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ANALYSIS OF STATE DEBT AND OPERATIONALISATION OF BORROWING LIMIT: A STATE LEVEL ANALYSIS

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Introduction

The combined Debt to GDP ratio of the Union and the States after reaching its peak during Covid-19 pandemic at 89.6 per cent of GDP has started declining. As per the 2023-24 Union Budget estimates, the combined debt of Union and States is estimated to be 81.6 percent of GDP. The combined fiscal deficit has also declined sharply from its peak of 13.1 percent in 2020-21 to 8.6 percent in 2023-24. This decline in debt and deficit is similar to the trend of decline in the global public debt to GDP ratio. As per the IMF Fiscal Monitor 2024, global public debt to GDP ratio has declined from 99.4 to 93.2 percent during 2020 to 2023. However, it remains significantly higher than its pre-Covid level. In India, as per the FRBM review committee's recommendations and subsequent amendments to the FRBM Act in 2018, the debt to GDP ratio of the general government was expected to be brought down to 60 percent of GDP by 2024-25. However, the ratio is significantly higher than the target level.

Apart from the elevated levels of debt and deficit, quality of fiscal deficit continues to be a major concern. As per 2023-24 Union Budget, the share of the revenue deficit is expected to be around 53 percent of the gross fiscal deficit of the Government of India. For 18 major states, the same ratio for the year 2023-24 is estimated to be 28%.[1] Starting from 1979-80, revenue deficits—indicating borrowing to finance current expenditures—became a permanent feature of Union budget. From 1987-88 onwards, revenue deficits characterized states budgets as well. Finance Commissions from FC-XI onwards have been mandated to suggest specific measures to restructure finances of the Union and the States.

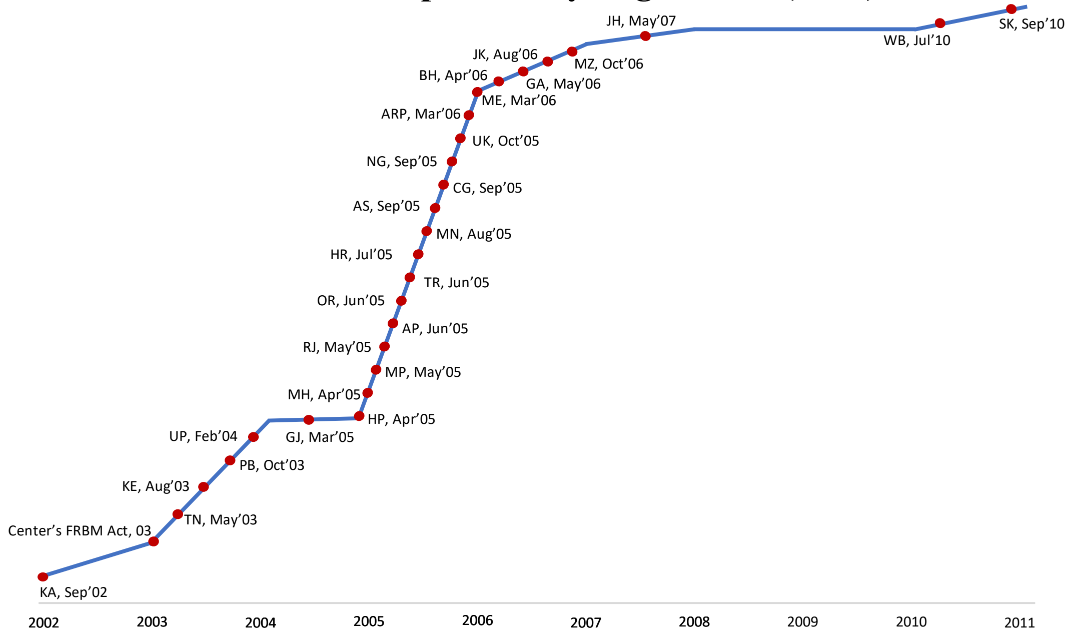
An important component of any restructuring program is defining targets for revenue and fiscal deficits, both for the Union and the States. In India, the Union government enacted FRBM Act in 2003, which required time-bound reduction in revenue and fiscal deficits of the Union government.[2] Subsequently, States enacted their respective fiscal responsibility legislations (FRL) based on the recommendations of the Twelfth Finance Commission. The timeline of the introduction of State specific FRL is presented in Figure 1.

[1] https://forumforstatestudies.in/16th-finance-commission/issues-before-the-sixteenth-finance-commission/

[2] The Maastricht Treaty imposes two convergence criteria on members of the European Monetary Union: (i) each country's annual budget deficit must not exceed 3 percent of its GDP, and (ii) a country's public debt stock must be 60 percent or less of its GDP.

Figure 1

Timeline of Fiscal Responsibility Legislature (FRL) for States



The series of changes in the FRBM Act of the Union government are presented in Box 1. These changes need to be viewed in the context of general government debt. While the share of the expenditure of all the states put together is about 60%, the accumulated public debt of the states stands at only 30 percent of the country's GDP. Conversely, though the expenditure responsibilities as per the Constitution, under the Union is only 40 percent, their accumulated debt is around 58 percent of GDP. Hence deficits at the State level cannot be viewed in isolation but in a consolidated manner taking into consideration both Union and State debt.

Post the introduction of rule based fiscal control, significant fiscal corrections were observed at both the Union and the State level. The rules to monitor fiscal prudence also have undergone significant changes over the years. Specific economic circumstances have also played a major role in the relaxation of fiscal rules. Escape clause was introduced in the fiscal rules in the year 2018 through the amendments to the FRBM Act of the Union government. The escape clause allows the government to breach the deficit targets, on account of national security, act of war, national calamity, collapse of agriculture, structural reforms and decline in real output growth upto a maximum of 0.5 percent of GDP (Refer to Box 1). Though state FRLs do not have any escape clause, states borrowing limits were enhanced on many occasions to deal with the macroeconomic uncertainties and crisis. Since the current fiscal situation is characterized by elevated levels of debt and deficit of the Union and the State governments, the objective of this paper is to examine issues related to State debt keeping in view the federal context of general government debt management both by the Union and the States.

Box-1: FRBM Act of the Union government and its amendments

2003

- Central government to take appropriate measures to reduce the fiscal deficit and revenue deficit, so as to eliminate the latter by 2007-08 and thereafter build up an adequate revenue surplus. (Target date modified to 31st March, 2009 through the Finance Act, 2004.)
- Central government shall lay in each financial year before both houses of Parliament, three statements relating to
    - Medium Term Financial Policy Statement
    - Fiscal Policy Strategy Statement, and
    - Macroeconomic Framework Statement

2012

- The FRBM Act was amended through the Finance Act 2012. The rules contained a revised target of 2 per cent of GDP by 31 March 2015 for revenue deficit and for fiscal deficit of not more than 3 per cent of GDP by 31 March 2017.
- A new fiscal indicator of effective revenue deficit (ERD) was introduced. It is computed by excluding revenue expenditure incurred on 'grants for creation of capital assets' from the revenue deficit. The target for elimination of ERD was set at 31st March 2015.
- The target date for all three fiscal indicators was pushed to 31 March 2018 by amendment of the Act in May/June 2015.
- The target date for effective revenue deficit was deferred to 31 March 2019 in Budget 2016-17 through MTFP statement and then was subsequently deferred to 2019-20 in budget 2017-18.
- Amended FRBM Act and Rules required the Government to lay down another Statement, viz. Medium Term Expenditure Framework (MTEF) Statement besides other three policy statements
- On the recommendation of the 13th Finance Commission, the Act was amended by an insertion of Section 7A, which allowed the Union government to entrust the CAG with the authority to review compliance with the Act. This is meant to improve compliance as CAG audit reports are placed before both Houses of Parliament.

2018

- Government debt became the primary anchor, with the fiscal deficit as the key operational target. The fiscal deficit was to be reduced to 3 per cent of GDP by the end of financial year 2020 21.
- The concept of total liabilities of central government was replaced with **'Central Government Debt'** which includes include the total outstanding liabilities on the security of the Consolidated Fund of India and Public Accounts plus financial liabilities of any body, corporate, or other entity owned or controlled by the Central Government, which the Government is to repay or service from the Annual Financial Statement.
- The amendment also incorporated the concept of "**General Government Debt**" which the Act defined as the sum total of debts of the Central Government and the State Governments, excluding inter-governmental liabilities.
- The target for the General Government debt was set at 60 per cent of GDP and Central Government debt was set at 40 per cent of GDP to be achieved by the end of financial year 2024-25.
- Expansion of **escape clauses** on which the Union Government is allowed to breach the deficit targets, including national security, act of war, national calamity, collapse of agriculture, structural reforms and decline in real output growth. However, any deviation from the fiscal deficit target shall not exceed 0.5 per cent of GDP.
- In case the real output growth of a quarter increases by at least 3 percentage points above its average of the previous four quarters, fiscal deficit must be reduced by at least 0.25 per cent of GDP in a year.

