Managing State Debt and Ensuring Solvency

The Indian Experience

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Abstract

The paper presents the policymakers' perspective on the reforms undertaken to manage states' debt and ensure solvency. While the sustained high growth rates of the Indian economy played a part in alleviating the interest burden on debt and ensuring that the debt does not grow in an explosive trajectory, major reforms were implemented to reverse the fiscal decline, develop fiscal responsibility rules to ensure sustained adjustment, and move toward a market-based financing of state

deficits. The serious efforts at fiscal consolidation and institutional reforms have enabled states to set on the path toward fiscal correction. Nonetheless, weak global growth prospects and the risk of a further rise in global commodity and fuel prices could generate the dilemma of needing to compress expenditures for ensuring fiscal sustainability while simultaneously needing counter-cyclical spending to boost growth, and challenge the fiscal adjustment process.

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Managing State Debt and Ensuring Solvency: The Indian Experience

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Managing State Debt and Ensuring Solvency: The Indian Experience

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Introduction

There has not been any default among the Indian states², although fiscal stress and debt repayment pressures³ were experienced by many states in the late 1990s with continued deterioration evidenced in the early 2000s. The deterioration in the current account was the driving force for declining fiscal health as reflected by worsening in the fiscal and primary balances. An analysis of the evolution of states' debt, deficits, and interest payments reveals three distinct phases.

The first, pre-1998 phase, was characterized with low current account (revenue balance)⁴ and fiscal deficit with moderate debt levels. The second, during the late-1990s to mid-2000s reflected significant decline in all key deficit indicators along with rising debt levels and interest burden. During this period, the outstanding states' debt to gross domestic product (GDP) peaked to 32.8 percent in 2003-04 from 20.0 percent in 1997-98, and interest payments as a share of revenue receipts increased from 16.9 to 26.0 percent over the same period.

Of concern was the fiscal stress experienced by the central government over the same period (Pinto and Zahir, 2004), during which the combined center-state fiscal deficit rose from

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² The word 'states' has been used interchangeably with state governments and refers to the 28 state governments in India.

³ Literature approaches insolvency from the sustainability of fiscal policies, in a number of countries, specific legal definitions serve as procedural triggers for initiating insolvency procedures. In a legal sense, subnational insolvency refers to the inability to pay debts as they fall due; however, details vary across countries. See Liu and Waibel (2008) for a discussion across subnationals and Eduardo Ley (2011) Fiscal (and External) Sustainability, PREM, World Bank.

⁴ In Indian fiscal accounting, revenue balance refers to current balance, i.e. total revenue minus current expenditures.

7.3 percent of GDP to 9.4 percent. Furthermore, this reflected only the direct liabilities of states; exacerbating the debt burden and repayment pressure were the contingent liabilities, in the form of guarantees issued by states to support their enterprises. This was followed by the third phase and the onset of fiscal correction and reforms from the mid-2000s onward, as reflected in the lowering of all key deficit indicators and debt and interest payments as a share of GDP.

The resulting reform package had three inter-related components. First, to reverse the fiscal decline, a fiscal adjustment package was formulated to control the growth of current expenditures (such as wages and pension), and structural reform of the taxation system (such as moving from a turnover tax to a value-added tax) was instituted. Second, a rule-based institutional framework was developed to ensure the sustainability of the adjustment and consolidation. Third, there was a move from central government on-lending to states toward market-based financing, with a focus on both self-regulation (through fiscal legislation) and market discipline.

The priority of fiscal consolidation was to restore the balance of revenue accounts, that is, to reduce the revenue deficit to zero. It was realized that even after lowering the primary deficit, the debt service repayment pressure and high indebtedness would continue, because about 80 percent of states' borrowings during 2003–04 was at high-cost, nonmarket rates. But turning states to a sustainable fiscal path implied reducing both the stock of debt and the cost of borrowing. However, debt restructuring, write-offs, and relief would have an inherent moral hazard challenge. Being cognizant of this, the debt restructuring program was linked with broader institutional reforms, including providing incentives for states to undertake difficult fiscal reforms.

The Twelfth and Thirteenth Finance Commissions (FCs)⁵ comprehensively examined the situation for both the center and the states, highlighted their interdependence, and presented an overall strategy. Most subsequent reforms in terms of fiscal responsibility legislation (FRL) were

⁵ The FC is a constitutional body appointed every five years or sooner to review the finances of the center and state governments and recommend devolution of taxes and other proceeds from the center to the states (vertical transfers) and among the states themselves (with the objective of horizontal equity). The FC uses a formula-based approach, assigning weights for various relevant factors such as population, income disparity, area, tax effort, and fiscal discipline. These weights have changed over time. There have been thirteen FCs since independence.

based on a well-considered strategy and incentive structure. Although the steps taken were gradual, the synergistic effect of many institutional, fiscal, and legislative reforms was much greater. The reform efforts were initiated and implemented by different parts of the government—the FC, the Ministry of Finance (central government), the states themselves, the Planning Commission, and the Reserve Bank of India (RBI). All parties were aware that this was not “business as usual” (World Bank 2004), and there was a sense of urgency about transforming the situation.

Among the states, themselves, there was a move away from competitive populism (Kurien 2000), which included subsidies and lowering tariffs, toward coordination by ending the competitive tax rate reduction and instituting the value-added tax, which proved to be highly buoyant. This, coupled with increases in the states’ share of central taxes instituted by the Twelfth and Thirteenth FCs and the high buoyancy of the center’s direct taxes, improved state finances and led to their progress toward the FRL goals. The coordination and consultation among all engaged entities ensured consistency of approach and moved the reforms forward.

There is ample fiscal literature on the states’ fiscal reform—fiscal rules, the quality of fiscal adjustment, expenditure and taxation reforms, power sector reform, and budget and financial management reforms.⁶ This paper focuses on the states’ borrowing and debt restructuring process, underpinned by the move toward a rule-based framework and market discipline.⁷ It concentrates on the perspective of the policy maker during this period and reflects on the key challenge that was to balance the provisions of debt relief with the need to avoid moral hazard and enforce fiscal discipline.

The rest of the paper is organized as follows. Section 2 presents the states’ borrowing framework as prescribed by the constitution, and changes in the borrowing channels and lending policy for states, while incentivizing market access with a rule-based system. Section 3 summarizes the trends in states’ deficits, debts, and interest payments in the last two decades,

⁶ See Ianchovichina et al. (2000); Pinto and Zahir (2004); Rangarajan and Srivastava (2008); Reddy (2000); and World Bank (2000, 2004).

⁷ The share of debt of the local governments—the third tier of government—are not be covered in this paper. Local government debt in India is small. Local governments, with limited fiscal autonomy, are largely dependent on fiscal transfers and on-lending from higher levels of government.

and highlights interstate disparities in fiscal performance. Section 4 presents the major policy and institutional reforms undertaken to restructure states' debt and discusses efforts to minimize moral hazard. Section 5 presents the impact and challenges of the ongoing global financial crisis. Section 6 offers conclusions.

Section 2: States' Borrowing Regime

India is a federal polity of 28 state governments and 7 union territories. The states' borrowing regime is defined by federalism, characterized through the constitutional division of powers among the three levels of government—the center, the states, and the local bodies.⁸ The power to raise major taxes is allocated to the central government, while major expenditure responsibilities are assigned to states due to their proximity to local issues and needs. While states' own revenues constitute 37 percent of total revenue receipts, their expenditures account for 55 percent of total central government expenditure (RBI 2011). The imbalance is addressed through fiscal transfers from the center to the states, mandated by the FC.

