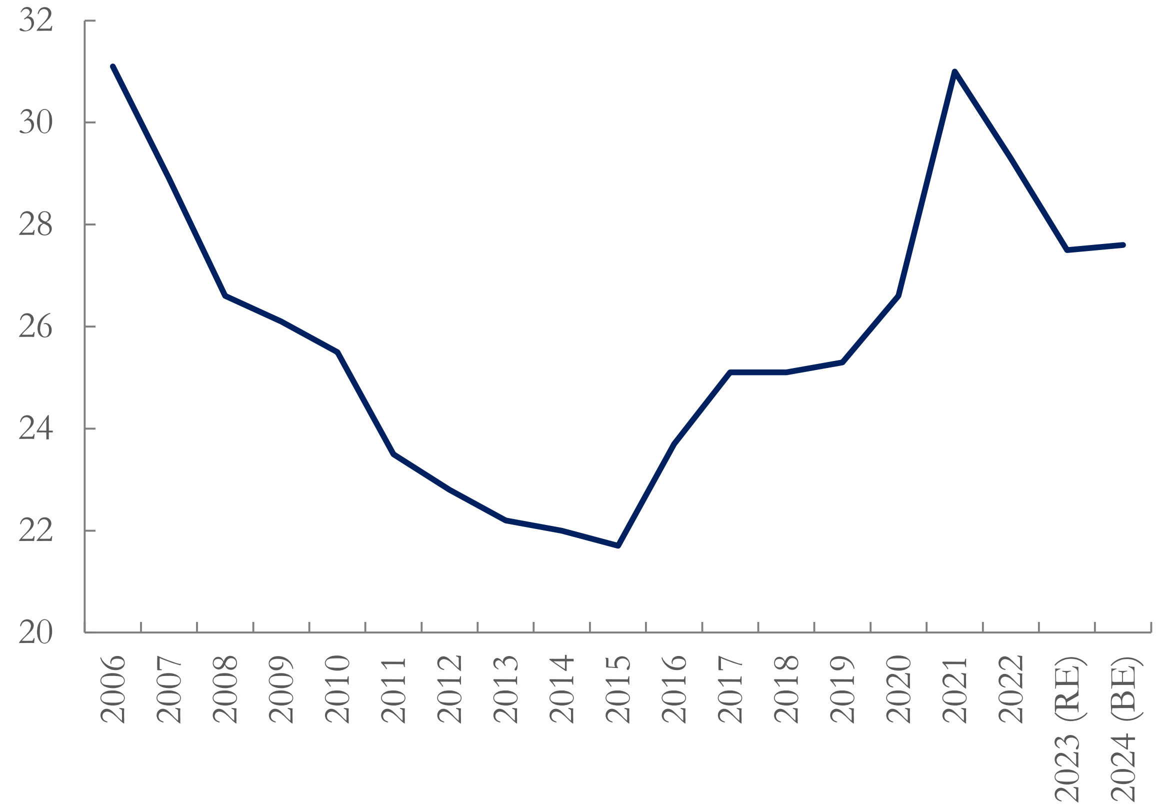
States' debt/GDP levels were trending down until 2016 but increased sharply during the COVID-19 pandemic

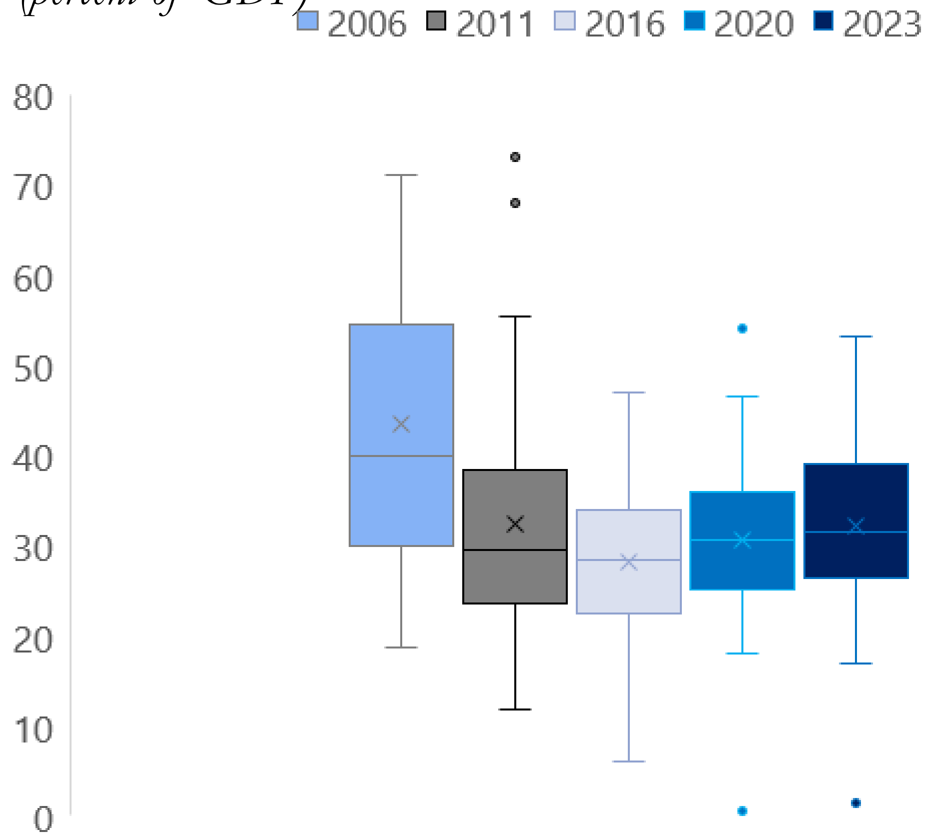
(percent of GDP)