Source: Various CAG reports, Fifteenth finance commission report.

The specific issues examined in this paper consist of a detailed understanding of debt profile of major states and operationalisation of borrowing limits/fiscal rules at the State level under various regimes of fiscal rules recommended by the successive Finance Commissions. In this context, it is important to note that adherence to the borrowing limits were also incentivized by successive Finance Commissions. These incentives can be divided into following broad categories: (a) incentivize States by providing debt relief and incentive grants to achieve fiscal prudence (by Twelfth and Thirteenth Finance Commissions), (b) incentive for higher borrowing for capital expenditure (by the Fourteenth Finance Commission) and (iii) incentivization of economic reforms by providing additional borrowing to States (by the Fifteenth Finance Commission). Specific economic circumstances that changed the fiscal rules were the Global Financial Crisis of 2008, the Covid-pandemic and the need for reform in the power sector at the State level. We examine how different regimes of fiscal rules have worked at the State level during the award period of the Twelfth to Fifteenth Finance Commissions.

Apart from the Introduction, this paper has following sections. In Section I, we analyses the debt and deficit profile of States and incidence of debt servicing cost on individual State Budget. Section II discusses the management and operationalization of fiscal rules across finance commissions from twelfth to fifteenth. In this section, we also examine various provisions for additional borrowings over and above the FRBM limits recommended by fourteenth and fifteenth finance commissions. about Section III analyses emerging fiscal risks. Section IV concludes.

1. Debt, deficit and interest burden – A state level analysis

The issue of state debt was referred for the first time to the second finance commission. Successive finance commissions (FC) have been mandated to review the debt position of States and suggest relevant measures for its appropriate management.[3] For an overall perspective, we start this section by discussing the debt position and the fiscal and revenue deficit of the Union and the States.

Figure 2 shows the ratio of the combined liabilities to Gross Domestic Product (GDP) for the Union and the States from 2000-01 to 2022-23. During this period, the ratio peaks on two instances – the first one occurred during the early 2000s when the ratio was about 85 percent (2003-04) and the other (relatively steeper rise) of about 89 percent occurred in 2020-21 due to Covid-19 pandemic. For about a decade between 2009-10 and 2018-19, this ratio remained more or less stable at around 70 percent. During the period under review, the 60:30 ratio of liability-GDP has been maintained, between the Union and the States. However, from a low of about 22 percent in 2013-14, states have experienced a rise in the liabilities-GDP ratio to about 30 percent currently. This is primarily due to the power sector liabilities being brought on the States books of accounts and Covid-19 pandemic induced rise in the fiscal deficit.

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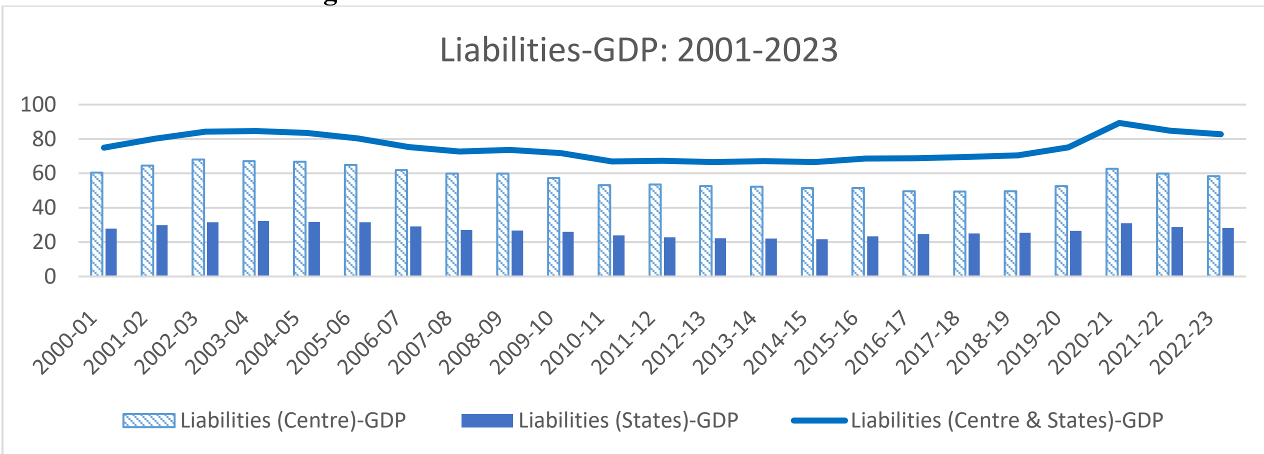
[3] Chapter 12 of 12th FC report discusses evolving FC approaches in relation to states' debt position.

Figure 2: Total Liabilities-GDP for Union and States



Note: Source: RBI. Liabilities (Centre) consists of internal (market loans, 91/182/364 days Tbills, small savings, deposits & provident funds and reserve funds) and external liabilities. Liabilities (States) consists of market loans, comp & other bonds, WMA from RBI, Loans from banks and other institutions, special securities issued to NSSF, loans & advances from central government, State Provident Funds and Insurance and Pension Fund Trust and Endowments, etc.

Gross fiscal deficit (GFD) and revenue deficit as a share of GDP of the Union and States are shown in Figures 3 and 4, respectively. As Figure 3 shows, fiscal deficit of the Union government has been driving the overall deficit trend between 2000 and 2023. Between 2000-2023, on an average GFD-GDP for the Union and the States was about 5 percent and 3 percent, respectively. A similar trend was observed with the revenue deficit. As seen in Figure 4, the states recorded revenue surplus between 2006-2009 and for a couple of years between 2011-2013.

Figure 3: Gross Fiscal Deficit-GDP (Union & States)

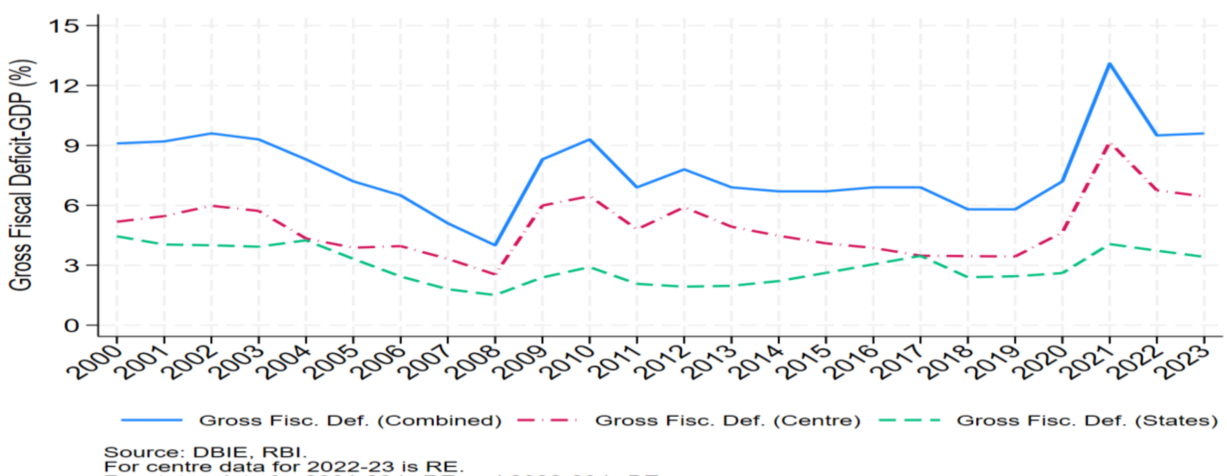


Figure 4: Revenue Deficit-GDP (Union & States)