The constitutional arrangements for revenue sharing among the Indian federation and the consultative mechanism among the center and states have tended to reduce the risk of explicit state defaults.⁹ Regarding the constitutional arrangement, the FC uses a formula-based approach to allocate taxes and grants, with the objective of filling the expenditure-revenue gap (deficit financing). The vertical sharing between the center and states is simplified by including all central taxes and excise duties in the divisible pool of central taxes.¹⁰ For the horizontal sharing among states, the FCs have attempted to correct the differentials in revenue capacity and cost factors inherent in the diversity of states. The pattern of transfers through the FC channel shows that the share in central taxes has persistently been the predominant component of revenue

⁸ These were added in the 73rd and 74th Amendments to the Constitution. The Seventh schedule to the Constitution specifies the legislative, executive, judicial, and fiscal domains of Union and State governments in terms of Union, State, and concurrent lists.

⁹ The “financial relations between the Centre and the States are designed with great care and circumspection ... to forestall precisely the kind of difficulties that even the older federations do not appear to have overcome in securing closer correspondence between resources and functions of the different layers of Government” (Sixth FC).

¹⁰ Over time, the FCs have taken various approaches to addressing state concerns regarding the composition of the divisible pool of central taxes and interse allocation criteria between and among states. Although FCs have aimed to foster fiscal stability among the states, an empirical analysis reveals that while transfers have helped to reduce the overall gross fiscal deficit of the states, horizontal fiscal inequity is yet to be addressed (Kannan et al. 2004).

sharing since the First FC (RBI 2011). Starting with the Ninth FC, a greater emphasis on fiscal discipline has been added to balance the gap-filling approach (RBI 2007).¹¹

Residual imbalances in the fiscal accounts after the federal transfers, are financed through borrowing. The main borrowing sources are domestic, external, and issuance of loan guarantees. The borrowing channels are multiple and the process complex but are organized around the principles of maintaining sustainability, solvency, and liquidity of the states (for a description, see box 1).¹² The overall control is with the center, under Article 293(3) of the Constitution, which states that if any state government is indebted to the center, it requires the center's permission to borrow. Further, the Constitution forbids states from borrowing abroad on their own. Thus, all external borrowing must be on-lent or guaranteed by the center.¹³

The limit on the annual amount and sources of borrowing is based on consultations among the center, the state government, the Planning Commission, and the RBI.¹⁴ Previously, after the delinking of plan¹⁵ borrowing and plan grants, states tended to revise their objective of maximizing plan assistance by arguing for higher plan sizes, thereby committing to higher borrowing. This changed considerably with the enactment of FRL targets. Key decision parameters on the demand side include the states' financing needs, developmental needs, repayment profile, and, since the early 2000s, its debt sustainability. On the supply side, an important factor is the absorption of liquidity from the market by both the center and states,

¹¹ RBI, "State Finances: A Study of Budgets" (2007, 58).

¹² Solvency refers to the government's ability to service its debt without defaulting. It is defined as the condition that the state government's net stock of debt does not exceed its ability to pay off that debt at some time in the future (measured by the present discounted value of its future primary surpluses). Liquidity is the ability to meet short-term cash needs (within the year); that is, in each period the state government has enough resources (cashflows) to cover expenditures plus debt service. Debt is considered unsustainable if it will lead to insolvency in the future (see Ley 2011). Also important is the concept of credibility, or the confidence of investors that solvency and liquidity will be maintained.

¹³ External loans are project-based loans, except for some structural adjustment loans, from multilateral development banks at concessional terms.

¹⁴ Since 2006, the Standing Technical Committee (STC), with representation from the center, state, and RBI, has been making annual projections of states' borrowing requirements. The committee considers several factors including the macroeconomic and financial conditions, sustainability of debt, provisions of fiscal responsibility legislation, and fiscal risks from issuance of guarantees.

¹⁵ India used to have a system of planned development under which grants/assistance was provided to states.

without impinging on the supply of credit for the private sector for productive purposes.¹⁶ Since the mid-2000s, the ceiling on borrowing by a state has been capped by the fiscal targets under the state-level FRLs.¹⁷

¹⁶ It may be argued that because India still has a large fiscal deficit, this effectively crowds the private sector. But banks are not required to hold more than 25 percent of their net deposits in liquid liabilities such as government securities. Banks, hold a higher percent, which raises the question of demand for credit off-take from businesses.

¹⁷ The central government temporarily allowed states to increase the fiscal deficit to 3.5 percent of gross state domestic product (GSDP) during 2008–09 and to 4.0 percent during 2009–10 in response to the global financial crisis (Canuto and Liu 2010).

Box 1: Borrowings of States

Borrowing channels for states are multiple and the process complex; some channels are controlled and restricted by the center and others are more autonomous.

Borrowing channels controlled by the center are:

- *Market borrowings:* Market borrowings are controlled by the center and managed by the RBI.^a The state securities issued through this channel are eligible for meeting the banks' statutory liquidity requirements and are thus backed by "automatic" intercepts from the state treasury account (automatic debit). There have been no restructuring or defaults associated with these, and investors perceive an implicit sovereign guarantee attached to them.
- *Loans from the center:* Historically, the center used to borrow and on-lend to states. This has now changed, with financial market developments and states' ability to borrow on their own behalf, on-lending from the center was discontinued in May 2005.
- *Loans from banks and financial institutions:* The center sets the global ceiling on the amount states can borrow from the banks and financial institutions, but the rate of interest is negotiated directly by the state with the concerned creditor. The rate of interest depends on the perceived credibility and fiscal position of the state.
- *External loans:* Previously, the center would on-lend the proceeds in rupees at harder terms, adjusting exchange exposure and elongating maturities. With the recent change in lending policy, the entire loan proceeds are passed through directly by the center to states at the same terms (currency, maturity, and amortization) given by the creditor. The states bear the currency and the refinancing risk, but most do not undertake an impact evaluation of the cost-risk trade-offs of such transactions on their total debt portfolios (see table B.1a).

Table B.1a Sources and Features Attached to State Borrowings

	Amount controlled by the centre	Automatic intercepts	Creditor perceives guarantee
External Loans	Yes	Yes	Yes
Loans from centre	Yes	Yes	
Market Borrowings	Yes	Yes	Yes
Loans from Banks and financial institutions	Yes	No	Partially
Provident funds	No	No	No
NSSF	No	No	Yes
Contingent Liabilities	No	No	Partially

Borrowing channels not controlled by the center are:

- *Small savings loans and use of state provident funds^b:* Prior permission from the center is not required for these. The small savings schemes are run by the center with a social security objective to encourage household savings. Eighty percent of the collections within a state's territory are automatically passed on by the National Small Savings Fund to that state. The rate of interest paid by states is currently fixed at 9.5 percent. The money is available for 25 years with a five-year grace period.
- *Special purpose vehicles:* States issue loan guarantees to special purpose vehicles, which borrow in the market with the backing of these guarantees. Anecdotal evidence suggests that loan proceeds have been sometimes used to finance current state expenditures.

Liquidity management:

- *Ways and means advances (WMA) from the RBI:* These are designed to meet temporary liquidity shortfalls. They are formula based and depend on the state's total expenditures. If the shortfall is higher than the WMA amount, the state gets into overdraft, which is extended at a penal rate of interest to be cleared within 10 days or the account of the state is frozen. If there is surplus cash in the single treasury account, it is invested in 14-day intermediate treasury bills.

In the interest of transparency, the number of days a state uses the facility during a financial year is published in the RBI's Annual Report. Access to this short-term credit facility disciplines states to manage liquidity shortfalls prudently to avoid closure of accounts, and benefits them in avoiding arrears and payment defaults.