Source: RBI and World Bank staff calculations

The variance in debt levels has increased across states between 2020 and 2023

(percent of GDP)



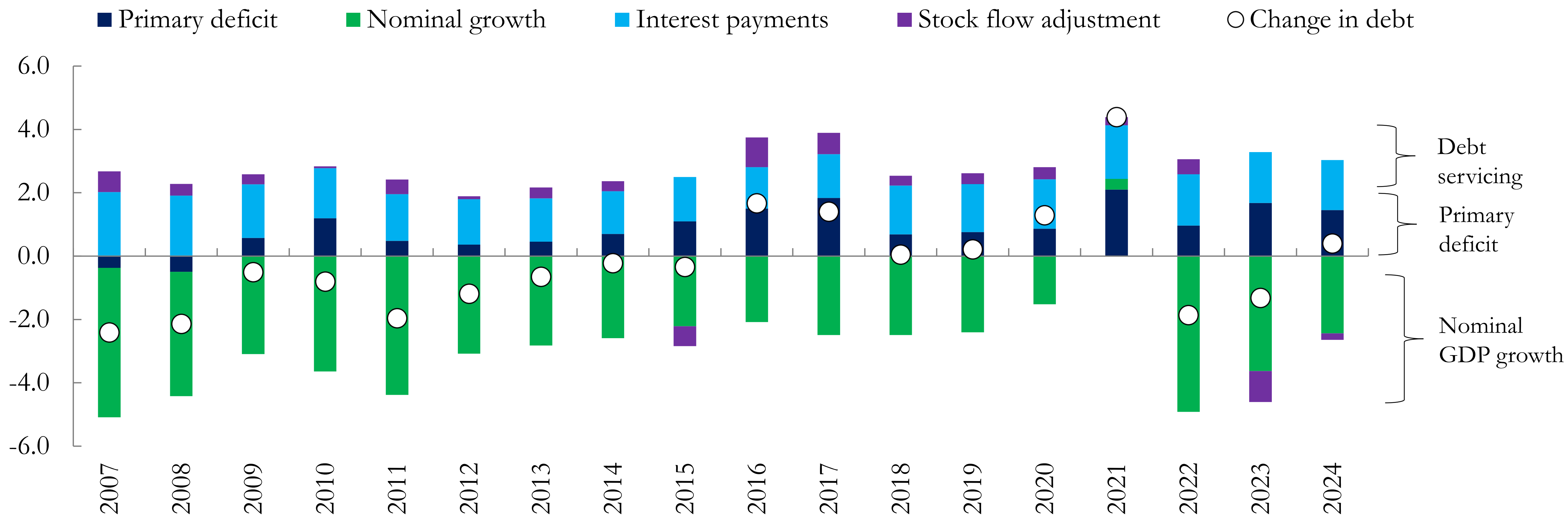
Source: RBI and World Bank staff calculations

Note: The size of the box shows the inter-quartile range, the whiskers show the minimum and maximum levels.

In recent years, higher primary deficits and slower growth have contributed to a higher debt-to-GDP ratio

States' debt/GDP drivers

(percentage point contribution to change in debt/GDP ratio)



Source: RBI and World Bank staff calculations

What is the current scenario?

- Currently, states have a common borrowing limit (recommended by the FC, enforced by the central government) with some conditional flexibility based on adoption of reforms, unused limits and the extent of off-budget borrowing.

- Not all states have a defined medium-term debt target in their fiscal responsibility legislation (FRBM), and those that do also set the target at varying levels as a share of GSDP. The FRBM in many states simply refers to the debt target recommended by the central government or finance commission.

