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STATE GOVERNMENT FINANCES

Inclusion of off-budget debt in the borrowing ceiling of states to bring greater transparency to state finances

MAY 2022

Highlights

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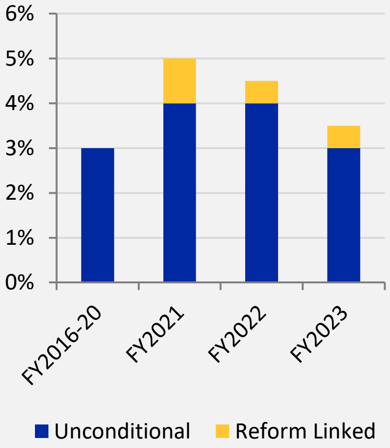
Exhibit: NBC as a percentage of GSDP for state governments



The net borrowing ceiling (NBC) of the state governments is typically communicated by the Government of India (GoI) to the state governments at the start of each fiscal year. This year, the NBC has been accompanied by some changes. Most critically, off-budget borrowings raised by state entities are now being equated with the state governments' own debt, which will enhance transparency of state finances. However, some state governments may find this change difficult to comply with, given the perceived proliferation of off-budget borrowings since the pandemic started. States witnessing a large downward adjustment in their net borrowing ceiling in FY2023 may be forced to undertake lower borrowings, while simultaneously resorting to higher usage of liquidity facilities such as ways and means advances (WMA) and overdraft (OD) from the Reserve Bank of India (RBI).

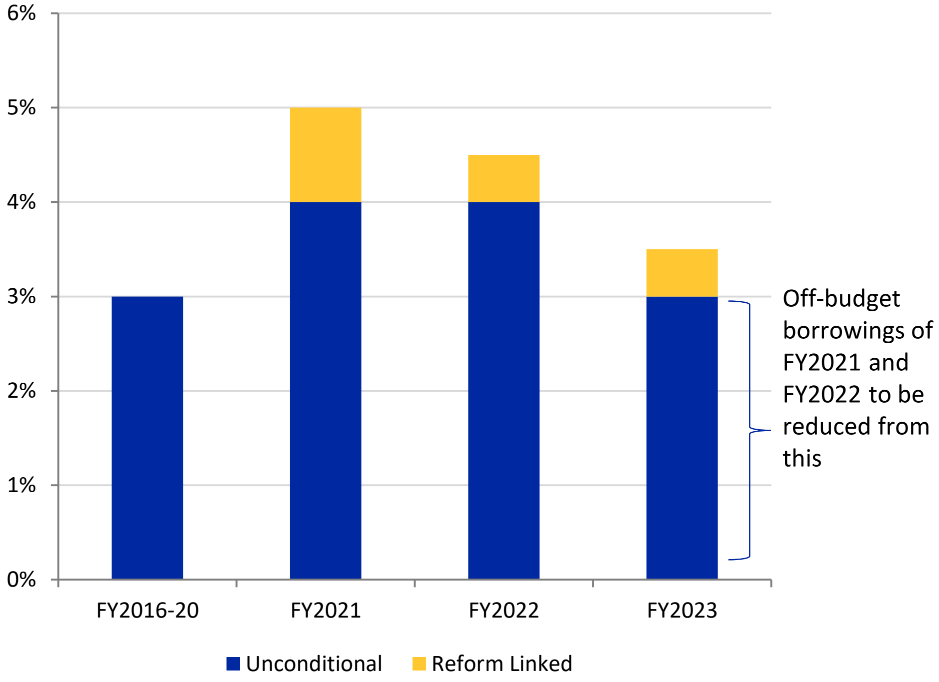
Off-budget borrowings by a state government refer to loans taken by its entities, special purpose vehicles etc., which are expected to eventually be serviced through the state government's own budget, instead of the cash flows or revenues generated by the borrowing entity. Anecdotal evidence suggests that such loans have proliferated in some states in the recent years. Typically, most states do not disclose the extent of off-budget debt in their budget documents. While most states do provide an estimate of the guarantees that they have extended in their budget documents, the entire guaranteed debt may not be off-budget, and at the same time a portion of the non-guaranteed debt may well be off-budget. Given the paucity of adequate data, it is difficult to ascertain the amount of downward adjustment that will made from the NBC of each state in FY2023.

For FY2023, the GoI has allowed the state governments additional borrowing of 0.5% of GSDP related to power sector reforms and an amount equivalent to the state government's and employee's share of contribution under the New Pension Scheme (NPS) over and above the base borrowing limit of 3.5% of GSDP.

