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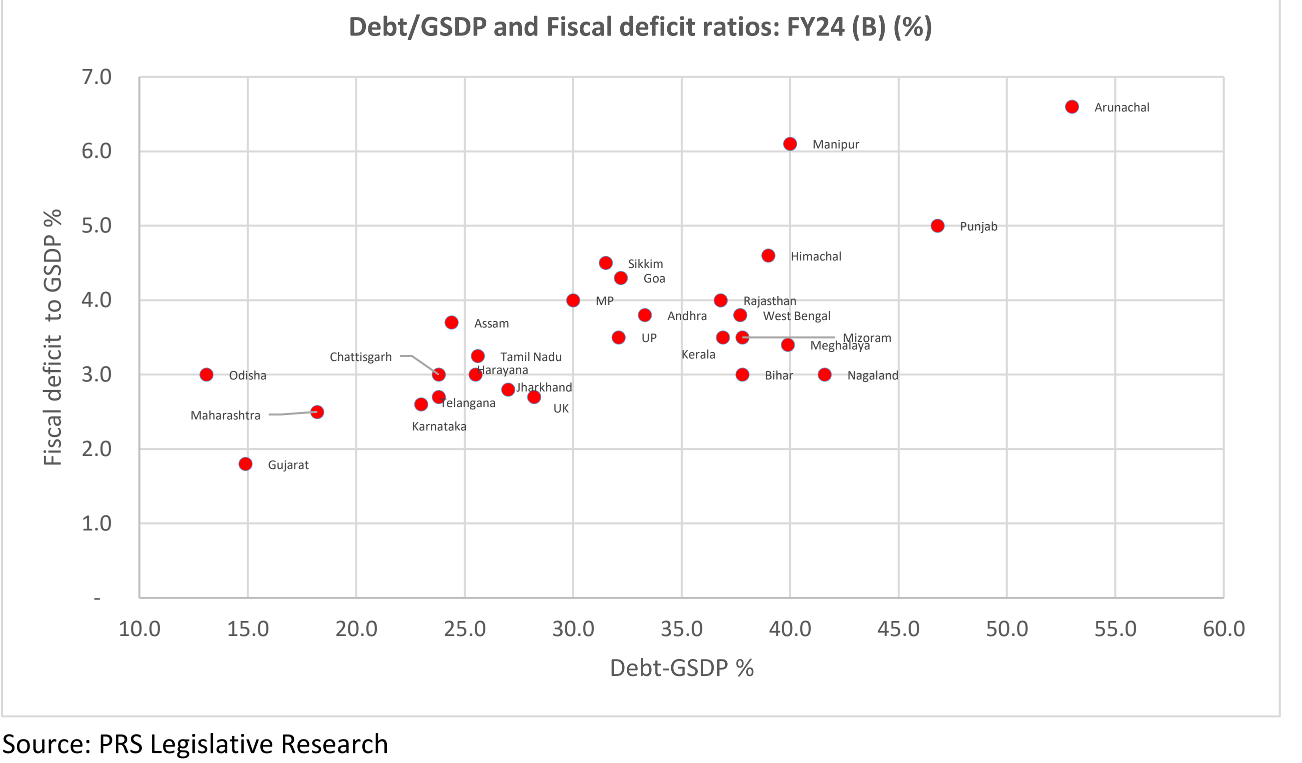
The question of state debt

An issue that has been irking policy makers is the rising level of state debt. In FY23, based on the budgeted numbers, total liabilities of all states put together was projected at 29.5% of GDP. In FY21 it had peaked at 31.1% (RBI). Hence there has been some improvement. However, this level is still a long distance away from the 20% mark which has been proposed under the revised FRBM. In this context, it would be interesting to see how states have positioned their debt levels for FY24. Information is available for 27 states from the data analyzed by PRS Legislative Research.

The chart below plots the debt to GSDP levels of various states against the fiscal deficit ratios. The two are inter related as the fiscal deficit in any time period adds to the level of borrowing as well as the outstanding debt of the entity. Therefore, typically as states run higher fiscal deficits, the level of outstanding debt also increases (after adjusting for repayments). For FY24, the coefficient of correlation between the two for 27 states was high at 0.74. This means that states with higher fiscal deficit ratios also tend to have higher debt/GDP ratios which sounds logical.