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Under a highly stylized scenario, even with a uniform fiscal deficit, the states' debt-to-GDP ratios are projected to converge around 30 percent of GSDP

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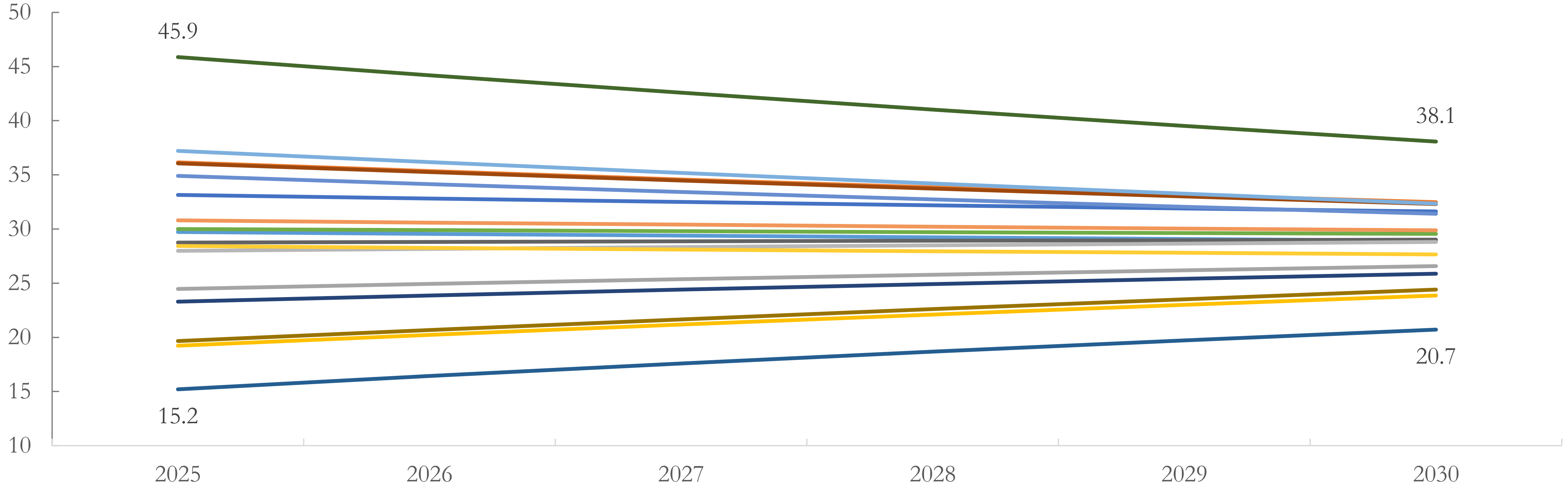
Stylized debt paths for major states under common assumptions

(percent of GSDP)

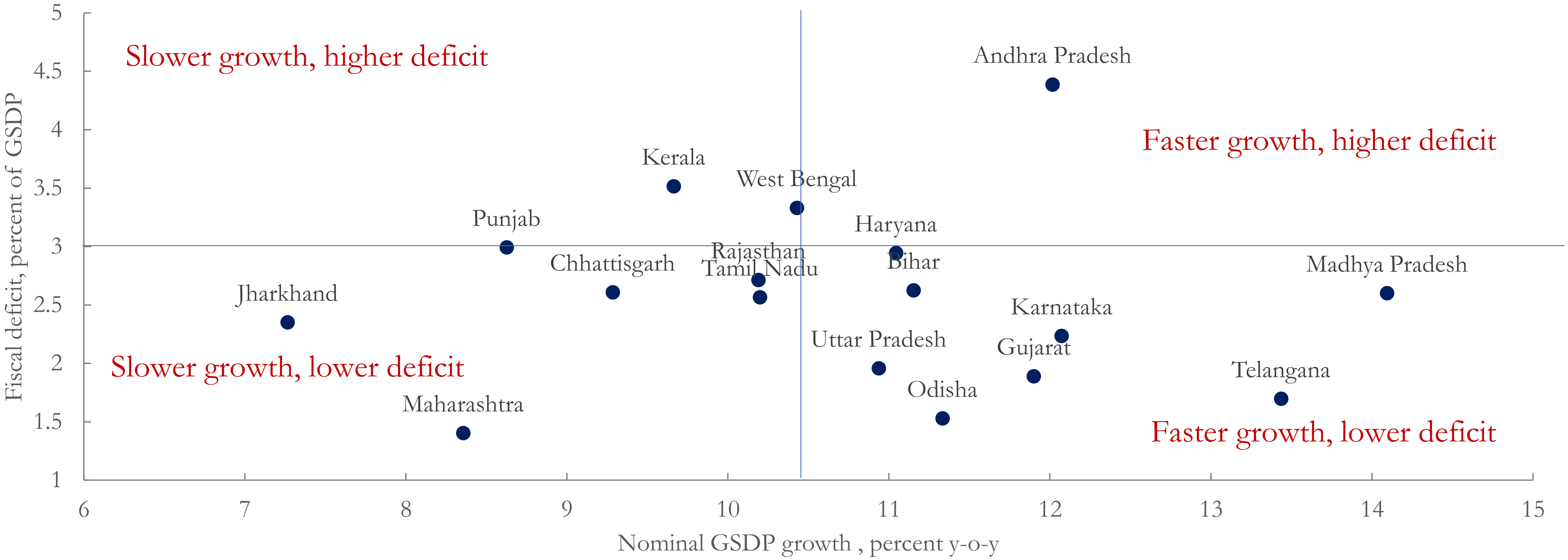


Assuming a common nominal growth of 10.5 percent, a common fiscal deficit of 3 percent and each state's respective interest burden and effective interest rate based on historical data.