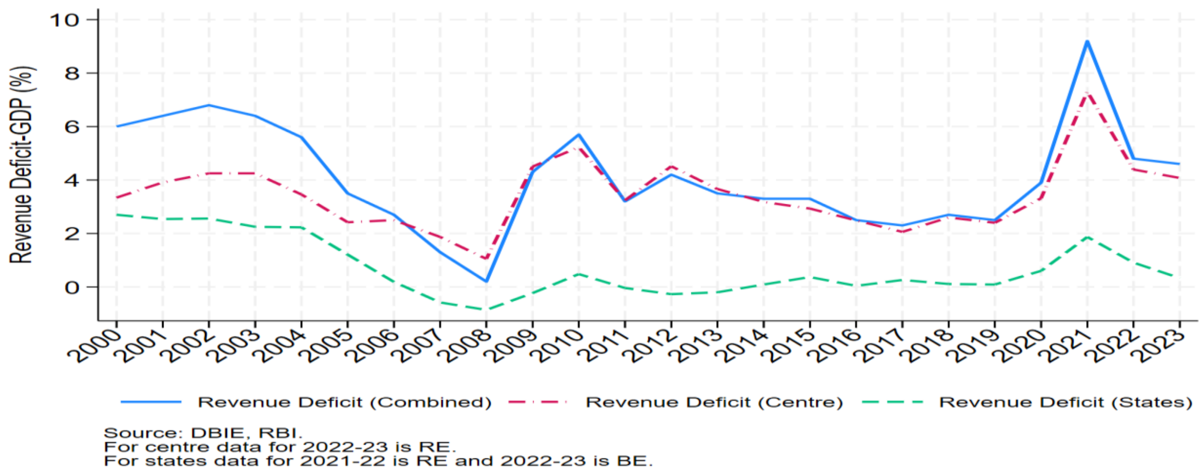
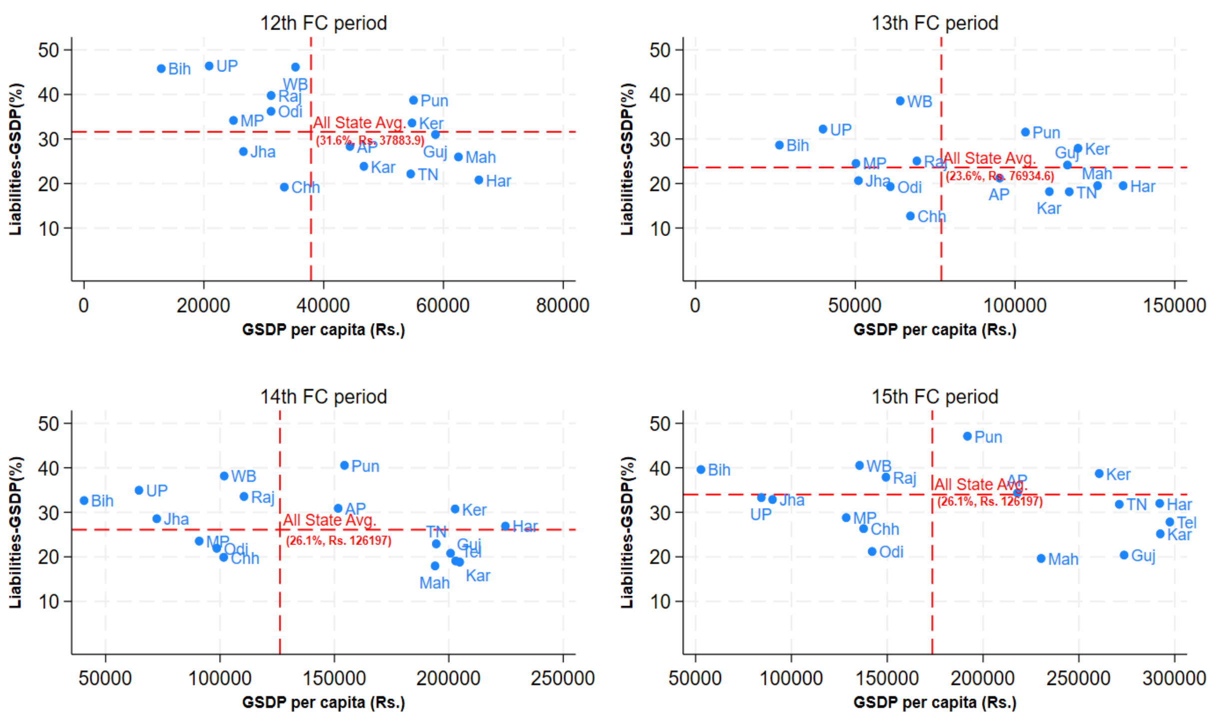


Figure 5: Liabilities as a share of GSDP vs. GSDP per capita across FC award periods



Note: Source: RBI, MOSPI. Liabilities-GSDP shows the average of the ratio for the award periods under consideration. For the 15th FC period data was taken until 2022-23 RE. Dotted lines show the average across 17 general category states for Liabilities-GSDP and GSDP per capita for any particular FC award period.

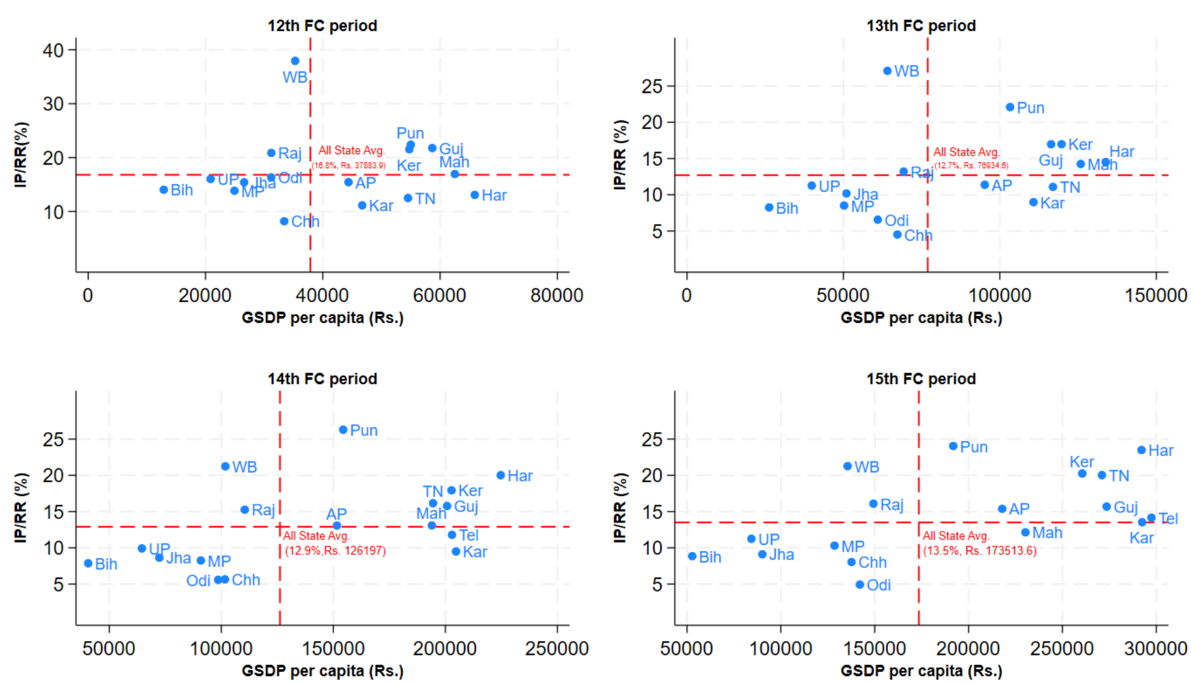
State's liability position vis-à-vis their GSDP per capita is presented in Figure 5 covering the award periods of 12th (2005-06 to 2009-10), 13th (2010-11 to 2014-15), 14th (2015-16 to 2019-20) and 15th (2020-21 to 2025-26) FCs. The dotted lines denote the average liability-GSDP and GSDP per capita across four FC periods. States above (below) the horizontal lines have higher (lower) than average liability-GSDP and those to the left (right) of the vertical line are those with lower (higher) than average GSDP per capita. Accordingly, we segregate states into "high debt" (HD) or "low debt" (LD) (given their placement in comparison to horizontal dotted line) and "high income" (HI) or "low income" (LI) (given their placement in comparison to horizontal dotted line).

Across FC periods, Gujarat improved its position from a marginally high debt state to a relatively low debt state, whereas, Andhra Pradesh gradually inched up to a high-debt state. Karnataka, Haryana, Maharashtra, and Tamil Nadu, remain in the LD-HI category states across FC periods. However, among these, Tamil Nadu and Haryana experienced higher Liabilities-GSDP ratio in the recent times.

Figure 6 shows the interest payments to revenue receipt (IP/RR) ratio across FC periods. Among the HI states, Kerala had an above average IP/RR across FC periods. Also, Tamil Nadu showed a gradual rise in the IP/RR. Punjab also has seen a significant increase in IP/RR over the FC periods.