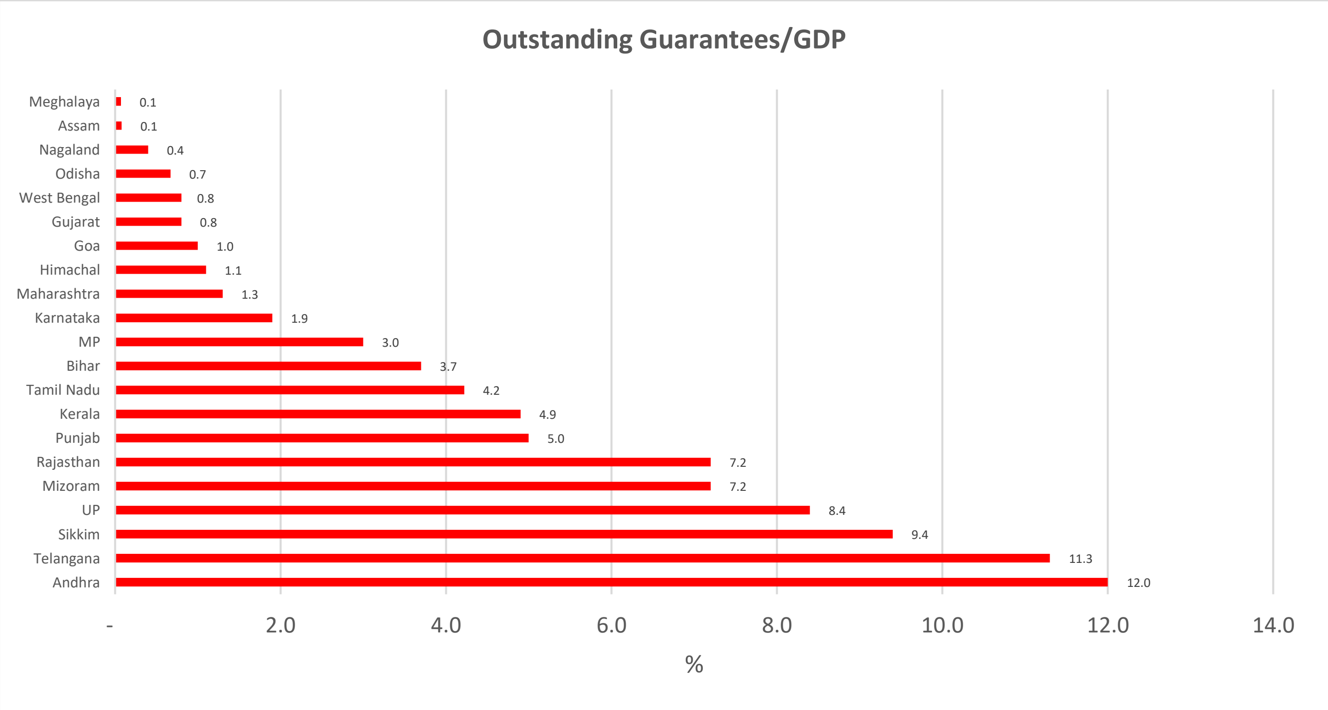
Source: PRS Legislative Research

The Chart makes some revealing points.

1. There are only 3 states which have a debt-GSDP ratio of less than 20%. Hence when the country is aiming to bring down the aggregate ratio to 20% intuitively it can be seen that this will take a lot of time. Odisha, Gujarat and Maharashtra are the prime performers here.
2. There are another 4 states, Karnataka, Telangana, Assam and Chhattisgarh which are at a level of less than 25%, while 5 others, Tamil Nadu, Haryana, Jharkhand, Uttarakhand and MP have ratios between 25-30%.

3. The balance 15 states have ratios above 30% and would need very strict fiscal monitoring to bring down the debt levels. This would require both lower fiscal deficits as well as higher growth in GSDP.
4. 4 states have levels which raise a red flag: Manipur, Nagaland, Punjab and Arunachal Pradesh. Of these Punjab has the highest size of the budget.
5. On the side of fiscal deficit, 11 have targeted ratios of up to 3% which indicates that they are confident of their finances and are also within control of their future debt levels. Gujarat has the lowest at 1.8% and Maharashtra follows with 2.5%.
6. 3 states have fiscal deficit of 5% and above. These are Punjab, Manipur and Arunachal. If this is juxtaposed with the debt ratios, it can be said that these states will have a challenging time in reducing their debt as they are still to rein in their deficits.
7. There are 3 states that have fiscal deficit ratio of between 4-5.5% and include Goa, Himachal and Sikkim. The balance 10 have ratios between 3-4% (Rajasthan and MP are at 4%), where it may be assumed that the additional space linked with reforms as laid down by the centre are being implemented.

While debt levels are the ones that are monitored on a regular basis, the contingency liabilities of government are also important. State run utilities especially in the areas of power, transport and irrigation are the ones relevant here. These units tend to subsidize their consumers in conjunction with the government and run high debt levels that are in turn guaranteed by the government. These would be only contingency liabilities of the state as the entities are independent companies which borrow money. The outstanding guarantees of state governments can be looked at in the chart below.