Source: World Bank staff calculations

But all states are not growing at the same pace, and the fiscal deficit for all states has not been 3 percent

Historical average growth rate and fiscal deficit

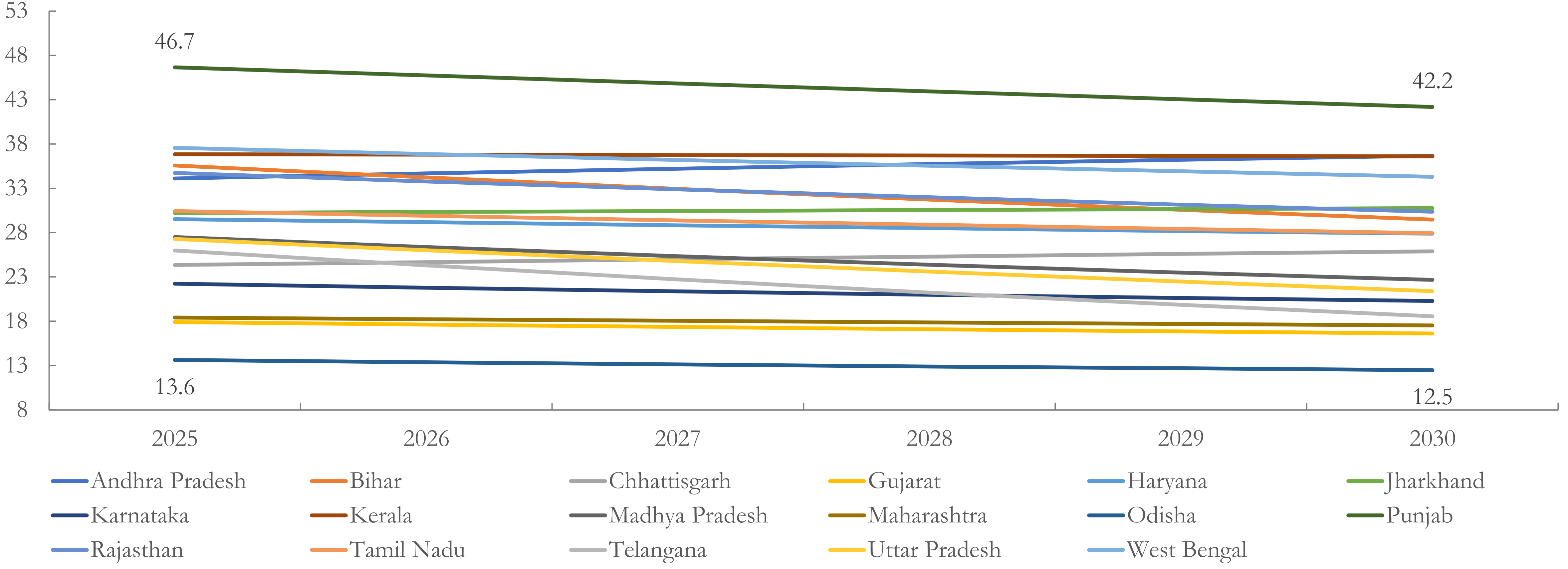


Source: NSO, RBI and World Bank staff calculations

Debt paths won't converge if states grow at their historical average rates and maintain their historical average deficits

Projected debt paths for major states using historical averages for growth and fiscal balance

(percent of GSDP)



Source: World Bank staff calculations

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Implications for fiscal management: What is the alternative?

- Adopting a common medium-term debt target instead of a common annual borrowing limit could have several benefits:
  - It would allow states with a record of high growth and low deficits to step up government spending, particularly on areas like infrastructure, education and health that have high multiplier effects
  - It would also require more restrictive borrowing limits for slow-growing, highly-indebted states to create space for more productive spending in the future.

- However, differentiated borrowing limits and fiscal glide paths would require more transparency, reporting and oversight to ensure compliance
- They may also require highly-indebted states to cut spending significantly in the short term, which may not be practically or politically feasible

Is there an optimal level of debt?

Bhattacharya, Prasanth and Rao have estimated the optimal level of subnational public debt at 25 percent for major Indian states.