These changes, along with the timing and size of monthly tax devolution, release of goods and services tax (GST) compensation and disbursement of the Special Assistance to States for Capital Investment Scheme of Rs. 1.0 trillion, will affect the size of FY2023 gross market borrowings relative to our recent forecast of Rs. 8.4 trillion.

The annual borrowing ceiling of state governments is set by the GoI, in accordance with Finance Commission norms

Exhibit: NBC as a percentage of GSDP for state governments



***Source:** Ministry of Finance (MoF); FC reports; ICRA Research*

- Under Article 293(3) of the Constitution, the Government of India sets the annual borrowing ceiling of the state governments based on the recommendations of the successive Finance Commissions (FCs).

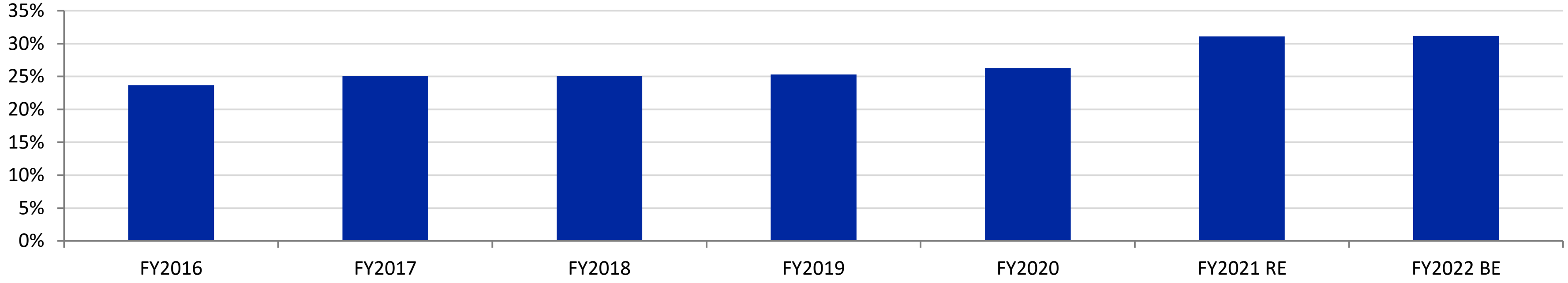
- The absolute borrowing limits are typically linked to the estimated GSDP of a state for that financial year and covers all sources of borrowings, namely, open market borrowings (predominantly state development loans), negotiated loans from the financial institutions, national small saving fund loans and public account liabilities among other things.

- For FY2023, the net borrowing ceiling of the states has been set at 3.5% of GSDP or Rs. 8,578 billion and an additional 0.5% of GSDP or Rs. 1,226 billion will be conditional on certain power sector reforms. The loans to be provided by the GoI to the states under the Special Assistance to States for Capital Investment Scheme of Rs. 1.0 trillion, will be above this limit.

- The GoI has now decided that borrowings by State Public Sector companies/corporations, SPVs and other equivalent instruments, where the principal and/or interest are to be serviced out of the State Budgets and/or by assignment of taxes/cess or any other State's revenue, shall be considered as Borrowings made by the State itself for the purpose of issuing the consent under Article 293(3) of the Constitution of India. This equating of the off-budget borrowings with the state's own debt, is a watershed decision for state finances.

The 15th Finance Commission had sounded a note of caution on off-budget debt

Exhibit: Total liabilities outstanding for all state governments/Union Territories as a proportion of GSDP



In its FY2021 report, the 15th FC had suggested that there should be no further addition to the extra-budgetary funding of expenditure and that the accumulated stock of such liabilities should be eliminated in a time-bound manner.

The 15th FC had reiterated its stance of time bound clearance of off-budget debt in its FY2022 report, while adding that regular tax and non-tax revenues may not be adequate for doing so, and therefore additional resources should be mobilized for this purpose.

The 15th FC had further mentioned that the purpose for higher borrowing limits to the Union and state governments is to encourage them to undertake all expenditures (committed and developmental) within the augmented limit and to not utilize off-budget or any non-transparent means of funding their expenditures.

Source: *MoF; Reserve Bank of India (RBI): ICRA Research*

FY2023 borrowing ceiling of states is to be adjusted for the off-budget borrowings they had raised in FY2021 and FY2022

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The GoI has now indicated that the incremental off-budget borrowings undertaken by the state governments in FY2021 (the first year of the 15th Finance Commission's award period) and FY2022, will be adjusted from their NBC of FY2023. Additionally, any future off-budget borrowings will be included under the NBC of the state government.