Note: a. The RBI manages domestic borrowings for each of the 28 states through separate agreements with each.
b. A provident fund is a retirement benefit scheme; employees contribute 12 percent of monthly wages and can withdraw funds on retirement or on reaching age 55. Contributions are an unfunded liability in the Public Account, but balances are available to the state (see Rao, Prasad, and Gupta 2001).

Figure 1 illustrates the changing financing pattern of states debt during the 1990s and 2000s. This mirrors three phases, with a decline in the center's loan intermediation and on-lending (since 1998–99), an increase in the National Small Savings Fund (NSSF)¹⁸ and small savings borrowings (from 1999–2000), and the move toward market-based financing since mid-2000.

Figure 1. Composition of financing pattern of state deficits (as of end-March)

Source: Reserve Bank of India, NSSF=National Small Savings Fund, described in Box 1.

Traditionally, loans from the center were the dominant source of funding for states. In keeping with the trend of financial sector liberalization, the center's loan intermediation role has been reduced since 1999–2000. The other notable change has been the rising share of NSSF and small saving loans (see box 1 for a description). The share of NSSF increased sharply to 69

¹⁸ The NSSF was established in April 1999; small savings collections are invested in central and state government special securities. At present, 80 percent of all small savings collections within a territory of state are invested in the same state securities. This adds to the debt of the state but is not controlled by the center. Moreover, the inflows are autonomous and depend on the spread between the small savings rate and the deposit rate. See "Report of the Committee on the Comprehensive Review of the National Small Savings Fund," June 2011. There is an inflexibility associated with NSSF borrowing, since these are based on availability and not necessarily on the requirement by the state to borrow, and are at higher interest costs and with an asymmetry toward the center (Thirteenth FC, p. 144).

percent during 2004–05 from 39 percent during 2001–02. This characterized a move from center-controlled borrowings to the autonomous NSSF but at higher cost (NSSF loans at 9.5 percent compared with cheaper market loans, weighted average of 8.39 percent during 2010–11). There is an inflexibility related with NSSF borrowings, since these are based more on availability and collection within the geographical territory of the state than the requirement by the state to borrow. The NSSF loans are also at higher interest costs and have been more asymmetrically beneficial for the center (Thirteenth FC, p. 144).

Given the Twelfth FC recommendations for greater autonomy and discontinuation of the financial intermediary role for the center, the lending policy was changed, with more market access for states.¹⁹ Thus, states got more freedom, but also greater responsibility to manage their debt. A consequence of the new lending policy was the move to market discipline and transparency to enhance credibility among the market participants. Competition gradually increased among states to avail the best market terms and obtain credit ratings. There has been evidence of some variation in the spreads among states, with some states borrowing at slightly lower rates, although the overall range of the spreads has been narrow (table 1).

Table 1: Weighted Average Spreads during 2010-11

Weighted Average Spread^b (Basis Points)	General Category States/UTs	Special Category States^a
1	2	3
30-40	Puducherry, Gujarat, Goa, Rajasthan, Tamil Nadu, Bihar	Manipur, Nagaland, Meghalaya, Tripura
40-50	Kerala, Andhra Pradesh, Madhya Pradesh, Punjab, West Bengal, Uttar Pradesh, Karnataka, Haryana, Orissa	Assam, Himachal Pradesh, Jammu and Kashmir
50-60		Sikkim, Uttarakhand

Source: Rakshitra, various issues, The Clearing Corporation of India Ltd.

Note: a. Special category states are all the North-eastern states, along with Jammu and Kashmir, Himachal Pradesh, and Uttarakhand. They have distinct characteristics: a low resource base, cost disabilities due to their physical geography, sparse terrain, remoteness, and historical circumstances. These states account for only 5 to 6 percent of all states' gross state domestic product. ^b Over the Center's benchmark.

¹⁹ The Twelfth FC stated that "...as regards the future lending policy, the central government should not act as an intermediary and allow the States to approach the market directly." The practice of on-lending from the center has been discontinued since then (recommendations of the Twelfth FC were accepted in May 2005).

Cross-country evidence shows that spreads over central government securities should be linked to debt and deficit (fiscal) indicators of states. For example,²⁰ Schuknecht, von Hagen, and Wolswijk (2009) concluded this for the European Union member states; and Lemmen (1999) analyzed similar issues for the subnational governments in Australia, Canada, and Germany. Poterba and Rueben (1999) found that states with tighter anti-deficit rules and authority of state legislatures can issue debt at a lower interest burden. However, somewhat counterintuitive is the case in India. Bose, Jain, and Lakshmanan (2011) indicate that the conventional deficit indicators have not been significant in determining the yield spreads during 2006–07 to 2010–11. The study, however, concludes that since the period is characterized by the prevalence of rule-based fiscal policy, it appears to have provided confidence to investors regarding states’ commitment to fiscal discipline, and although the impact of FRLs cannot be directly determined, it cannot be undermined.

This shift in the sources and methods of state borrowing has had a bearing on the interest payments, deficits, and debts of the states. The next section presents the changing trends of states’ fiscal deficit, debt composition, and the interest burden, and details on interstate variability in these key indicators.

Section 3: Trends and Composition of States’ Deficits, Debt, and Interest Burden

An analysis of the evolution of states’ deficit, debt, and interest burden (defined as the ratio of interest payments to current receipts) during the 1990s and 2000s reveals three distinct phases (as depicted in figure 2). The first phase, in the early to mid-1990s, was characterized by low current account and fiscal deficits, moderate debt levels, and a tolerable interest burden. The second phase, during the late-1990s to mid-2000s, was characterized by a significant deterioration in state finances, with all key deficit indicators, debt levels, and interest burden rising. The third phase, from the mid-2000s, was characterized by the onset of fiscal correction and reforms, and manifests with improvements in key fiscal indicators.

²⁰ These studies are quoted in Bose, Jain, and Lakshmanan (2011).

Figure 2. Deficit, debt and debt service indicators

Source: RBI Handbook of Statistics on State Finances, various issues.

Note: GFD: Gross fiscal deficit, IP: Interest payments, RR: Revenue Receipts, GDP: Gross domestic product.

Until the mid-1990s, states' finances were relatively stable, characterized by low current and fiscal deficits, averaging below 1 percent and 3 percent of GDP. Debt levels remained moderate at about 20 percent of GDP, and the interest burden hovered close to 15 percent of revenue. The turning point came during 1998–99, with a significant deterioration in the current account, which became a key driving force for the declining fiscal health of the states, with increased spending on administrative services and interest payments.

The next phase, 1998–99 to 2003–04, saw the steep rise in the fiscal deficit as a ratio of GDP—from 2.8 percent to 4.2 percent; the revenue deficit more than doubled from 1.1 percent of GDP to 2.5 percent. As a result, the states' outstanding debt to GDP grew from 21.7 percent during 1997–98 to its peak of 32.8 percent during 2003–04. Interest payments as a share of revenue receipts (repayment burden) rose from 17.9 percent to 26.0 percent over the same period, and the primary deficit grew from 0.9 percent to 1.5 percent. This period, until 2003, was also characterized by higher interest rates, with the interest rates being gradually liberalized; the average market interest rate on states' borrowing was over 10 percent during this period. Concomitantly, the average interest burden, at 23.4 percent, was significantly higher than the 15 percent considered tolerable for a sustainable debt level (Dholakia, Mohan, and Karan 2004).²¹

²¹ Interest payments as a ratio of revenue receipts provide an explanation of the interest burden and the level of “tolerable” debt. Debt is said to be tolerable if servicing it does not impose an intolerable burden on the fiscal

There is vast fiscal literature on the factors leading to the deterioration of state finances in the late 1990s. Factors considered critical to the fiscal deterioration include the impact of the wage revisions; inability to contain wasteful expenditure, including subsidies; reluctance to raise additional resources; and competitive reduction in taxes. Mohan (2000) pointed to the increasing debt service payments and inadequate returns on government spending as important factors behind the deterioration in states' fiscal conditions. Acharya (2001) and Rao (2002) attributed the worsening of revenue (current) balance during this period to the implementation of the Fifth Pay Commission recommendations.²² The RBI Study of State Budgets, 2002–03, while drawing attention to the growing fiscal and revenue deficit and high debt levels of states, pointed to the following causes of the deterioration in states' fiscal condition: (a) an inadequate increase in tax receipts, (b) negative or negligible returns from public investments due to losses in public sector undertakings, (c) large subsidy payments, (d) increased expenditure on salaries due to pay revisions, and (e) higher pension outgo. Another study, by Prasad, Goyal, and Prakash (2004), concludes that interest payments played a prominent role in the deterioration of state finances.