- Public debt accumulation up to 25% of GSDP is conducive for improving primary surplus. At a low level of public debt, higher government spending financed by borrowing can increase output and revenues via positive fiscal multiplier and crowding in effects to improve the primary balance

- Primary surplus deteriorates with public debt accumulation beyond 25% of debt-GSDP ratio. Beyond 25 percent, incremental borrowing reduces investment and output and causes the primary balance to deteriorate

- The FRBM review committee had proposed a debt target of 20 percent, but at the time, the prevailing debt level for states was around 21 percent of GD while the XV FC had proposed a debt target of 32.5 percent by 2025-26.

Some states will need to substantially reduce spending or mobilize more revenues to reach a 25 percent target

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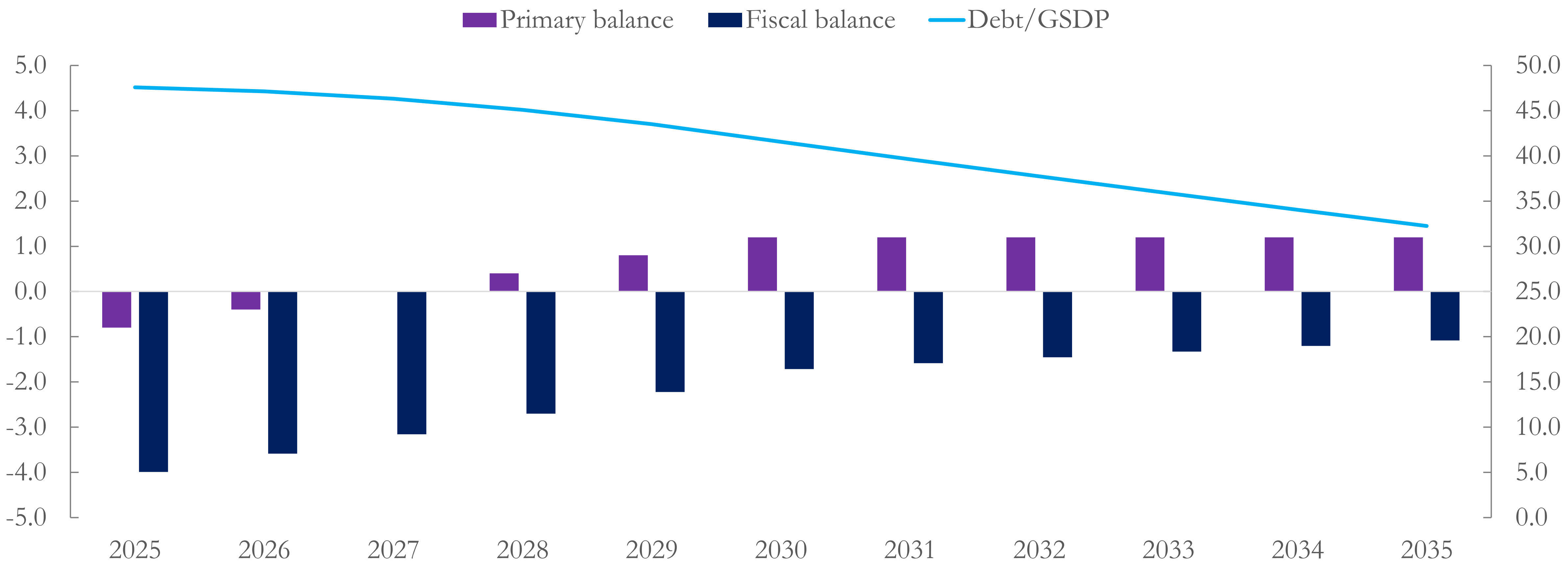
Primary and fiscal balance glide path to reach 25 percent - Punjab

(percent of GSDP)