As per the GoI, the off-budget debt tantamount to state governments bypassing their annual borrowing ceilings of that financial year. Moreover, such borrowings surpass the targets for various fiscal indicators that were set under the respective FRBM Acts passed by the state legislatures.

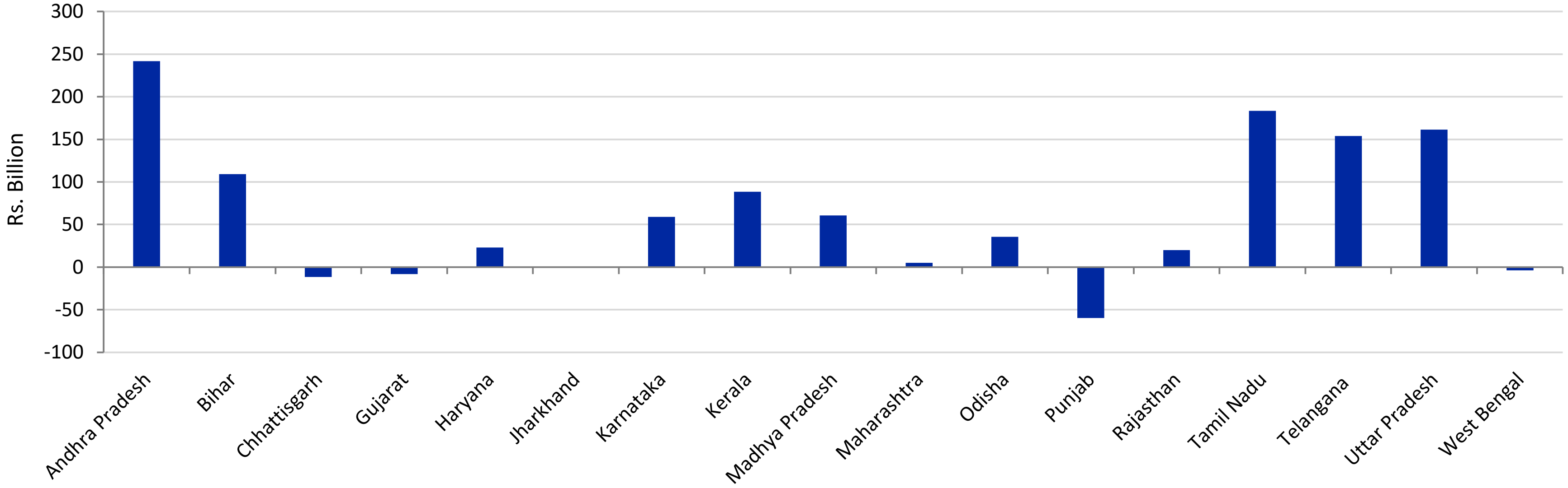
Moreover, the size of off-budget debt raised affects the ability of the state government concerned to service the debt, going ahead. The potential servicing of such obligations by the state governments in the future could materially widen their deficits and compress the fiscal space available for other priorities at the time of the servicing.

It appears that if any state had undertaken large off-budget debt prior to the cut-off of FY2021, it would be out of the purview of this recently announced adjustment in borrowing limit. We are unclear about the how some states would implement the recently announced changes, especially if their incremental off-budget debt in FY2021 and FY2022 will appropriate a significant portion of its FY2023 NBC. In such a scenario, will the affected states squeeze their announced expenditure for FY2023, and/or resort to frequent tapping of the liquidity facilities offered by the RBI?

Source: *MoF; FC reports; ICRA Research*

Off-budget debt of states could include both guaranteed and non-guaranteed debt

Exhibit: Increase in guarantees outstanding by state governments in FY2021 relative to FY2020



- Guarantees extended by Andhra Pradesh, Tamil Nadu, Uttar Pradesh and Telangana to their state level entities increased relatively sharply in FY2021 compared to FY2020.
- The guarantees outstanding by a majority of the states in FY2022 are not available in the public domain. **Additionally, it is important to note that the entire guaranteed debt may not be off-budget, and at the same time a portion of the non-guaranteed debt may well be off-budget.**
- Given the paucity of adequate data, it is difficult to ascertain the amount of downward adjustment that will made from the NBC of each state in FY2023.