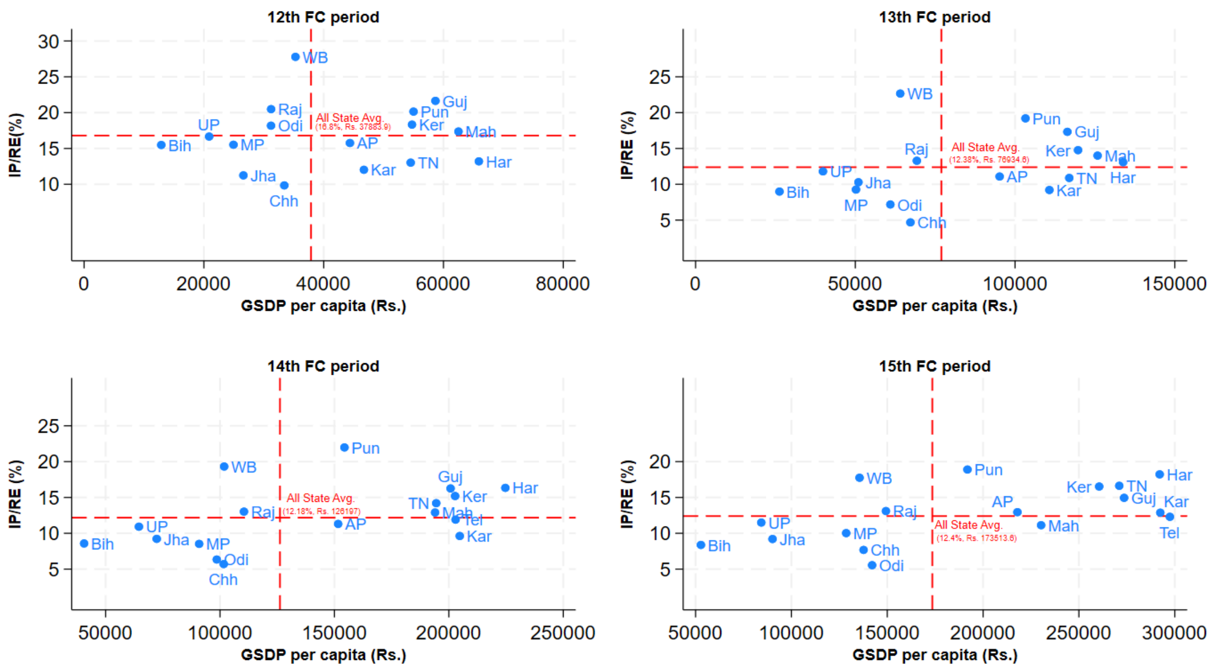
Figure 7 depicts the interest payment as a share of revenue expenditure (IP/RE) against the GSDP per capita for seventeen states across four FC periods. The results are close to that observed in Figure 6. Among the low income states, West Bengal and Rajasthan maintained their status quo of remaining in the high IP/RE category across FC periods. Punjab overtakes West Bengal in terms of higher IP/RE in recent years. Moreover, almost all high income states experienced gradual rise in the IP/RE over the years spanning the four FC periods. Higher interest payments for low income category states imply that there is less fiscal space available for primary expenditure.

Figure 6: Interest Payment-Revenue Receipts vs. GSDP per capita across FC award periods



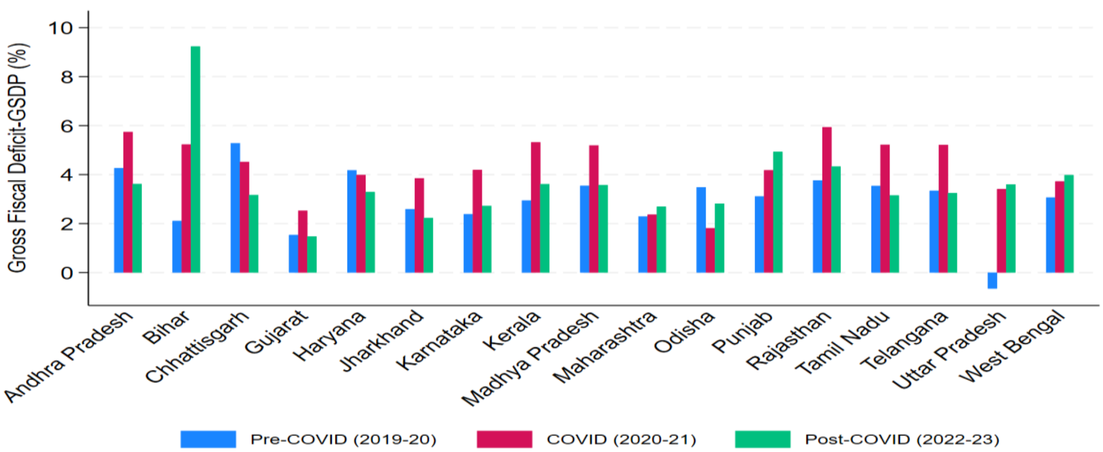
Note: IP/RR and GSDP per capita are averages over the award periods under consideration. For the 15[th] FC period data was taken until 2022-23 RE. Dotted lines show the average across all states for IP/RR and GSDP per capita for any particular FC award period. Source: Finance Accounts.

Figure 7: Interest Payment-Revenue Expenditure vs. GSDP per capita across FC periods



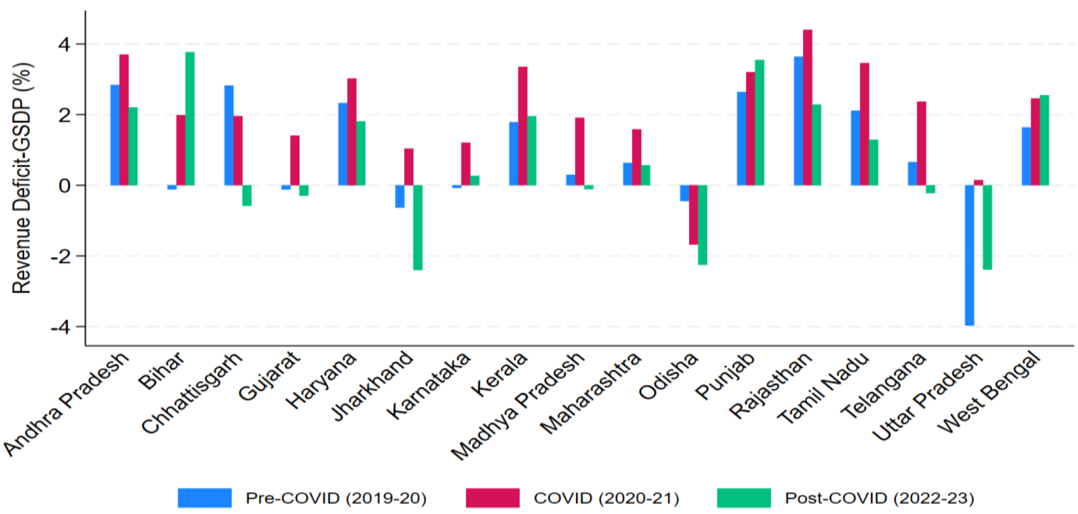
Note: Source: RBI. IP/RE and GSDP per capita are averages over the award periods under consideration. For the 15th FC period data was taken until 2023-24 BE. Dotted lines show the average across all states for IP/RE and GSDP per capita for any particular FC award period.

Figure 8: Fiscal Deficit/GSDP across states Pre and Post COVID



Source: Finance Accounts

Figure 9: Revenue Deficit-GSDP across States Pre and Post COVID



Source: Finance Accounts

Figure 8 and Figure 9 show the pre-and post-Covid fiscal situation. Though post-Covid fiscal imbalance is different across states, three important observations in this context are worth highlighting: (i) All the states had seen a significant rise in fiscal and revenue deficits during the Covid-period compared to their pre-Covid levels. The highest increase was observed in Rajasthan while the lowest was in Odisha; (ii) All the states have witnessed post-pandemic fiscal correction on both the revenue and fiscal accounts. States that generated post-pandemic revenue surplus in the year 2022-23 are Chhattisgarh, Gujarat, Jharkhand, Madhya Pradesh, Odisha, Telangana and Uttar Pradesh; (iii) The correction in the fiscal position of the States post-pandemic was on account of the underutilization of the additional borrowing space provided by the finance commission in 2021-22.

2. Operationalizing the borrowing limit

Starting from FC-XI onwards, finance commissions have recommended borrowing limits for states. Over time, these limits were modified/enhanced in response to the exogenous shocks to the economy such as Global Financial Crisis of 2008 and the Covid-pandemic. Moreover, fifteenth FC (FC-XV) tried to drive power sector reforms by making a provision for additional borrowing contingent on undertaking specified reforms in the power sector. This section evaluates individual State's performance within the framework of compliance of borrowing limits prescribed by twelfth to fifteenth finance commissions.

3.1 A review of framework of compliance by various Finance Commissions

Eleventh commission (FC-XI) gave an overall fiscal deficit target of 6.5 percent of GDP to be reached by 2004-05 with Union's target being 4.5 percent and State's target being 2.5 percent of the GSDP while revenue deficit of all states was targeted to fall to zero. Further, the commission recommended setting up an incentive fund in the form of a Fiscal Reform Facility (FRF) which linked 15 percent of the revenue deficit grant recommended by the FC to the fiscal performance of the states. However, the compliance of FD and RD targets was not mandatory and consequently, both the Union and the States missed these targets.

Twelfth finance commission's (FC-XII) plan for restructuring was based on an incentive framework for States. The Finance Commission recommended a Debt Consolidation and Relief Facility (DCRF) for States[4] with the condition that they could avail of such a facility if they enacted a fiscal responsibility legislation that prescribes specific annual deficit reduction targets and eliminate the revenue deficit and reduce the fiscal deficit to 3 percent of GSDP by 2008-09. A combined fiscal deficit of 6 percent of GDP and zero revenue deficit was the target set to be achieved by 2009-10 by the commission. The commission targeted Debt-GDP ratio to be brought down to atleast 75 percent by the end of 2009-10. The commission further suggested phasing out the system of on-lending by the Union government to the states. Wherever unavoidable, such lending should be conducted through a public account rather than the consolidated fund of India. Table 1 summarizes the borrowing limits prescribed for states by the Finance Commissions from FC-XII onwards.