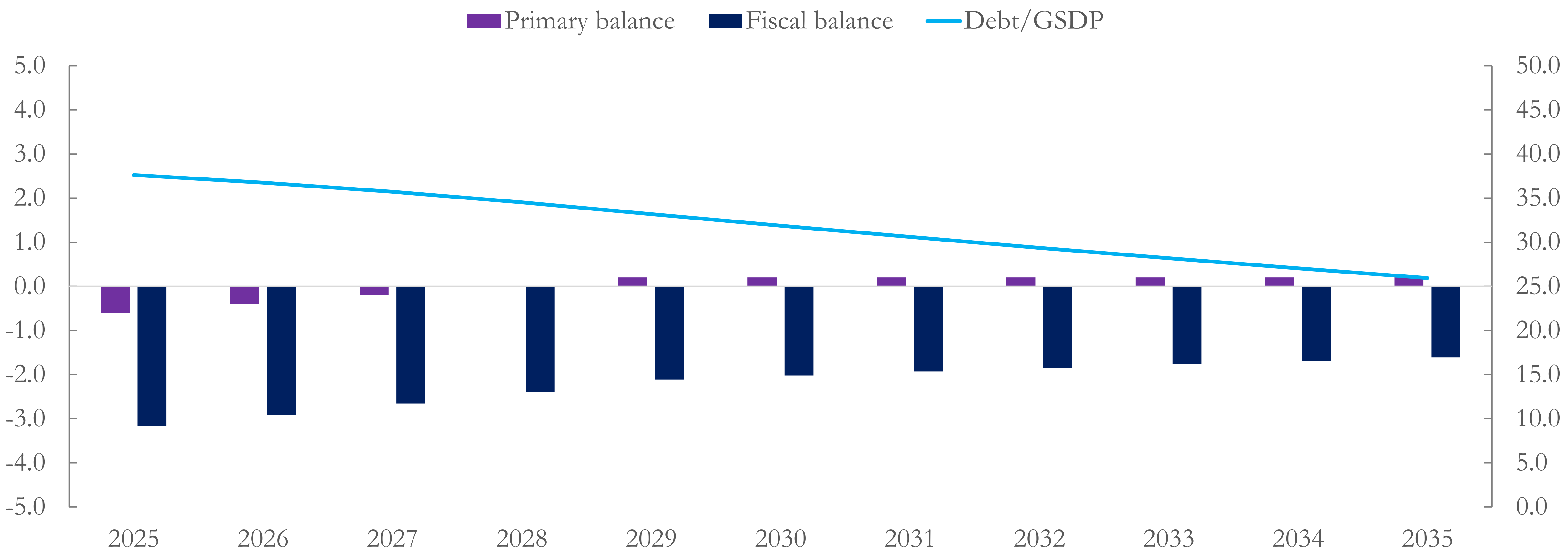


Source: World Bank staff calculations

Some states will need to substantially reduce spending or mobilize more revenues to reach a 25 percent target

Primary and fiscal balance glide path to reach 25 percent – West Bengal

(percent of GSDP)

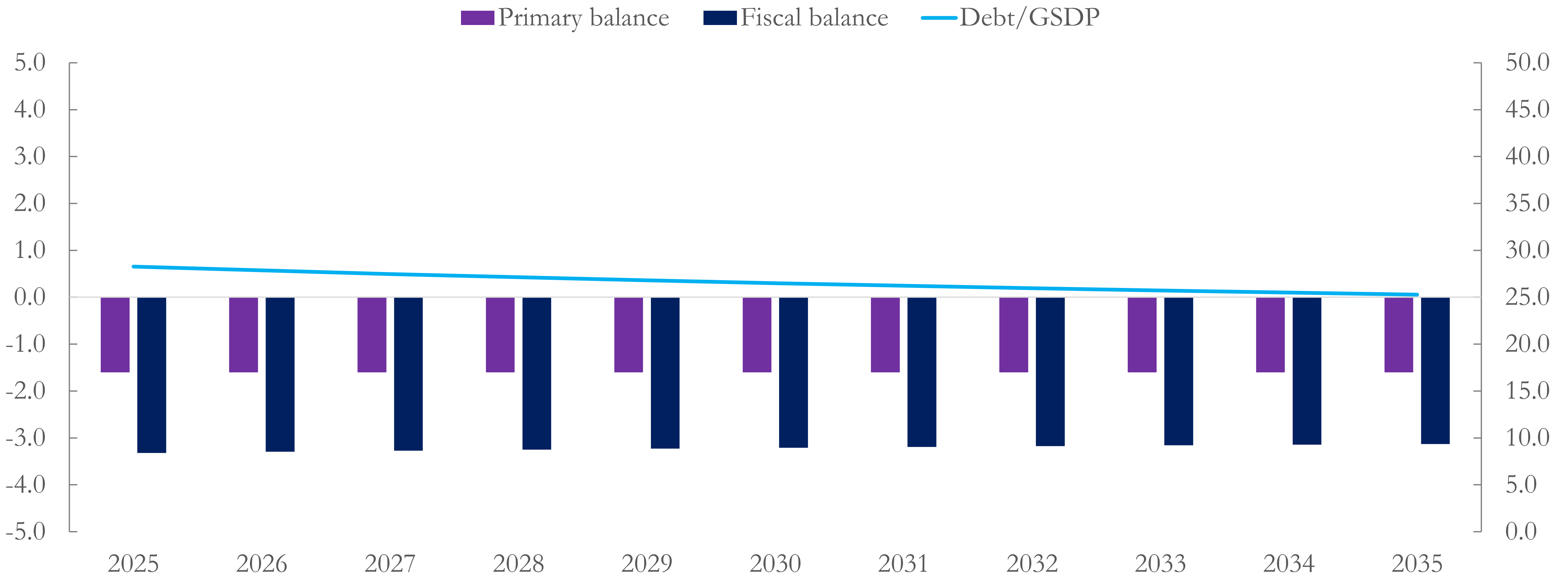


Source: World Bank staff calculations

States close to the target level can maintain their deficits around the 3 percent level as long as they are growing

Primary and fiscal balance glide path to reach 25 percent – Madhya Pradesh

(percent of GSDP)