Until the mid-1980s, interest rates on government borrowing were highly subsidized, indicative of the degree of financial repression. After the 1980s, the rates on government bonds became progressively aligned with market interest rates; during the 1990s there were increases in both bank deposit rates and policy rates (table 2). During the 1990s, average interest rates rose, and those on state government bonds averaged over 10 percent during the 1990s (RBI). At the same time, the reliance on market borrowing to finance the fiscal deficits increased from 11 percent in the 1980s to 16 percent in the 1990s. Significant changes in the structure and cost of state government debt contributed to a sharp increase of about 60 percent in the repayment burden from the beginning to the end of the 1990s. Interest rates started softening in the mid-2000s, and these were taken advantage of in formulating the debt-swap scheme for states (discussed in section 4).

position. Dholakia, Mohan, and Karan (2004) analyzed what interest burden a state can tolerate as a proportion of its revenue receipts. In 2004, Dholakia, Mohan, and Karan used one-fifth of revenue receipts as a tolerable ratio. The FC also considered the same.

²² In India, government wages are reviewed and revised periodically, usually every 10 years.

Table 2: Deposit Rate of Major Banks for Term deposits of more than 1 year maturity

(percent)		
Year	Average Interest Rate	Bank Rate/ Repo Rate/ Reverse Repo
1	2	3
Mar-91	10.0	10.0
Mar-92	12.5	12.0
Mar-93	11.0	12.0
Mar-94	10.0	12.0
Mar-95	11.0	12.0
Mar-96	12.5	12.0
Mar-97	12.0	12.0
Mar-98	11.3	10.5
Mar-99	10.3	8.0
Mar-00	9.5	8.0
Mar-01	9.3	7.0
Mar-02	8.0	6.5
Mar-03	5.3	5.0
Mar-04	4.8	4.5
Mar-05	5.8	4.75
Mar-06	6.5	5.5
Mar-07	8.3	6.0
Mar-08	8.3	6.0
Mar-09	8.3	5.0
Mar-10	6.8	5.0
Mar-11	8.6	6.75

Note: Average interest rate refers to mid-point of interest rates charged by commercial banks on demand deposits. In column 3, policy rate used is relevant policy rate at that time. Bank Rate was used for the period prior to 2003 when it was in active use. For the subsequent period, repo/reverse repo rate was used depending on the prevailing liquidity conditions in the system.

Source : RBI Deregulation of Savings Bank Deposit interest Rate : A Discussion Paper

The data in table 2 capture only the direct and explicit state liabilities; exacerbating the debt burden and repayment pressure were the contingent liabilities, in the form of guarantees issued by states to support their enterprises. During the mid-to-late 1990s, there was a rapid increase in the issuance of guarantees by states to support their public enterprises, many of which

could not borrow on their own credit strength.²³ Although the latest data indicate that loan guarantees issued by states were lower at 2.8 percent of GDP by end-March 2009 compared to 3.3 percent of GDP in 2008, this does not incorporate the unfunded pension liabilities or the losses of the state public sector undertakings (PSUs). The Thirteenth FC estimated that by the end of 2007–08, about 1,160 state PSUs had accumulated losses of about Rs 659.24 billion (almost 1.3 percent of GDP), particularly the implicit liabilities associated with power utility companies, because their large accumulated losses represent a huge exposure for states.^{24,25} The probability that these liabilities will devolve are not identical for each state, and thus cannot be treated uniformly in terms of their fiscal impact.²⁶ -As a rule of thumb, assuming that about one-third of such liabilities devolve to the states to service, figure 3 presents a broader concept of “extended” debt, that is, debt inclusive of the likely devolvment of outstanding guarantees, to provide an assessment of the exposure and fiscal risk for the states. Extended debt is calculated as direct debt (explicit) plus one-third of the contingent liabilities²⁷ extended by the state governments (as reported by them). This adds to the stress scenario being faced by the states.

²³ “The Report of the Group to Assess the Fiscal Risks of State Government Guarantees,” (RBI, July 2002) reported that guarantees grew at an average rate of 16 percent per year during 1992 to 2001 (paragraph 5). To avoid an escalation of the fiscal risks, the RBI had issued regulatory guidelines to banks (which were the major investors) to only invest in state public sector undertakings (PSUs) if there was a clear revenue stream from the PSU/project, rather than that accruing from the state government budget. In addition, all the PSU issues were to be rated by at least two domestic credit rating agencies if banks were to invest in them. Also, such investments had credit risk weights and provisioning requirements.

²⁴ Thirteenth FC, p. 103.

²⁵ A recent note (2011) by Citi Investment Research and Analysis indicates that the total losses of state electricity boards in 2010–11 were Rs 635 billion, and those from five states (Bihar, Madhya Pradesh, Rajasthan, Tamil Nadu, and Uttar Pradesh) account for about 71 percent of the total losses.

²⁶ “The Report of the Group to Assess the Fiscal Risks of State Government Guarantees,” (RBI, July 2002), calculated the sectoral default ratios in 2001. The power sector was 15.09 and industry was 39.19. The total default ratio was 3.7.

²⁷ These relate only to those that are reported by the states. Indirect and implicit liabilities, although a source of fiscal risk, are not included here. A comprehensive review is difficult because of inconsistencies and gaps in data coverage and definitions, and is not the remit of this paper.

Figure 3. Extended Debt as Share of GDP

Source: Reserve Bank of India and author's calculations. Latest data on guarantees are available only till 2009.

Along with the deterioration in state finances during the second phase (1998–99 to 2003–04), was the fiscal stress experienced by the central government. The combined center-state fiscal deficit rose from 7.3 percent of GDP in 1997–98 to an average of 9.3 percent over the period. Studies indicate that although India has had primary deficits, it has avoided an explosive rise in debt, mainly because of high economic growth rates relative to the interest rate paid on government debt. Milan (2011) analyzed the decomposition of India's public debt trajectory using the method of debt dynamics, and concludes that the strong rate of economic growth compared to the interest rate paid on debt helped avoid an explosive debt trajectory. The situation was similar for states' finances, where the lower rate of interest on debt and the higher revenue buoyancy (Thirteenth FC, p. 126) from both own taxes and share in central taxes enabled improvements in the fiscal stance.

Fiscal correction set in after 2004–05, with the onset of reforms that went beyond the “realm of fiscal space” (World Bank 2004, 11). These included reforms on the expenditure side to contain spending, restrict recruitment, and curb growth in administrative expenditures; and some states cut the cost of pension schemes and reduced subsidies (through power sector reforms), including closure of and privatization of selected PSUs. On the revenue side, reforms aimed to enhance revenue receipts by revising tax rates and broadening the base, while focusing on improving tax compliance. Institutional reforms reflected a paradigm shift, with the adoption of medium-term fiscal frameworks and fiscal responsibility legislation at the state level (Howes, Lahiri, and Stern 2003).