Table 1: Summary of borrowing limits set for States by Finance Commissions

FC	**Fiscal path recommended for States**
XII	**FD -** 3% of GSDP by 2009-10 **RD -** 0% of GSDP by 2008-09 These targets also served as a precondition for availing Debt Consolidation and Relief Facility
XIII	For all general category states except Punjab, Kerala and West Bengal which incurred revenue deficit in 2007-08 - **FD -** 3% of GSDP from 2011-12 to 2014-15 **RD** – 0% of GSDP from 2011-12 to 2014-15 For Punjab, Kerala and West Bengal **FD -** 3.5% in 2011-12 and 2012-13 and 3% in 2013-14 and 2014-15 **RD** – 0% by 2014-15 For North-Eastern and Himalayan (NEH) States **FD -** path to reach 3% by 2014-15 **RD -** 0% during the award period.
XIV	**FD -** 3 % of GSDP from 2016-17 to 2019-20 **Additional conditional borrowing upto 0.5% of GSDP** -Primary condition - no revenue deficit in the year in which borrowing limits are to be fixed and in the immediately preceding year - additional 0.25% if Debt/GSDP < 25% - additional 0.25% if interest payment/revenue receipt ≤ 10% Provision for carry forward of the unutilized borrowing amount in the following year within the award period
2020-21	**FD -** 5% of GSDP.

[4] Debt restructuring scheme consists of two parts (i) rescheduling of all Central loans contracted till 31.3.2004 and outstanding as on 31.3.2005 into fresh loans for 20 years carrying 7.5 percent interest w.e.f. the year a State enacts the Fiscal Responsibility Legislation (ii) A debt write off scheme linked to the reduction of revenue deficit of states.

	Of this, 0.5% - unconditional; 1.5% - conditional. Out of the conditional component, 1% of the GSDP was to be given in 4 tranches of 0.25%, with each tranche linked to specified reform actions related to distribution of electricity, universalisation of the One Nation One Ration card scheme, ease of doing business and revenues of urban local bodies. The remaining 0.50% was permissible if milestones were achieved in at least three out of the four reform areas. **RD** - -0.1% by 2021-22
XV	**FD** - 2021-22 – 4% 2022-23 – 3.5% 2023-24 to 2025-26 – 3% Additional borrowing of 0.5% conditional on power sector reforms **RD** - 2022-23 – -0.5% 2023-24 – -0.8% 2023-24 – -1.2% 2024-25 – -1.7% 2025-26 – -2.5%

While all fiscal indicators improved after the enactment of FRBMA by the Union government in 2003 and the corresponding FRLs by most States from 2005-06 onwards (see Figure 1), they deteriorated following the Global financial crisis of 2008. Thirteenth finance commission (FC-XIII), which came in office when the economy was facing the contraction due to the global financial crisis provided an incentive grant to the States for time-bound reduction of fiscal and revenue deficits from 2011-12 onwards. FC-XIII provided different adjustment paths of fiscal prudence for fiscally stressed state, namely, Kerala, Punjab and West Bengal. Table 1 gives the details of recommended path of fiscal correction for fiscally stressed and other states given by FC-XIII. Further, the commission set a combined debt to GDP target of 68 percent for the general government, split into 44.8 percent for the Union and 24.3 percent for the States. Moreover, the commission recommended extension of the DCRF introduced by FC-XII to the states that have not yet availed this benefit. It further recommended: (a) aligning the National Small Savings Fund (NSSF) to the market rate of interest and resetting interest rates on NSSF loans to States subject to certain conditions; (b) conditional write-off of specified loans given by the Union government to the States. This is the only commission that targeted FD, RD and Debt to GDP ratio. Based on the recommendations, states carried out necessary amendments to their FRLs to avail the performance incentive grants.

Fourteenth finance commission (FC-XIV) brought in two important changes to the existing framework of setting borrowing limits. First, it introduced expansion of borrowing limits based on fiscal performance of states. Second, it introduced a new method of assessing state's GSDP for the purpose of defining borrowing limits (See Box 2). The commission recommended a ceiling on the fiscal deficit at 3 percent of GDP from 2016-17 up to 2019-20 for the Union Government and 3 percent of GSDP for all States. States were given additional borrowing space upto 0.5 percent of GDP conditional on fulfillment of certain conditions related to fiscal prudence (see Table 1). Moreover, if a state was not able to fully utilize its approved borrowing limit of 3 percent of GSDP in any particular year, the unutilised borrowing amount (calculated in rupees) could be availed only in the following year but within the award period of the commission.

Box 2: Methodology to compute GSDP for fixing borrowing limits recommended by FC-IV

For estimating borrowing limit for given fiscal year (t), GSDP should be estimated on the basis of the annual average growth rate of the actual GSDP observed during the previous three years or the average growth rate of GSDP observed during the previous three years for which actual GSDP data are available. This growth should be applied on the GSDP of the year t - 2. Specifically, GSDP for the year (t-1) and the given fiscal year (t) should be estimated by applying the annual average growth rate of GSDP in t - 2, t - 3 and t - 4 years on the base GSDP (at current prices) of t - 2.

Due to Covid-19 pandemic, the Fifteenth Finance Commission (FC-XV) provided flexibility to the Union and the State governments by providing additional borrowing powers to deal with the Covid-induced revenue contraction. As per FC-XV assessment, the general government fiscal deficit which was around 11.6 percent of GDP in 2020-21 was expected to reach 6.8 percent of GDP in the terminal year. For the Union government, the commission gave a path for revenue and fiscal deficit as given in Table 2.

Table 2: Adjustment path for the Union government recommended by FC-XV

Indicator	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Revenue deficit	5.9	4.9	4.5	3.9	3.3	2.8
Fiscal deficit	7.4	6.0	5.5	5	4.5	4
Total liabilities	62.9	61.0	61.0	60.1	58.6	56.6

Source: FC-XV report

For states, the Commission allowed greater flexibility through three channels (a) additional unconditional borrowing space in the first two years of the award period to compensate for the loss of tax revenues; (b) an additional borrowing of 0.5 percentage of GSDP to be allowed to the States in case they meet the criteria for power sector reforms[5]; (c) allowing the states to utilize the unutilised borrowing space in the subsequent years within our award period. The RD and FD path for states is given in Table 1. FC-XV continued the methodology for computation of GSDP suggested by FC-XIV.

[5] An additional borrowing space of 0.5 percent of GSDP for States, during the four-year period 2021-22 to 2024-25 based on 5 conditions around the performance of DISCOMs in the state. For this extra borrowing, the Ministry of Power (MoP) was made nodal agency for monitoring progress of the indicators, based on whose recommendations, Ministry of Finance would make the final decision.

This was preceded by an enhanced borrowing limit provided by the Union government to the states upto 2 percent of the GSDP to deal with the Covid-induced revenue contraction in 2020-21, based on certain conditions (See Table 1).

3.2 Estimated borrowings vs ex-post compliance

FC-XII did not set specific borrowing limits for states, neither had it given a year-wise targets for such a reduction. FC-XII's period coincided with period of transition when states were enacting their respective FRLs (see Figure 1). Thus, we analyse the actual implementation of the borrowing limits from FC-XIII onwards.

Table 3 presents the assessment of estimated borrowing based on estimated GSDP against the actual gross fiscal deficit during the FC-XIII period. States, in aggregate, borrowed less than the borrowing space recommended by the FC-XIII in the first two years, i.e., 2011-12 and 2012-13 but they borrowed more in the following two years. However, the actual fiscal deficit as a percentage of GSDP turned out to be well within the target. This is because, the actual GSDP of States, in aggregate, was much more than the GSDP estimated by the commission.

Table 3: Assessing FD target prescribed by FC-XIII against actual``

Year	Actual GFD	Estimated borrowings	FD (as percent of GSDP)	
			Targeted	Actual
2011-12	168351	185665	3.1	2.3
2012-13	195467	210209	3.1	2.4
2013-14	247850	231352	3	2.6
2014-15	317781	261943	3	3

The aggregate picture, however, hides some state-wise differences. Among the general category states, the three states of Punjab, Kerala and West Bengal all missed the targets throughout the four year period and had fiscal deficit of 3.1, 4.3 and 3.4 percent, respectively, in terminal year, 2014-15. This was despite the actual GSDP turning out to be well above the FC estimates giving them an additional borrowing space over and above the extra limit specified for them by the commission. Andhra Pradesh was another state that consistently missed the target. Chhattisgarh, Jharkhand, Rajasthan and Uttar Pradesh missed the target of 3 percent in the terminal year alone. The deficit numbers for all-states gets compensated by the excessive low borrowings of states such as Maharashtra, Madhya Pradesh, Gujarat and Odisha. Among North eastern and Himalayan states, Himachal Pradesh, Jammu and Kashmir, Meghalaya and Mizoram, Tripura, Uttaranchal missed the targets (See Table 4).