Note: *Guarantee estimate is sourced from Comptroller and Auditor General of India for all states where data was available. For the remaining the guarantee estimate was based on estimates provided in state budgets.*
Source: *State budgets; CAG; ICRA Research*

Completion of power sector reforms and fulfilling NPS contributions to enhance FY2023 borrowing limit

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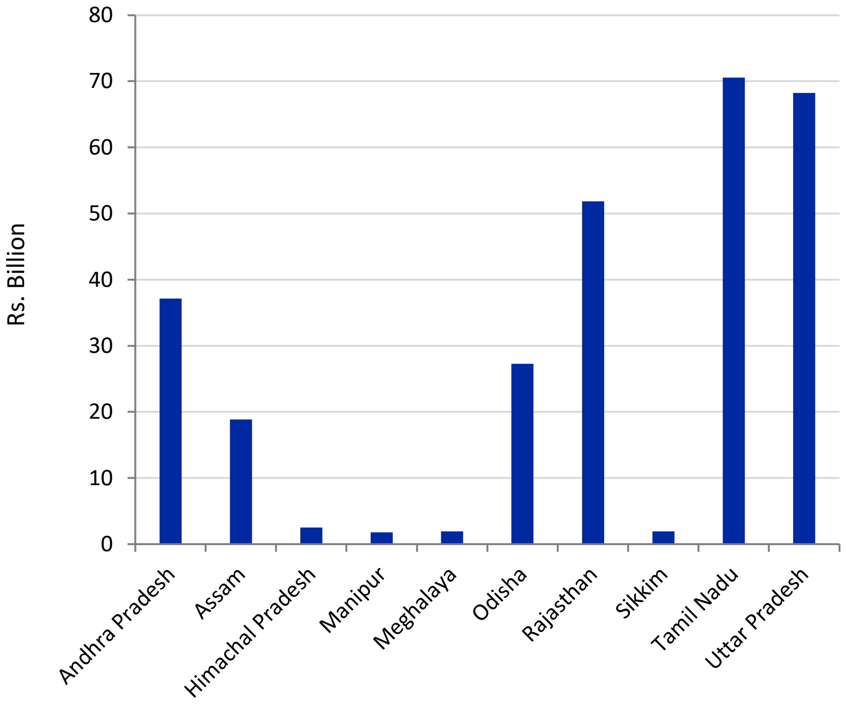
Exhibit: Additional borrowing linked to power sector reforms during FY2022



- Based on the recommendation of the 15th FC, the GoI has allowed additional borrowing flexibility of 0.5% of GSDP over and above the 3.5% of GSDP limit for a state in FY2023. This flexibility is conditional on achievement of each state on certain reforms.

- During FY2022, 10 states received permission to borrow Rs. 282 billion for completing power sector reforms.

- The GoI has indicated that some of the states that have adopted the NPS have not been making the necessary contributions under NPS. This is resulting in understating of the actual fiscal deficit of those states.

- For FY2023, the GoI will allow the state governments additional borrowing over and above the 3.5% of GSDP equivalent to the state government's and employee's share of contribution under the NPS.

Source: *Ministry of Power; MoF; FC reports; ICRA Research*

Several factors will affect the actual FY2023 gross market borrowings vs. our recent forecast of Rs. 8.4 trillion

Downside

- Off-budget borrowings of FY2021-22 to be adjusted from FY2023 NBC, reducing space available to borrow fresh funds
- Excess borrowing over and above the net borrowing ceiling in previous years to be deducted from FY2023 NBC

Upside

- Additional borrowing flexibility of 0.5% of GSDP under power sector reforms
- Fulfilling NPS liabilities equivalent to the employee and employer's share to be over and above the NBC
- Unutilised borrowing space of FY2022 that has been carried forward to FY2023

- Aside from the impact of the adjustments in the FY2023 NBC, other factors that would influence the actual size of SDL issuance include trends in monthly tax devolution, release of GST compensation in FY2023, and disbursement of the Special Assistance to States for Capital Investment Scheme of Rs. 1.0 trillion.
- **The timing of such flows from the Centre will be critical, in our view- front loading of funds will increase the likelihood of enhanced capital spending, whereas back ending would end up reducing the borrowing amount.**
- **States witnessing a large downward adjustment in their net borrowing ceiling in FY2023 may be forced to undertake lower borrowings, while simultaneously resorting to higher usage of liquidity facilities such as WMA and OD from the RBI.**

Source: *MoF; ICRA Research*

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