Much has been written about the reforms to correct the fiscal imbalances and sectoral improvements, including improving the business climate to facilitate growth (World Bank 2003). The reforms undertaken specifically to restructure or reduce the debt and interest burden, along with those to enhance the credibility of states and ensure sustainability of debt, are discussed in the next section. Since the implementation of reforms in the mid-2000s, the declining fiscal/debt trends have been reversed. However, the 2008–09 global financial crisis has posed challenges.

Another aspect to consider is that, at the macro level, the states' aggregate analysis masks state-level disparities in fiscal performance. The differentiation among state performance persists, but the dynamics change over time, with some states reversing their fiscal decline from the second phase to the third phase (for example, Karnataka and Orissa), while the record of some states continued to deteriorate (for example, West Bengal). Assessing the performance of individual states against the median for the period reveals that in terms of the primary deficit, among the nonspecial category states,²⁸ Bihar, Chattisgarh, Gujarat, Haryana, Karnataka, Madhya Pradesh, Orissa, Punjab, and Uttar Pradesh have improved fiscal performance (primary balance)²⁹ since 2004–05 (until 2009–10) compared with the deterioration during 1998–99 to 2003–04 (compared with median values), while Goa, Jharkhand, Kerala, Maharashtra, Uttar Pradesh, and West Bengal continued to have persistently high deficits even during the fiscal correction phase (from 2004 onward) (see figure 4).

²⁸ The focus of this analysis is on the general or non-special category states, since they account for almost 95 percent of the all states GSDP and over 92 percent of the all India population.

²⁹ Analyzed as the average of the indicator with reference to the median values during the period of study.

Figure 4: Primary deficit as percent of GSDP³⁰

GSDP = gross state domestic product.

As expected, most of the states that reflected weak fiscal performance are also plagued with high debt and repayment burdens across the three periods. As can be seen from the box plot in figure 5, a large number of states have both debt and interest burden above the 75th percentile across the three periods under study. A case in point is West Bengal, which has persistently had high debt (an average of 45 percent during 2005–10) and a large interest burden (39.3 percent) continuing relentlessly, even during the current period (figure 6).

³⁰ The box plot is created by Stata. The line in the middle of the box indicates median (50 percentile), top of the box 75 percentile and bottom 25 percentile. The lines above and beneath the box represent the adjacent values, which are within 1.5 iqr of the nearer quartile (75 percentile for the line above and 25 percentile for the line below). The iqr is calculated as value of 75 percentile minus that of 25 percentile. So the largest value (upper end of the upper line) is identified by 75 percentile plus 1.5 times iqr and the smallest value (lower end of the lower line) is 25 percentile minus 1.5 times iqr.

Figure 5. Box plot showing debt to GSDP ratio and interest burden ratio

Source: Authors compilation using data from RBI reports

Figure 6. Interest Burden in select States (percent)

Source: Authors compilation using data from RBI reports

Analyzing vulnerability in terms of debt as a ratio of GSDP and interest burden (interest payments as a share of each state's revenue receipts) provides a useful indication of the susceptibility that states face. Table 3 is a matrix that presents the states that face more vulnerability. Gujarat, Himachal Pradesh, Kerala, Punjab, Rajasthan, and West Bengal reflect both debt levels of over 30 percent of GSDP and a high interest burden. The combined GSDP of these states accounts for over 12 percent of the national GDP. Their continued struggle with

fiscal adjustment poses a challenge, which is further compounded by the global financial crisis (discussed in Section 5).

Table 3 : States' Vulnerability Matrix

Debt Interest Payment		Debt-GSDP Ratio			
		Very High (Above 50 %)	High (30-50 %)	Medium (20-30 %)	Low (Below 20 %)
Ratio of Interest Payment to Revenue Receipts	Very High (Above 25 %)		West Bengal		
	High (15-25 %)	Himachal Pradesh	Gujarat, Kerala, Punjab, Rajasthan	Maharashtra	
	Medium (10-15 %)	Jammu and Kashmir	Andhra Pradesh, Bihar, Goa, Jharkhand, Madhya Pradesh, Orissa, Uttar Pradesh, Uttaranchal,	Karnataka, Tamil Nadu	Haryana, NCT Delhi
	Low (10 %)	Arunachal Pradesh, Manipur, Mizoram, Nagaland, Sikkim, Puducherry	Meghalaya, Tripura	Assam	Chhatisgarh

Note: GSDP=gross state domestic product

Source: Authors compilation using data from RBI reports.

In keeping with the diverse fiscal situation in states, the Thirteenth FC recommended a state-specific approach for adjustment based on past fiscal performance (with 2007–08 the base year), and prescribed differentiated adjustment paths for different groups of states. It was estimated that to attain the aggregate target of states' debt-to-GDP ratio of 25 percent, the aggregate fiscal deficit of states should be maintained at 3.0 percent of GDP. Being an aggregate, however, this target indicator does not reflect the specific realities of individual states. For example, an abrupt reduction in fiscal deficits in states that also had high revenue deficits would lead to undesirable compression in capital expenditures. Thus, the Thirteenth FC, while keeping a balance between the need for customization with the requirement for adopting a uniform approach for determining targets for all states, recommended a differentiated approach. It was recommended that the non-special category states that had a revenue surplus or balance in the base year 2007–08 adopt a road map that eliminated their revenue deficits by 2011–12, and target fiscal deficit to 3.0 percent of GSDP. Other states with a higher revenue deficit in the base

year were to adjust following a gradualist approach to avoid sudden cutbacks in capital expenditures, and eliminate the revenue deficit by 2014–15 and achieve a 3 percent fiscal deficit by 2013–14.³¹

Section 4: Debt Restructuring and Institutional Reform

The structural deterioration in states' finances led to intense deliberations among stakeholders—parliamentarians, policymakers, think tanks, and other interested parties—about reform options to not only reverse the fiscal decline and lower debt levels, but also to put state finances on a more sustainable path going forward. The fiscal correction in state finances since the mid-2000s thus resulted from interrelated reforms on multiple fronts, helped in large part by the higher revenue buoyancy (Thirteenth FC) and the overall strong economic growth in India. The priority of fiscal consolidation was to restore the balance of revenue accounts; that is, reducing the revenue deficit to zero. The reforms included the standard fiscal consolidation measures through expenditure and taxation reforms. But, importantly, efforts were taken to develop a rule-based institutional framework, including fiscal responsibility laws, to ensure the sustainability of the consolidation. Such a rules-based system complimented the move from central government on-lending to the market-based financing mechanism for meeting the states' financing requirements. It was realized, however, that even after lowering the primary deficit, the debt service repayment pressure and high indebtedness would continue, since about 80 percent of states' borrowing in 2003–04 was at high-cost, nonmarket rates.