Table 4: Actual Fiscal deficit of states as a percentage of GSDP during FC-XIII period

States	2011-12	2012-13	2013-14	2014-15
Andhra Pradesh	4.3	4.3	3.9	6.1
Bihar	2.4	2.2	2.4	2.8

Chhattisgarh	0.6	1.6	2.7	3.8
Goa	2.0	2.7	2.8	1.5
Gujarat	1.8	2.5	2.4	2.1
Haryana	2.4	3.0	2.1	2.9
Jharkhand	1.4	2.2	1.3	3.3
Karnataka	2.7	2.8	2.8	2.8
Kerala	4.1	4.3	4.3	4.3
Madhya Pradesh	1.9	2.6	2.3	2.2
Maharashtra	1.7	1.0	1.7	1.9
Orissa	-0.3	0.0	1.7	1.8
Punjab	3.3	3.3	2.8	3.1
Rajasthan	0.9	1.8	2.9	3.3
Tamil Nadu	2.6	2.2	2.4	2.8
Uttar Pradesh	2.3	2.5	2.7	3.3
West Bengal	3.4	3.2	3.6	3.4

FC-XIV gave a flexibility of availing a higher borrowing than 3 percent of GSDP based on certain conditions. Table 5 shows the actual gross fiscal deficit of states in comparison to (i) 3 percent borrowing limit and (ii) borrowing limit inclusive of the additional space according to FC criteria[6]. During the first two years of FC-IV period, 2015-16 and 2016-17, states borrowed more than 3% borrowing limit. However, for the next three years, the actual gross fiscal deficit of states was even less than the 3 percent criteria. A major reason for high fiscal deficit in the first two years was the implementation of UDAY scheme in 2015 under which the participating states took over 50 percent of the outstanding debt of DISCOMs as on 30-09-2015 by 31st March, 2016. A total of 16 states participated in the scheme (Misra et al., 2020).

Table 5: Actual gross fiscal deficit against assessed borrowing cap during FC-IV period

Year	Actual gross fiscal deficit	3% borrowing limit	Borrowing limit including the additional borrowing space according to FC criteria
2015-16	420672	382220	404409
2016-17	534330	433490	454931
2017-18	410409	477119	502736
2018-19	464705	554420	585642

[6] We have computed additional borrowing limit by first estimating the states that become eligible for extra borrowing and then aggregating across states inclusive of the additional limits.

Table 6: State's eligible for additional borrowings during FC-IV period

		Additional borrowing	
	Borrowing limit	**States eligible according to FC criteria**	**States eligible according to MoF**
2016-17	3.25%	Bihar, Goa, Gujarat, Jammu and Kashmir, Manipur, Meghalaya, Nagaland, Tripura, Uttar Pradesh, Uttarakhand	Bihar, Meghalaya, Sikkim, Uttar Pradesh
	3.5%	Telangana, Sikkim, Odisha, Madhya Pradesh, Karnataka, Jharkhand, Chhattisgarh	Madhya Pradesh, Odisha, Telangana
2017-18	3.25%	Arunachal Pradesh, Bihar, Gujarat, Jharkhand, Manipur, Meghalaya, Mizoram, Nagaland, Tripura, Uttar Pradesh	Bihar, Jharkhand, Manipur, Meghalaya
	3.5%	Chhattisgarh, Karnataka, Madhya Pradesh, Odisha, Sikkim, Telangana,	Chhattisgarh, Madhya Pradesh, Odisha, Sikkim, Telangana
2018-19	3.25%	Arunachal Pradesh, Bihar, Gujarat, Jharkhand, Manipur, Meghalaya, Mizoram, Tripura, Uttar Pradesh	Arunachal Pradesh, Bihar, Jharkhand, Manipur, Meghalaya, Telangana
	3.5%	Chhattisgarh, Karnataka, Madhya Pradesh, Odisha, Sikkim, Telangana,	Chhattisgarh, Madhya Pradesh, Odisha, Sikkim

Table 6 analyzes states that met the eligibility criteria and could potentially utilize this additional borrowing limit. However, according to the data shared by Ministry of Finance, a lesser number of states are eligible, as indicated in the rightmost column of Table 6. Even among states that became eligible for additional borrowings, not all states utilize it. For instance, Odisha is eligible for an additional borrowing space of 0.5% for all three years listed in the table, but its actual fiscal deficit has remained below even 3 percent during the period. Likewise, Meghalaya, Chhattisgarh and Sikkim have not utilized the extra borrowing space as their actual gross fiscal deficit remained below 3 percent. On the other hand, Bihar, Uttar Pradesh, Telangana and Madhya Pradesh had utilized the additional borrowings as evident from their actual fiscal deficit number.

3.3 Implementation of carry forward and additional borrowing space recommended by FC-IV and FC-XV

In their recommendations, both FC-XIV and FC-XV specified carry forward of unutilized borrowing space by the States within their respective award periods. FC-XIV gave a provision to carry forward the unutilized borrowing amount from year t-1 to year t. However, there was a caveat: this provision could only be availed over a borrowing limit of 3 per cent in the next year, and not a higher limit. As explained in the FC- XIV report

"For example, the borrowing limit of State for 2015-16 is set at 3 per cent of gross State domestic product (GSDP), amounting to Rs. 3,000 on the basis of an estimated GSDP of Rs. 1,00,000. However, the State only avails of Rs. 2,500 as borrowing in 2015-16, under-utilising the borrowing limit by 0.5 per cent of GSDP which amounts to Rs. 500. In such an event, the State would be allowed to borrow over its limit of 3 per cent of GSDP to the extent of Rs. 500 in 2016-17. So, if

the estimated GSDP for 2016-17 is Rs.1,50,000, the State's borrowing limit for 2016-17 would be calculated as follows: 3 per cent of GSDP + 500 = 4500 + 500 = 5000 rupees.

Note, if the State is eligible for flexibility in 2015-16 by fulfilling both debt/GSDP and interest/revenue receipts criteria, and is accorded a borrowing limit of 3.5 per cent of GSDP for that year, but it only utilises 2.5 per cent, then in the following year, that is 2016-17, the State will be eligible to avail only 0.5 per cent (3-2.5=0.5) borrowing in excess of the base limit, which is 3 per cent, and not 1 per cent (3.5-2.5 = 1). So, in 2016-17, the State can borrow 3 per cent of GSDP plus Rs. 500 (corresponding to 0.5 per cent of the last year's GSDP). However, if the State again becomes eligible for flexibility in 2016-17, fulfilling the debt/GSDP and interest/revenue receipts criteria, it will not be allowed to add Rs. 500 to the 3.5 per cent."

Similarly, if a state borrows above its sanctioned borrowing limit in year t-1, the excess amount will be deducted from borrowing limit for year t.

We analyse the pattern of over- or under-utilization of borrowing limit by states. Table 7 shows state-wise assessed cap according to FC-IV criteria against actual gross fiscal deficit in the first year of the FC-XIV award period, 2015-16. As seen in the table, 11 states exceeded their estimated borrowing caps. Among these, Rajasthan, Uttar Pradesh, Haryana, and Jammu and Kashmir exceeded their limits by the largest margin. According to FC's recommendations, the excess amount should be deducted from respective state's borrowing limit for the year 2016-17.

Table 7: State-wise assessed borrowing cap and actual gross fiscal for 2015-16 (Rs crore)

State	Assessed Borrowing cap	Actual GFD	Difference
Andhra Pradesh	17844	21863	4019
Arunachal Pradesh	559	-190	-749
Assam	7152	-3005	-10157
Bihar	14453	12062	-2391
Chhattisgarh	8310	5444	-2866
Goa	1727	1482	-245
Gujarat	32262	23015	-9247
Haryana	15180	31480	16300
Himachal Pradesh	3140	2164	-976
Jammu & Kashmir	3382	8060	4678
Jharkhand	7740	11522	3782
Karnataka	29217	19169	-10048
Kerala	15157	17818	2661
Madhya Pradesh	21765	14065	-7700
Maharashtra	58625	28364	-30261
Manipur	599	341	-258
Meghalaya	918	555	-363
Mizoram	463	-413	-876
Nagaland	739	597	-142

Odisha	11686	7063	-4623
Punjab	11805	17359	5554
Rajasthan	19258	63070	43812
Sikkim	560	520	-40
Tamil Nadu	35785	32628	-3157
Telangana	16295	18498	2203
Tripura	1181	1650	469
Uttar Pradesh	35031	58475	23444
Uttarakhand	5049	6125	1076
West Bengal	28528	20891	-7637

Conversely, 18 states under-utilized their borrowing limits, amounting to Rs 91,735 crore in aggregate. However, according to the FC's methodology, carry forward amount needs to be calculated only from the base limit of 3 percent. Thus these states can carry forward in aggregate of Rs 75,083 to their next year's borrowing limits, subject to their next year's borrowing limit being below 3.5 percent.