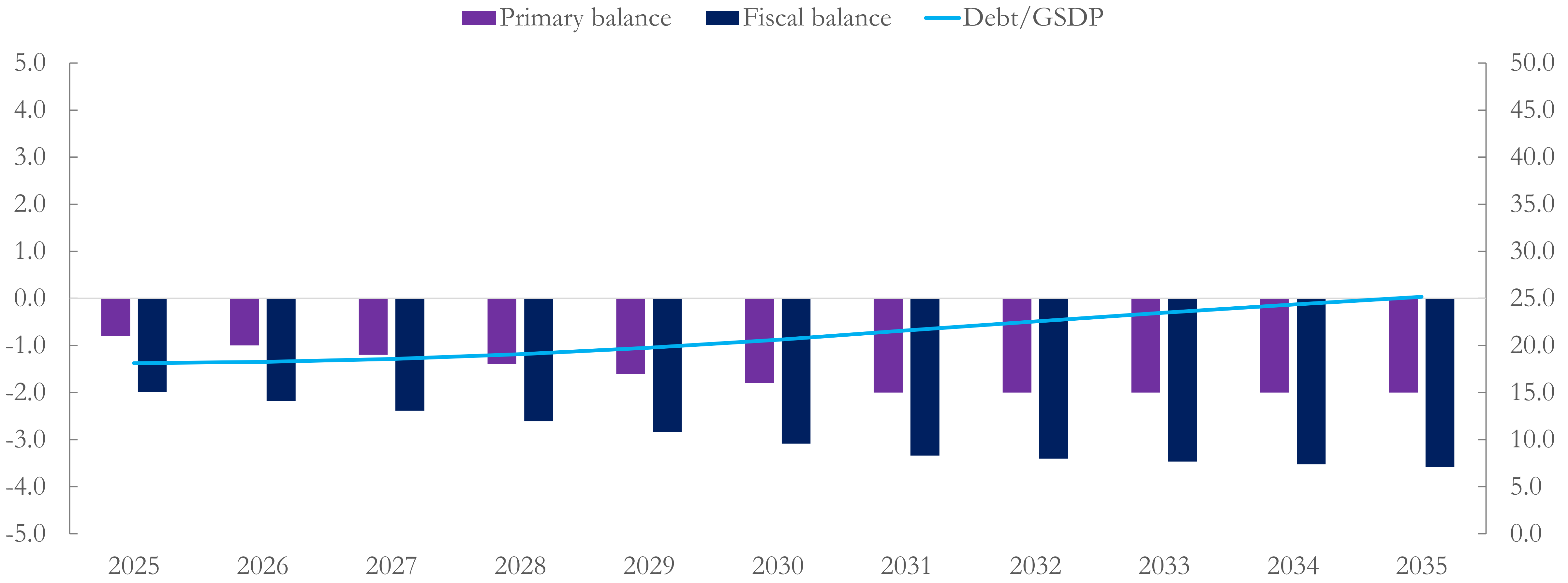


Source: World Bank staff calculations

While those below the target level can substantially increase spending

Primary and fiscal balance glide path to reach 25 percent – Gujarat

(percent of GSDP)



Source: World Bank staff calculations

Implications for fiscal management: Does the fiscal framework allow for differentiated borrowing limits?