Research indicates that in addition to the important elements of fiscal consolidation, such as controlling the rapid growth of current expenditures and implementing structural taxation reforms, fiscal consolidation must include the objective of reducing repayment pressure by reducing interest costs (Dholakia, Mohan, and Karan 2004; Prasad, Goyal, and Prakash 2004). The Twelfth FC had also viewed the large interest payments as a major factor leading to the outstanding debt of states, and felt that reducing these payments was integral to attaining debt sustainability. With regard to the broad approach on the issue of debt sustainability, the Twelfth FC was of the view that debt relief measures were required as a prerequisite to achieve revenue

³¹ All special category states with a base fiscal deficit of less than 3 percent of GSDP during 2007–08 could incur a fiscal deficit of 3 percent during 2011–12 and maintain it thereafter. Manipur, Nagaland, Sikkim, and Uttarakhand should reduce their fiscal deficit to 3 percent of GSDP by 2013–14.

balance. Moreover, international experience showed that given the high indebtedness of states, it would be difficult to adhere to the fiscal targets when established by the states' fiscal responsibility law (Liu and Webb 2010). To achieve this would imply reducing both the stock of debt and the cost of borrowing.³²

However, it was also recognized that debt write-offs, relief, and restructuring alone cannot ensure the sustainability of state finances. Policy makers were cognizant that waivers of loans and interest should be restricted to avoid moral hazard problems and encourage debt repayment discipline. The debt restructuring was thus linked to states undertaking reforms to increase revenue efforts, controlling expenditure, and reorienting expenditures toward supporting growth (Twelfth FC). This section focuses on the debt restructuring program and its links to incentive packages offered to states for undertaking institutional reforms.

Debt Relief and Fiscal Responsibility Legislation

Debt relief had been provided by the waiving of repayment and/or interest payments due, altering the terms of repayment, reducing interest rates, and consolidation of loans. In the 1980s and 1990s, successive FCs had given unconditional debt relief to states, although the relief had been provided only periodically, and the amount of relief was not significant (table 4).³³ Thus, states have had to repay most of the debt they incurred. The Tenth and Eleventh FCs started to link debt relief with fiscal performance.³⁴ However, it was not until the Twelfth FC that debt relief was linked explicitly to rules-based legislative reforms. In a pathbreaking move, the Twelfth FC recommended debt relief for states contingent upon the enactment of fiscal responsibility laws and incorporation of a fiscal correction path, with milestones for attaining fiscal targets while improving the current (revenue) balance (reducing the deficit to zero by 2008–09).

³² The Twelfth FC states that “[L]arge interest payments have been a major factor leading to the increase in the outstanding debt of state governments ... and therefore, the reduction in interest payments is integral to attaining debt sustainability...” (p. 226). Dholakia, Mohan, and Karan (2004) conclude that the reduction in effective interest rates was an important factor for the interest burden (interest payment to revenue receipt, IP/RR) to be at a tolerable level and debt to be sustainable in the states. This required a reduction both in the stock of debt and its costs.

³³ The share of debt relief in GDP has declined from 2.95 percent in the 6th FC to 0.17 percent in the 11th FC, indicating a decrease in the relative commitment to central debt forgiveness over time (McCarten 2001).

³⁴ The 11th FC linked a portion of the untied central grants to the fiscal correction of the individual states as part of the Fiscal Reforms Facility. Although the grants were small, at Rs 106.07 billion (US\$2.43 billion equivalent), they helped trigger useful reforms (using an exchange rate at the end of the 1st quarter of 2000 of Rs 43.62 = US\$1.0).

Table 4. Debt Forgiveness by Finance Commission

Finance Commission	Year of report	Rs. billion	GDP Rs.billion	% of GDP
Sixth	1974	20	667	2.95
Seventh	1979	22	1025	2.11
Eighth	1984	23	2223	1.03
Ninth	1989	10	4357	0.22
Tenth	1995	5	10672	0.05
Eleventh	2000	34	20050	0.17
Twelfth	2005	535	31494	1.70

Source: McCarten (2001) and Report of Thirteenth Finance Commission, (2009)

To implement the recommendations of the Twelfth FC, the Debt Consolidation and Relief Facility was introduced during 2005–06, which provided debt relief through consolidation, rescheduling repayments for a fresh term of 20 years, and lowering of the interest rate on the debt to 7.5 percent. All states were eligible to obtain relief from the year they enacted fiscal responsibility legislation. This amounted to Rs 187 billion in terms of lower interest payments, and Rs 211 billion in terms of lower repayments, totaling Rs 398 billion (US\$8.9 billion³⁵) during 2005–06 to 2009–10. In addition, repayments due during 2005–10 on central loans contracted up to March 31, 2004, (after consolidation and rescheduling) were eligible for write-off subject to the reduction in revenue deficits. The debt write-off would also be subject to containment of the fiscal deficit to the 2004–05 level. Subject to these provisions, if the revenue deficit were brought down to zero by 2008–09, the entire repayments during 2005–10 would be written off.

Carrying forward the momentum to support states toward urgent fiscal correction, the Thirteenth FC worked out a differentiated fiscal adjustment road map (described in the previous section), with a state-specific approach based on past fiscal performance (using 2007–08 as the base year) for different groups of states. A key requirement is that all states eliminate their revenue deficits (the deficit on current balance), but they can have a fiscal deficit of 3 percent of

³⁵ The average of the quarterly average exchange rates from the 2nd quarter of 2005 to the 1st quarter of 2010 is used (from the IFS), which is Rs 44.64 = US\$1.0.

GSDP by 2014–15, along with a reduced debt target of 24.3 percent of GDP in the same year (from 27 percent in 2008–09). The debt relief granted was similar to the Twelfth FC; all loans to states from the Government of India outstanding as of 2009–10 would be written off if the state enacted or amended its fiscal responsibility legislation. Moreover, interest on past NSSF loans (contracted during 2006–07) was reduced to 9 percent from 9.5 percent.

The center enacted the Fiscal Responsibility and Budget Management Act in 2003, with applicability only to the national government. Some states had also enacted their own FRLs before the center (for example, Karnataka and Punjab, in 2002), and many states had since 2003 adopted FRLs in line with the national law. The Twelfth FC subsequently mandated that states pass FRLs to avail themselves of the benefit of debt relief, with revenue deficits (total revenue minus current expenses) to be eliminated and fiscal deficits to be reduced to 3 percent of GSDP by fiscal year 2009.³⁶ Since then, all 28 states have passed FRLs, most of which require the state to present a medium-term fiscal plan with multiyear rolling targets for key fiscal indicators, along with the annual budget, to the state legislature. Some of the FRLs, passed by states, also place limits on guarantees; others mandate the disclosure of contingent liabilities and other borrowing. Most FRLs require disclosure of significant changes in accounting policies.

Fiscal targets adopted by Indian states are remarkably similar to each other with respect to fiscal and revenue deficits. Some states adopted additional legislation on fiscal targets, such as the Kerala Ceiling on Government Guarantee Act (2003), which was enacted the same year as its FRL. According to the Guarantee Act, the guarantee outstanding for any fiscal year shall not exceed Rs 140 billion,³⁷ no government guarantee shall be given to a private entity, and the Guarantee Redemption Fund shall be established. Other initiatives included the setting up of (a) the Consolidated Sinking Fund (1999) to provide a cushion for repaying market loans of states (20 states have established this), (b) the Guarantee Redemption Fund (2001) to provide a cushion for servicing any contingent liabilities because of guarantees issued by state governments to its

³⁶ The summary of Fiscal Responsibility Laws in Indian states is based on Liu and Webb (2010).

³⁷ About US\$3 billion, assuming an exchange rate of Rs 46.7 (taken as representative of that period).

PSUs (11 states have established this), and (c) several technical committees and working groups on topical issues of cash and debt management.³⁸

Debt Swap and Securitization: Move toward Market-based Financing

The fiscal correction was given an impetus with the introduction of a “debt swap scheme” during 2003–04 to lower the existing interest burden and increase market access. Loans from the center amounting Rs 1,000 billion (US\$23 billion³⁹) with interest rates in excess of 13 percent were substituted with new market loans and small savings proceeds at lower rates of interest; the outstanding debt remained unchanged. The market conditions prevailing were fortuitous and the rates were significantly lower, at 7.5 percent (RBI State Finances Study 2004–05, 24), enabling an interest savings for states of Rs 310 billion (US\$7.1 billion⁴⁰) and 0.75 percent per year in revenue (Twelfth FC). This direction toward the market was reaffirmed by the Twelfth FC in conjunction with state debt relief, where it stated that, “As regarding the future lending policy, the central government should not act as an intermediary and allow the states to approach the market directly” (Twelfth FC, p. 236).