Table 8 provides details on the number of states of states whose actual GFD exceeded or fell short of the borrowing limit, along with the respective amounts involved during FC-XIV award period. In 2016-17, against the aggregate borrowing cap of Rs 4,54,931, State's actual gross fiscal deficit was Rs 5,34,330, an excess of Rs 79,399. Out of this, 14 states borrowed in excess of the assessed limit, amounting to Rs 1,54,483, while 15 states borrowed less than the limit. In 2017-18, states collectively borrowed Rs 4,10,409, which was below the assessed borrowing cap of Rs 5,02,736, indicating an underutilization of the borrowing cap by Rs 92,327. Similarly, during 2018-19, states borrowed Rs 4,64,705, which was Rs 1,20,799 less than the cap of Rs 5,85,504.

Table 8: Actual borrowings vs assessed borrowing cap for FC-XIV award period (Rs crore)

Year	Number of states that borrowed more than the cap (amount)	No of states that borrowed less than the cap (amount)
2015-16	11 (1,07,998)	18 (91,735)
2016-17	14 (154483)	15 (75084)
2017-18	11 (24212)	18 (116540)
2018-19	12 (32393)	17 (153192)

In 2020-21, aggregate fiscal deficit of States reached 4.2 percent of GSDP, up from 2.7 percent in 2019-20. Moreover, states, which were in revenue surplus in aggregate witnessed a revenue deficit of 1.1 percent of GSDP. States were granted an extra borrowing limit of 2 percent of GSDP over the 3 percent FRBM target by the Union government. Despite the strained fiscal position of states, states in aggregate, borrowed 1% below the limit.

For the period from 2021-22 to 2024-25, as per the recommendations of the FC-XV, states that implemented reforms in the power sector were allocated an additional borrowing space of 0.5 percent of GSDP annually. In the initial two years (2021-22 and 2022-23), a total of 12 states availed additional borrowing amounting to Rs 66,213 crore, approximately 0.13 percent of the combined GSDP of 2021-22 and 2022-23[7]. This indicates that a significant portion of the available additional borrowing space remained underutilized during this period.

The trend of underutilization of the additional borrowing space recommended by finance commissions raises important questions about the effectiveness of using higher borrowings to induce reforms. States appear to view borrowings primarily as liabilities and are cautious about increasing them due to concerns about future liabilities. This cautious approach suggests that the strategy of providing higher borrowing limits may have limited effectiveness in incentivizing reforms.

Furthermore, there has been a notable shift in the conditions attached to availing additional borrowing space across different finance commissions. For instance, FC-XIV linked additional borrowings to improved fiscal indicators, thereby promoting fiscal prudence as a prerequisite for accessing more funds. In contrast, FC-XV appears to have listed reforms that are not directly tied to fiscal prudence as conditions for additional borrowings. The strategy of using borrowing limits to induce broader reforms may not necessarily be the most effective way of undertaking the reforms as their implementation is left to the borrowing requirements of a state.

3. Fiscal risks and power sector finances

A major fiscal risk for States arises from the power sector losses. State power distribution companies (DISCOMs) have consistently been a significant strain on state finances and have adversely affected the overall performance of the power sector. The fiscal risks from this sector arise due to below-cost tariffs for various consumer groups, the supply of unmetered, free electricity to agriculture, and high aggregate technical and commercial (AT&C) losses. A study by Josey et al. (2024) observed that "The aggregate annual losses of State-owned DISCOMs are comparable to 35% of the aggregate revenue-deficit of State budgets in 2021–22". In the past, there has been several bail outs and the corresponding government interventions (see Table 9), which lead to sudden deterioration of state's fiscal position. For instance, the implementation of the UDAY scheme by 16 States led to a sharp rise in fiscal deficit, outstanding debt and interest payments in 2015-16 and 2016-17 (Misra et al., 2020). From Figure 10, we find that bailout amount of DISCOMs in 2020-21 was considerable and varied widely across major States.

[7] Source: PIB press release

Table 9: Power Sector Reforms at the State Level: Central Interventions and Bailout

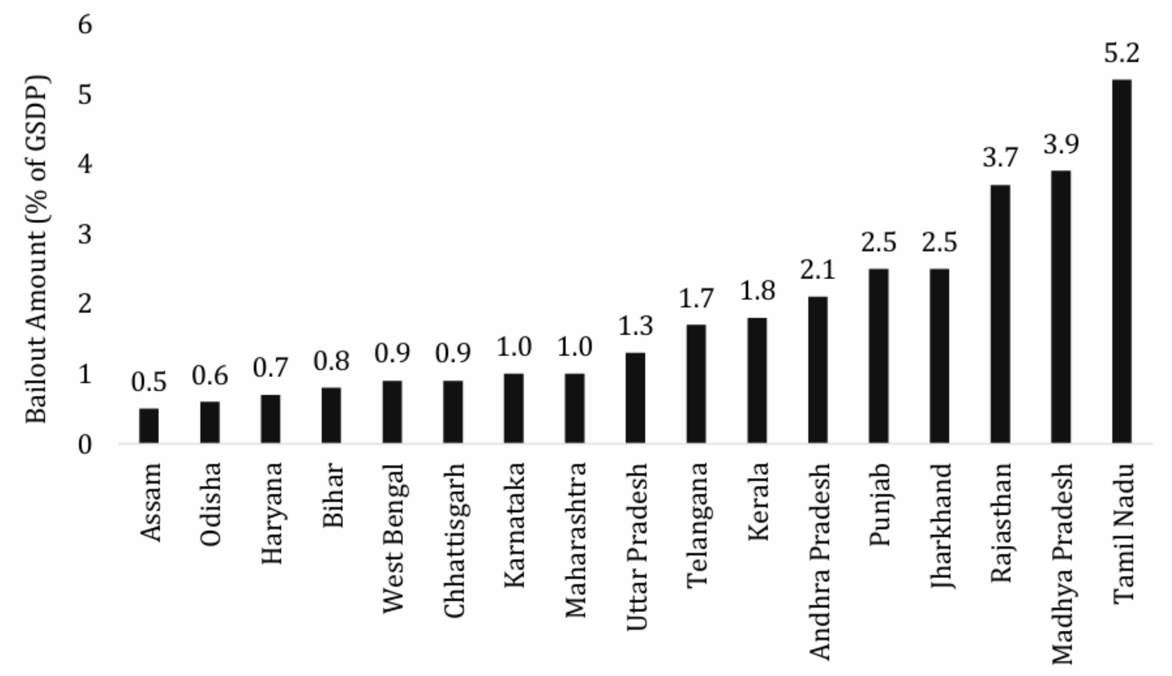
Year	Bailout Episodes and Interventions
2003	The State governments cleared the outstanding dues of respective State Electricity Boards to Central Power Sector Undertakings through the issuance of Power Bonds.
2012	The State governments had to undertake a Financial Restructuring Plan to enable DISCOMs to meet their short-term debt obligations.
2015	The Ujjwal DISCOM Assurance Yojana (UDAY) was launched by the Government of India (GoI) for operational and financial turnaround of State owned Power Distribution Companies (DISCOMs), under which the participating states took over 50% of the outstanding debt of DISCOMs as on 30-09-2015 by 31st March, 2016.
May, 2020	The GoI has intervened to improve the financial and operational efficiencies of DISCOMs by launching Liquidity Infusion Scheme (LIS).
July, 2021	The GoI launched Revamped Distribution Sector Scheme (RDSS) intending to improve the quality and reliability of power supply to consumers through a financially sustainable and operationally efficient distribution Sector. The scheme has an outlay of ₹3,03,758 crore and estimated Government Budgetary Support from Central Government of ₹97,631 crore.
2021-22	The GoI incentivised the States by allowing additional borrowing of 0.5% of GSDP to States linked to power sector reforms, and additional prudential norms for lending by Power Finance Corporation (PFC) Limited and REC Limited based on performance of utilities.
August, 2023	State would issue non-SLR (Statutory Liquidity Ratio) including SDL (State Development Loans) bonds, which will have a maturity period of 10-15 years with a moratorium on repayment of principal up to 5 years, as required by the State.

Sources: 1) UJWAL Discom Assurance Yojana (UDAY), Press Information Bureau (PIB), Ministry of Power, Government of India dated 03 March 2016;
2) Reforms in Power Sector, PIB, Ministry of Power, Government of India dated 31 March 2022;
3) Several interventions undertaken by Power Ministry to improve financial and operational efficiencies of DISCOMs, PIB, Ministry of Power, Government of India dated 26 July 2022;
4) National Level AT&C Losses in Power Network down from 22.3% in 2020-21 to 16.4% in 2021-22, PIB, Ministry of Power, Government of India dated 11 August 2023; and
5) State Finances: A Risk Analysis, RBI, Jun 16, 2022.