Source: PRS Legislative Research

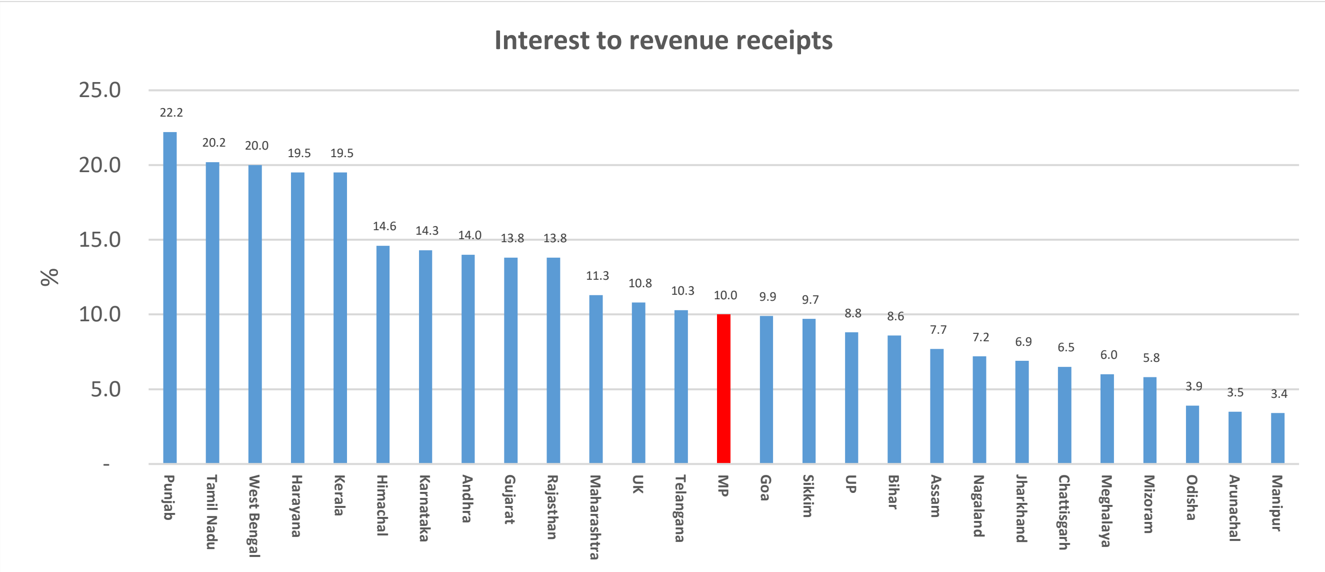
Information for 21 states has been presented in the chart and presents the outstanding guarantees to GDP for the latest period that is available, which can be FY21, FY22 or FY23. The states of Andhra and

Telangana have been most aggressive here and post the carving of two states have dealt actively outside the Budget. UP, Tamil Nadu, Rajasthan and Kerala also have high levels of guarantees with concentration in the power sector (UDAY has been partly successful in migrating contingent liabilities on to the books of the state). Punjab, Mizoram, Sikkim are other states that have given high levels of guarantees to their commercial entities.

This is another aspect of debt that has to be monitored because while the probability of invocation of guarantees is low, it pressurizes the states nonetheless and is not looked upon positively in the context of fiscal prudence.

Impact of high debt

The rising debt levels puts pressure on the state finances in terms of servicing commitments. As debt increases so does the interest outgo, which in turn puts pressure on the revenue account as a larger part of the revenue receipts are used to pay interest which means that less is left for other purposes. The Chart below presents data on how states are placed for FY24 on this score. The interest to revenue receipts ratio (debt servicing ratio) is provided for the 27 states.



Source: PRS Legislative Research

There is significant variation in this ratio across states from 22.2% in case of Punjab to 3.4% for Manipur (which also has high debt ratios). The median for this set is 10% for Madhya Pradesh. Here interestingly the smaller states have low debt servicing ratios compared to the larger ones. Punjab, TN, West Bengal have ratios of above 20% while Haryana and Kerala are almost at 20%. Clearly the larger states are more pressurized than the smaller states in this context.

Putting all the pieces together

Odisha is probably the best placed state when it comes to debt. The debt to GDP ratio is the lowest and there are low contingent liabilities. The fiscal deficit too has been within the FRBM norms and the debt servicing ratio very low. This is a position of both comfort and strength.

Gujarat and Maharashtra have ideal debt ratios with the fiscal deficit being reined below the 3% mark. Gujarat has lower guarantee ratio compared with Maharashtra which is also at a low level of 1.3%. The debt servicing ratios, though above the median level, are manageable.

Punjab is probably the one state that is pressurized on all scores - debt ratio, fiscal deficit, guarantees and debt servicing. Manipur and Arunachal have high debt ratios but are comfortable with the servicing aspect. Himachal Pradesh is however more vulnerable as the debt servicing ratio is high. Andhra and Telangana have the highest guarantee levels which stands out more for the former where the debt levels are also high. This has kept the debt servicing ratio at 14%. West Bengal too has been working with high debt levels which has pushed up the debt servicing ratio. Tamil Nadu on the other hand has debt levels of around 26% which is more reasonable but has a high servicing commitment. This goes along with high levels of guarantees.

There is definitely need for reforms at the level of state finances. To begin with the guarantee system needs to be relooked at again as such assurances do keep entities less responsible for their business. Second, the fiscal deficit ratio of 3% has to be maintained with greater firmness as the present dispensation of allowances being given for various purposes has tended to also put burden on debt levels and debt servicing. Ideally the debt to GDP ratio should also be pegged to 25% as a short term goal and the interest to revenue receipts ratio targeted at around 15%. This can be a good beginning with roadmaps drawn up for various states.

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