States issued “power bonds” to securitize the fiscal risks emanating from the losses of electricity utilities arising from the gap between the cost of producing power and the tariff charged. This gap between the cost and tariff had resulted in significant losses and an accumulation of arrears. With the securitization, arrears and accrued interest at about 1.5 percent of GDP were cleared by states through the issuance of 15-year tax exempt “power bonds”.⁴¹ Cognizant of the moral hazard issue, this was clearly announced as a one-time settlement measure and was supplemented with reforms to ensure discipline going forward. Participating states qualified for funds on the basis of reform milestones and improvements in the reduction of commercial losses. Although, states’ liabilities had increased by 22.8 percent during 2003–04 at

³⁸ These include issues relating to debt sustainability, model fiscal responsibility legislation, pension liabilities, state-government-guaranteed advances and bonds, fiscal risk of state government guarantees, voluntary disclosure norms for state governments, state government guarantees, and methodology for compilation of outstanding liabilities and periodic revisions in the ways and means advances limit.

³⁹ Using the end of March 2004 exchange rate at Rs 43.445 = US\$1.0. (Source: IFS)

⁴⁰ At an exchange rate of Rs 43.445 = US\$1.0 (taken as representative of that period)..

⁴¹ Settlement of state electricity boards dues, May 2001 and World Bank (2005), State Fiscal Reform in India: Progress and Prospects, page 13. The balance accrued interest at Rs.100 billion was written off (see chapter by Rastogi, A. in India Infrastructure Report 2004, pg 24).

the time of issue of these bonds, many states have pre-paid, and only Rs.144.23 billion (US\$ 3.23 billion⁴²) remained as at end-March 2011.

In addition to the above debt restructuring program to link with institutional reform and move toward market access, the role of the RBI is also important. First, as the regulator of the banking sector, the RBI sets the statutory requirements for banks to hold state debt. This increases the acceptability of state securities by the market. Second, the RBI tightened the regulation for use of the overdraft facility by states. Previously, states had resorted to the facility as a way to roll over short-term borrowing to finance structural deficits. The terms and conditions for facility use were formula based and specified. Moreover, the use of the facility by the states is disclosed to the market on an ex-post basis. For example, the market has information on the better performers compared to the chronic-deficit states (table 5 shows that Punjab, Uttarakhand, and West Bengal, depended heavily on this facility during 2010–11 to meet their temporary resource gap). Such information influences market sentiment and spreads, while lowering credit ratings.

Table 5: States Overdrafts and Access to Cash-credit (number of days)

	Special WMA		Normal WMA		Overdraft	
	2009-10	2010-11	2009-10	2010-11	2009-10	2010-11
1	2	3	4	5	6	7
Andhra Pradesh	1	3	—	—	—	—
Haryana	7	10	5	10	—	8
Kerala	18	—	2	—	—	—
Madhya Pradesh	11	—	11	—	—	—
Maharashtra	—	—	—	—	—	—
Karnataka	—	—	—	—	—	—
Nagaland	69	—	45	—	13	—
Punjab	130	133	128	132	29	13
Rajasthan	—	—	—	—	—	—
Uttar Pradesh	8	4	8	4	—	—
West Bengal	95	195	15	113	8	62
Himachal Pradesh	—	—	—	—	—	—
Manipur	—	—	—	—	—	—
Mizoram	29	25	15	15	—	—
Goa	—	—	1	—	—	—
Uttarakhand	69	35	26	12	9	10
Meghalaya	—	1	—	—	—	—
Jharkhand	—	—	—	—	—	—

Note: WMA= ways and means advances. Normal WMA is formula-based, special WMA is after access to normal WMA but is collateralized. ‘—’ indicates no access to facility and strong cash management position.

Source: Reserve Bank of India, Annual report 2010-11

⁴² Exchange rate as at end-March 2011 at Rs 44.65 =US\$ 1.0 (source: IFS).

The intent of the FRL, debt swap, securitization, and the move toward market operation was to support the fiscal discipline reform at the state level to reverse the structural decline of state finance from the late 1990s to the early 2000s. It will be difficult to precisely evaluate the direct impact of these reforms. In this context, a study by Liu and Webb (2010) concludes it would be difficult to precisely separate and measure the effects of the FRL given the lender-borrower nexus and various channels that would influence government fiscal deficits and indebtedness. Nonetheless, it was noted that to the extent the FRL intends to improve government finance and avoid over-indebtedness, it is worthwhile ascertaining whether FRL has been associated with improved fiscal outcomes.⁴³

Liu and Webb (2010) choose growth of public debt before and after passing subnational FRL in several countries, including India. The measurement of the fiscal improvement or deterioration was normalized, since each state government might have passed its FRL in different years. The paper shows that in Indian states, the growth of debt to GSDP was slower in the post-FRL period than in the pre-FRL period for 24 of 26 states. Twenty-one of these 24 states had reversed the trend of increasing debt to GSDP in the pre-FRL period.

A study on the “Dynamics of Debt Accumulation in India” (Rangarajan and Srivastava 2003) pointed to the fact that accumulation of debt can be seen as the result of the balance between cumulated primary deficits and the cumulated weighted excess of growth over interest rate. Decomposing the change in the central government’s liabilities relative to GDP shows that a significant part of the cumulated primary deficit could be absorbed due to the excess of growth over interest rates. However, this cushion is not always available, and the sharp increases in debt relative to GDP during 1997–2003 were because of both factors, that is, cumulated primary deficit and excess of effective interest rate over growth rate.

One study (Milan 2011) shows that strong economic growth relative to the interest rate paid on government debt helped India avoid an explosive rise in debt despite the existence of

⁴³ Corbacho and Schwartz (2007) discuss the problems of determining the direction of causality. Their study compared national fiscal deficits in countries with and without FRLs, and found that the former had smaller deficits. Data on subnational deficits for such cross-country comparisons, however, are not readily available.

successive primary deficits. The same holds true for the aggregate performance of states; figure 6 shows that the fiscal correction phase in states also coincides with a higher GDP growth rate and lower rate of interest paid on state debt. This was also in part the result of fiscal correction, which led to a reduction in government dis-savings and debt. This, however, masks the varied fiscal performance of individual states, which has been mixed over the period, causing concern in the context of the global crisis.

Section 5: Impact of the Global Financial Crisis and Going Forward

Although, the immediate impact of the global financial crisis on state finances was somewhat subdued, there are implications going forward. The challenges will be more on the resource side through reduced central transfers, accentuated by the low-cost recovery by states. These may well render difficult the achievement of the Thirteenth FC road map. Going forward, sustainable finances require states to undertake reforms to maintain solvency via, among other things, increases in own taxes, implementing the goods and services tax (GST), and revising tariffs.

Assessing the impact of the crisis on the center, the immediate impact was relatively “muted” (Milan 2011⁴⁴; RBI 2011). Although there was a setback in the growth of the economy,

⁴⁴ Milan et al. (2011), “Fiscal Policy for Growth and Development in India: A Review” (work in progress).

the bounce back was swift and impressive (Reddy 2011). The countercyclical fiscal and monetary policy actions and, more critically, the high-growth trajectory that was maintained at over 7 percent during 2009–10 and over 8 percent during 2010–11, helped minimize the impact (“World Bank Economic Update,” September 2011). The initial conditions—the relatively low external debt, the high foreign reserves, and selective capital controls—helped reduce the impact of the external shocks. Nevertheless, worries remain because of the high general government deficit and public debt levels.⁴⁵ It is widely acknowledged that high levels of deficit and debt reduces “elbow room” and the ability to borrow and respond to such shocks and extreme events.