Note: The figure is taken from NIPFP working paper "State Finance in India: Managing Fiscal Risks and Sustaining Recovery" by Chakraborty and Bhadra (2024)

While FC-XV tried to bring reforms in this sector by incentivizing states through additional borrowing limit, the data for 2021-22 Actuals show the additional borrowing limit remains significantly underutilised (see Figure 11).

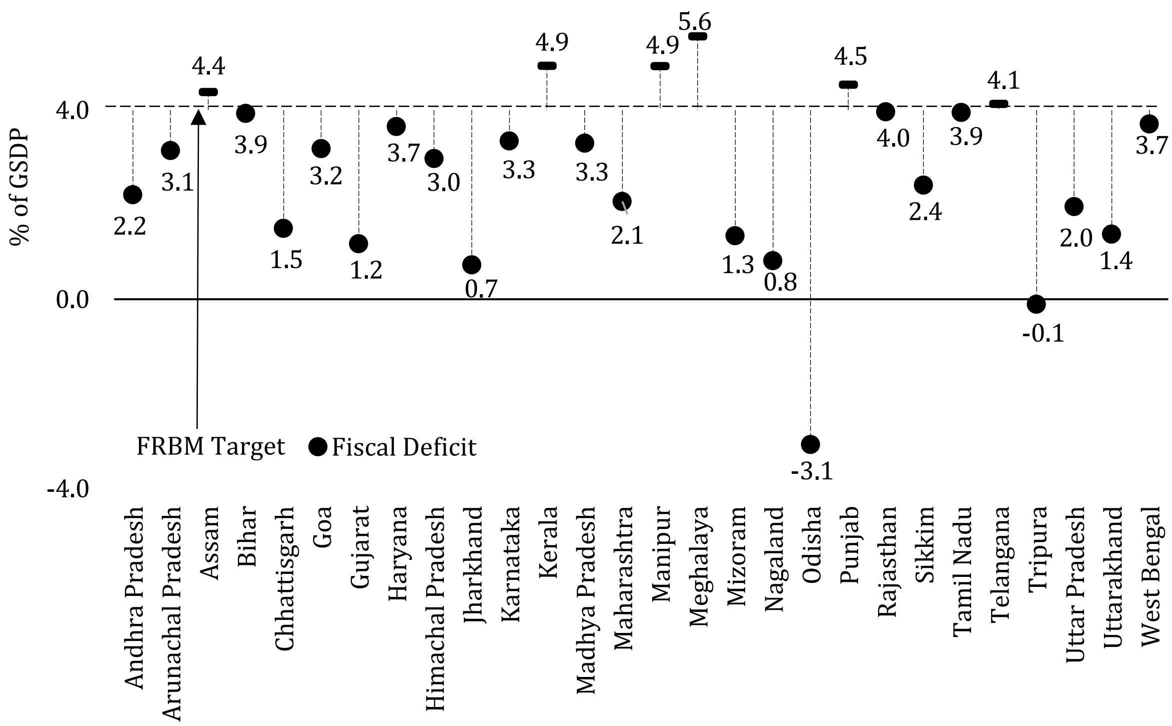
Figure 10: Bailout of DISCOMs in Major States: 2020-21



Source: State Finances: A Risk Analysis, RBI, Jun 16, 2022.

Note: The figure is taken from NIPFP working paper "State Finance in India: Managing Fiscal Risks and Sustaining Recovery" by Chakraborty and Bhadra (2024)

Figure 11: Fiscal Deficit – GSDP Ratio against FRBM Target: 2021-22 Actuals

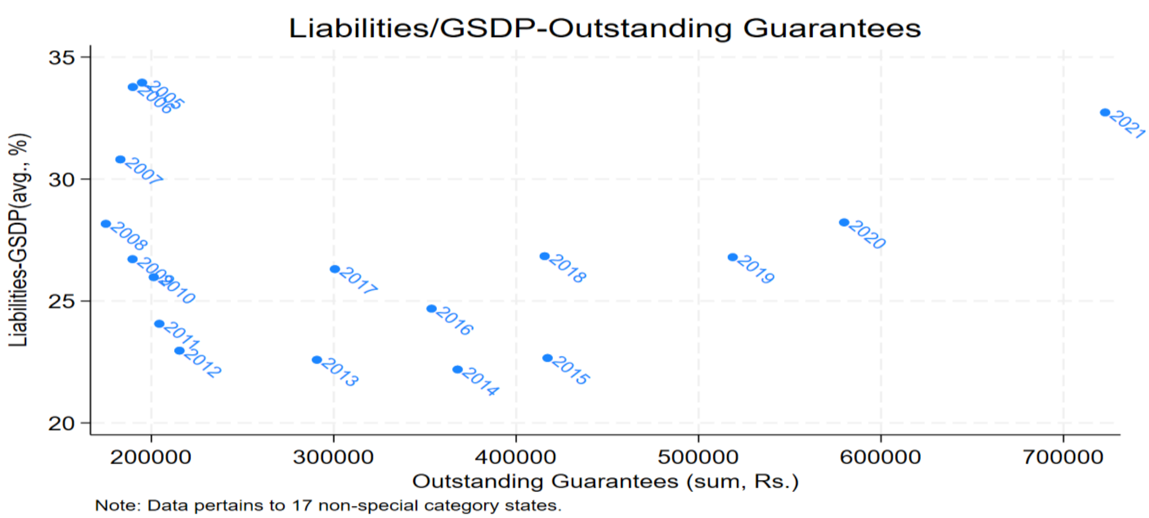


Note: The figure is taken from NIPFP working paper "State Finance in India: Managing Fiscal Risks and Sustaining Recovery" by Chakraborty and Bhadra (2024).

Another major fiscal risk arises from the guarantees issued by state governments, which typically constitute their contingent liabilities. If these guarantees are invoked, it could lead to a sudden increase in cash outflows, thereby increasing the deficit and debt levels. The recent RBI Report of the Working Group on State Government Guarantees (2023) noted that upfront cash payment does not usually occur when guarantees are issued, which is a primary reason for the increase in state-level guarantees. However, research shows that the uncertainty regarding the timing and amount of potential cash outflows from these guarantees complicates fiscal management for subnational governments and significantly impacts debt and deficit stock-flow adjustments (Campos et al., 2006).

Figure 12 shows the relationship between outstanding guarantees and the liabilities-to-GSDP ratio for general category states. It can be seen that the outstanding guarantees of the state governments have risen in recent years. Moreover, from 2004-05 to 2016-17, there was a negative correlation between outstanding guarantees and the liabilities-to-GSDP ratio. However, since 2017-18, a positive relationship has emerged, indicating that rising outstanding guarantees are accompanied by an increase in the liabilities-to-GSDP ratio.

Figure 12: Liabilities/GSDP- Outstanding Guarantees of States



Besides, there are risks from reversal to old pension scheme (OPS). As noted in the RBI study by Atri et al. (2022), OPS has negative implications on the medium-term fiscal sustainability of states and the tax burden on the future generations, Recently, Rajasthan, Chhattisgarh, Jharkhand, Punjab, and Himachal Pradesh have decided to revert to OPS for their state government employees. While the fiscal stress due to this reversal is not immediately apparent, it will become significant from 2034 onwards, when the employees under new pension scheme will start retiring.

4. Conclusion

This study assesses the debt and deficit profiles of Indian states from 1999-2000 to 2022-23 and reviews operationalization of borrowing limits/fiscal rules recommended for States by successive Finance Commissions. The analysis covers the award period of the Twelfth Finance Commission to Fifteenth Finance Commission. Our analysis shows that States, collectively, have adhered to fiscal targets after the introduction of rule based fiscal control at the State level. There were deviations in few years arising on account of UDAY scheme and the COVID-19 pandemic. However, there are notable inter-state differences in observing fiscal prudence. Some States have consistently breached the targets, while some states have consistently adhered to the target.

Successive finance commissions have attempted to drive reforms by incentivizing States with additional borrowing space or provisioning of incentive grants. Despite these incentives, States have consistently underutilized the additional borrowing space, suggesting that additional borrowing may not be the most effective mechanism for driving reforms. Our analysis of the borrowing limit indicates that an important factor determining state’s adherence to borrowing limits is the quality of GSDP forecast. For instance, during the Thirteenth Finance Commission period, actual GSDP exceeded assessed values, resulting in fiscal deficits remaining within specified limits. Going forward, two significant fiscal risks on state finances are power sector losses and rising state guarantees. Persistent power sector losses, despite several bailouts, have the potential to severely constrain the fiscal space available for development spending. At the same time, state guarantees have increased sharply since 2018, further exacerbating fiscal risks. Appropriate policy measures are needed to address these imminent risks to avert undue fiscal stress and ensure sustainable fiscal management.

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