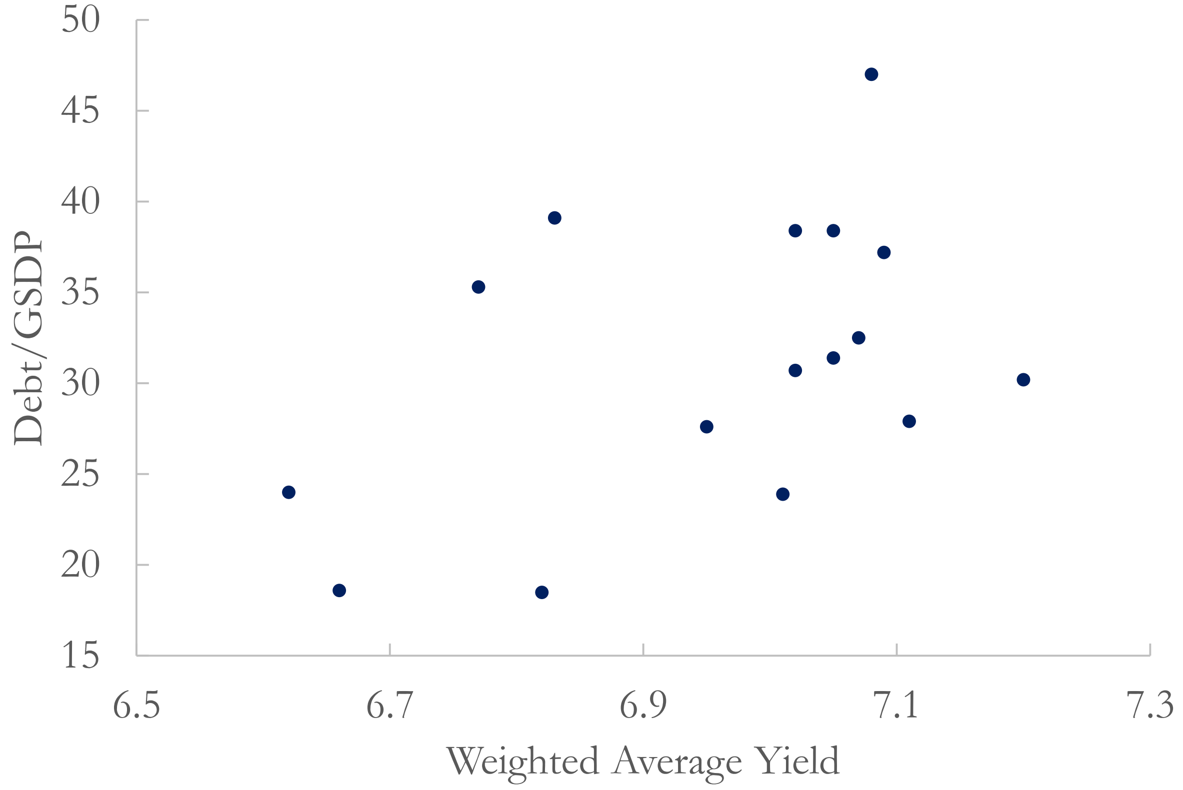
- The 13th Finance Commission acknowledged that one size does not fit all: states which had higher fiscal deficits at the beginning of the award period were given more time to reduce their fiscal deficits. At the same time, states which had lagged in revenue performance were expected to improve their tax effort faster than others.

- Successive FCs have also allowed states with relatively lower debt levels and a sustained revenue surplus to borrow more.

Markets do not price in subnational fiscal risks due to the implicit sovereign guarantee

Weighted average yield on new issuances and debt-to-GSDP ratio at end FY 21/22

(percent, FY21/22)



- While yields on new issuances of state government bonds do vary and appear to be correlated with debt levels, the spread between states is not significant.
- For example, in FY21/22, Punjab was able to issue bonds at roughly the same yield as Telangana and Kerala, and lower yield than Jharkhand despite having a much larger debt burden
- Similarly, Gujarat's bonds were priced yields similar to Rajasthan's, despite Rajasthan's debt levels being nearly double those of Gujarat.

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Several countries use a traffic light or rating system to assess sub-national debt sustainability

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Mexico	**Thresholds are established for each indicator to assign a rating of low, medium or high**
	States are classified into three broad categories: Stable (green), under surveillance (yellow) and high level of indebtedness (red)
New South Wales, Australia	**Weighted financial stability rating is assigned based on performance in each indicator**
	Each entity is allocated a positive, neutral or negative outlook
	Entities are grouped into seven categories from "Very strong" to "Distressed"
Brazil	**For each indicator, the sub-nationals are assigned a letter rating from A to C based on their performance against thresholds**
	A combined letter rating is assigned based on the rating for each indicator

Countries assign different weights to the indicators, for example, in Mexico's system highly indebted sub-nationals are automatically assigned the worst rating but in Brazil even highly indebted sub-nationals can get a better rating if they perform well on other indicators.

The rating systems mainly sue indicators measuring size of debt, capacity to service debt and liquidity

Mexico	Debt/Non-earmarked revenues
	Debt service/Non-earmarked revenues
	Short-term obligations/Total revenues
New South Wales, Australia	Operating balance (Current receipts net of current spending)
	Liquidity (Cash expense ratio and Unrestricted current ratio)
	Debt service cover ratio and interest cover ratio
	Infrastructure maintenance and capital expenditure
Brazil	Debt/Net current revenue
	Current spending/Adjusted current revenue
	Short-term financial obligations/Cash and cash equivalent balance

These ratings can be linked with borrowing limits and/or used to signal markets explicitly or implicitly

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- In both Mexico and Brazil, borrowing limits are linked with the rating of the subnational and the level of indebtedness. Sub-nationals with a better rating and lower debt have higher borrowing limits

- In Brazil, sub-nationals with a C or D rating do not receive a Treasury guarantee for their borrowing, which increases the cost of borrowing.

- In Mexico and in several other countries, sub-nationals with a poor rating are not allowed to borrow at all.

There are two ways to operationalize this in the Indian context – central oversight or market discipline

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- Through the Finance Commission - Differentiated borrowing limits anchored to a medium-term debt/GSDP target
- The Department of Expenditure would need to create norms for reporting, and auditing of accounts to improve transparency; and model states' debt paths on an annual basis
- With a market-based approach, the central government could start by rating each state's fiscal performance and publishing the ratings, which could influence the rates at which states are able to borrow.