On the growth front, there is concern of a slowdown in the next two years (World Bank 2011),⁴⁶ as a result of uncertainties weighing down investment, tighter macroeconomic policies intended to contain inflation, and the base effect of the strong agricultural rebound during 2010–11. Slow growth in the core Organisation for Economic Co-operation and Development countries implies that the domestic drivers for growth will need to be strengthened. Moreover, there is a realization that concerted efforts will be necessary to avoid fiscal slippages by the center during 2011–12, especially if the rise in commodity and fuel prices continues at an elevated level. The sustainability of the fiscal stance will, however, need measures to control, if not compress, expenditures along with revenue augmentation.

Turning to the states, the impact of the global crisis got intertwined with the wage rise, and the fiscal situation deteriorated during 2009–10. On the revenue front, there was a reduction in revenue receipts during 2008–09 and 2009–10, reflecting a fall in the state share of central taxes, which had been affected by the economic slowdown. There was also a deceleration of agricultural output that coincided with the crisis and could in part explain the revenue falls in some states. Expenditures rose primarily because of the revision of pay and salary arrears, which coincided with the crisis years. Of 17 nonspecial category states, 11 had current balance deficits, while the overall fiscal deficit widened in all states except Jharkhand and Kerala.

The impact on the management of state debt was, however, insignificant, reflecting in part the strengths of the state borrowing regime, with its ban on borrowing abroad; the limited

⁴⁵ The high fiscal deficits for the general government, which averaged around 8 percent of GDP in the 1990s and 2000s, are expected to have reached 10 percent of GDP in 2009–10, with debt averaging over 80 percent of GDP in the 2000s (World Bank, September 2011).

⁴⁶ “World Bank India Economic Update,” September 2011.

history of bailouts; and the enactment of FRLs. During 2008–09 and 2009–10, countercyclical measures were taken by states to mitigate the impact of the crisis on domestic economic activity. These included relaxing the deficit levels to 3.5 percent of GDP (from 3 percent legislated under the FRLs). Further, the center allowed states a larger share of market borrowings to compensate for the unprecedented impact of exogenous factors on the fiscal situation. Concomitantly, states increased market borrowings by 34.6 percent and 28.6 percent during 2008–09 and 2009–10, respectively, compared with the increase of 23 percent during 2007–08. Interestingly, a positive impact of this was an improvement in the interest profile of states, with the share of high-cost market loans (with an interest rate over 10 percent) declining further during 2009–10.

It needs to be emphasised, however, that macroeconomic stabilization and countercyclical policy actions are the key responsibility of the center and not of subnational governments. Accordingly, the Thirteenth FC recommended that instead of raising the borrowing limits for states in the event of such shocks, the center should assume the entire responsibility for the additional resource mobilization and pass these to states in the form of increased devolution. This (formula-based) devolution will meet the differential requirements of the states in terms of both fiscal capacity and fiscal need.⁴⁷

Much of the deterioration in the fiscal position of the states during that period was temporary, and thus could be attributed to deterioration in the share of central taxes because of the crisis and arrears of pay revision (Reddy 2011). Although the fiscal deficit had deteriorated to 3.3 percent of GDP during 2009–10, indications were positive for a turnaround in 2010–11, as reflected in the study of aggregate state budgets by the RBI. It also appears that fiscal discipline at the state level may have acted as a source of comfort for the market. This is corroborated by the fact that after witnessing some stress during the initial period of the global financial crisis, most states reverted to the path of fiscal consolidation, with lower deficit ratios during 2010–11.

In sum, even though the immediate impact of the global financial crisis on state finances was somewhat subdued, this has implications going forward. The challenges are likely to emerge through the reduced impact of central transfers, given that the center's deficit has not shown signs of abatement. The overall current transfers to states are budgeted to decline by 0.4

⁴⁷ Thirteenth Finance Commission, Chapter 9, p. 136.

percentage points of GDP during 2010–11 (RBI 2011). Going forward, sustainable state finances requires reforms to increase states' own tax revenues by speedily implementing the goods and services tax. Implementation of this tax is expected to reduce vertical imbalances, with states being able to tax the services sector (the fastest-growing sector, which accounts for over 65 percent to GDP), and provide gains to India's GDP of 0.9 percent to 1.7 percent (Thirteenth FC).

States also need to review their tariff policies, particularly in power and irrigation, to ensure that the gap between costs and recovery is narrowed, if not closed. It is estimated that for the power tariff, even for the best-performing states, increases of 7 percent per year are required to bridge the cost-to-recovery gap, while the not-so-good performers require increases of almost 19 percent per year (Thirteenth FC). If not rectified, these issues will render the achievement of the Thirteenth FC road map difficult.

Another critical issue is that, although in the aggregate, states have contained their fiscal accounts, the impact needs to be evaluated in the context of the contingent liabilities, which include not only guarantees, letters of comfort, and liabilities of state-owned enterprises, but also implicit contingent liabilities arising due to vulnerabilities in the state PSUs and pensions. Especially if tight liquidity conditions impact the health of the state-owned enterprises and PSUs, fiscal risks could spill over onto states' fiscal positions. Although these must be addressed more from the perspective of the fiscal risks that arise from such contingent liability, it is important to keep them in mind.

Section 6: Conclusion

Although states have faced fiscal stress, systemic insolvency and defaults have not occurred because of a mix of factors. The significant growth rates of the Indian economy in the late 1990s and 2000s have also played a critical role in alleviating the interest burden on debt and ensuring that the debt does not grow in an explosive trajectory. The serious efforts at fiscal consolidation and institutional reforms enabled states to get on the path toward fiscal correction. In addition, the restriction on borrowing and the constitutional arrangements enabled the onset of fiscal correction in an appropriate manner.

Furthermore, lowering the interest burden on debt was important in enabling the states to pursue a sustainable course. The approach to debt relief, linked with incentives to implement

reforms, has greatly helped avoid moral hazard problems. However, while the focus has been mainly on direct debt obligations, contingent liabilities pose a serious fiscal risk on states finances, unless monitored and adequately controlled. Moreover, the aggregate picture masks interstate disparities and vulnerabilities, which require customized reforms and correction packages rather than a “one-size-fits-all” approach.

The change in lending policy and patterns of borrowing has provided greater flexibility, but also more responsibility to states, with market discipline becoming an important plank. The greater access to resources from the market requires more active debt management and strategy development, using robust analysis to ascertain the cost-risk of the debt portfolio. Strengthened debt management capacity institutional arrangements at the state level, with a more active risk management approach, will be required to meet future challenges.

Although the global financial crisis has had a relatively insignificant impact on Indian states, policy makers must always be cognizant of the fact that despite an absence of systemic insolvency and defaults, high debt reduces the maneuverability and flexibility of policy to respond. However, it needs to be emphasized that countercyclical policy is the responsibility of the federal government and not of subnational governments. If at all the fiscal deficit targets are to be relaxed to overcome cyclical downturns, then that should be done by the federal government, which can increase its borrowing and pass it on via higher devolution and grants to the subnational governments. This means that the subnationals’ fiscal deficit targets are unchanged. Fiscal challenges remain and are likely to be critical if the rise in commodity and fuel prices continues at an elevated level. There are concerns that growth might slow to 7 to 8 percent in the next two years (World Bank 2011). This could generate the dilemma of needing to compress expenditures for ensuring fiscal sustainability while simultaneously needing countercyclical spending to boost growth.

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