

Escape from Certain Debt

For states, different levels of debt and growth call for different strategies for long-term sustainability

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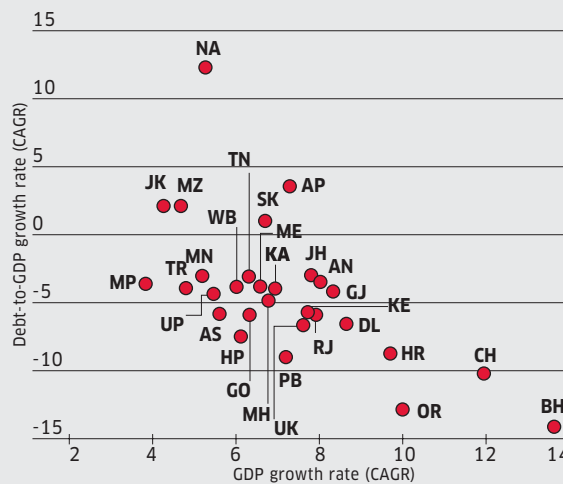
The current EU economic crisis has raised concerns over high sovereign debt and its harmful effect on economies that has left Greece and Portugal in crises. The theory of debt says that once external debt becomes very large, economies are unable to generate primary balance to repay the debt, causing currency deflation and adverse shocks. In light of the global impact of debt, we try to discern the state of affairs in India.

India has to pay external debt of \$305.9 billion that accounts for 17.3% of GDP and 10.3% of total public debt on India as of March 31, 2011. The gross public debt on India is more than 70% of GDP, as per IMF, in the year ending 2011. The country's external debt has grown at the rate of 12.3% annually during 2006-11 while the economy has grown at an annual growth rate of just 7.3%, which is alarming and will leave future generations under higher debt burden. This month, the Institute for Competitiveness' state performance barometer looks at the condition of debt across the states and assesses their position in managing their finances looking through the lens of fiscal deficit, debt-to-GDP and interest payment share in revenue receipts of the government.

Higher fiscal deficit makes debt bubble larger and compromises with growth: Uttar Pradesh has very high fiscal deficit of 24% of revenues that demands for more borrowing from the markets, and the debt burden has reached ₹2,34,581 crore in 2011, as per RBI. The debt on Uttar Pradesh alone constitutes 12.9% of the outstanding liabilities of all state governments and the debt-to-GDP ratio has reached 45.8 in 2011. The high debt leaves the government no option but cutting expenditure, decreasing subsidies and raising taxes in the economy, which also increases inflation and slows real growth rate. These fiscal irregularities are responsible for slower growth of the state that is just 5.5% annually in the last five years against overall India growth rate of 7.3%.

Mizoram and Sikkim have very high debt-to-GDP ratio of 98.1 and 82.2, respectively, and are on the verge of touching the level of debt-to-GDP of Ireland (101.6) and Belgium (103.1) in the EU, which is not appreciable for financial stability. The debt-to-GDP ratio of above 60 is considered dangerous both for developing and emerging economies. Such a high debt increases the risk of financial and economic turmoil and EU has put the mandatory condition of debt-to-GDP less than 60 for any nation to become the part

Debt and Growth: The Road Ahead for States



Investment Strategy (High growth, low-debt states)

Need to invest in developing more advanced factor conditions such as human capital, physical communication and administrative support to generate better economic output and become self-sustainable over the coming years.

Andhra Pradesh (AN), Bihar (BH), Chhattisgarh (CH), Delhi (DL), Gujarat (GJ), Haryana (HR), Jharkhand (JH), Kerala (KE), Orissa (OR) and Rajasthan (RJ)

Industrial Development Strategy (Low growth, high-debt states)

Need to bring a revolution in their development by identifying and developing the industrial clusters that have the potential of generating more economic value and employment. Investment by the government has to be more responsible and effective.

Himachal Pradesh (HP), Jammu & Kashmir (JK), Manipur (MN), Mizoram (MZ), Nagaland (NA), Punjab (PB), Sikkim (SK), Tamil Nadu (TN), Tripura (TR), Uttar Pradesh (UP) and West Bengal (WB)

Infrastructure Development Strategy (High growth, high-debt states)

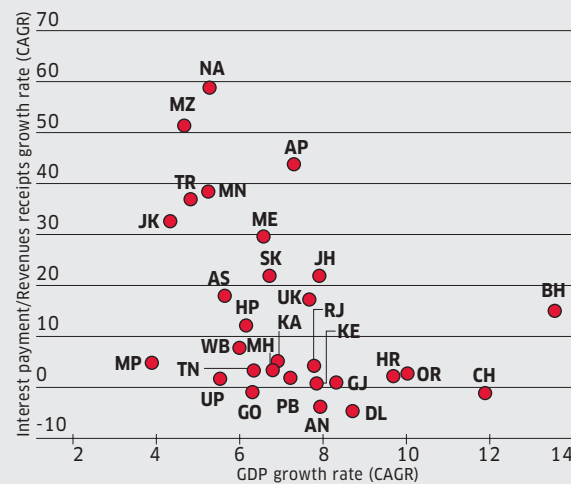
Need to develop advance infrastructure for industries such as tourism to increase revenues that help in repaying debt as tourism is the main driving factor for their regional economic growth.

Arunachal Pradesh (AP) and Uttaranchal (UK)

Restructuring Strategy (Low growth, low-debt states)

Need to invest and give more loans to the industrial sector for their expansion, which increase the economic output and help in lashing the growth. These states need to restructure their systems and make them more effective in policy implementation.

Assam (AS), Goa (GO), Karnataka (KA), Madhya Pradesh (MP), Maharashtra (MH) and Meghalaya (ME)



of the European Central Bank and EU.

Robust GDP growth in states makes debt sustainable: Orissa experienced tremendous growth rate of nearly 10.02% in the past five years, enabling the state to bring the debt-to-GDP ratio from nearly 60% in 2005-06 to its half in 2010 with the declining rate of above 12% annually (graph 1). The higher growth rate generates more economic activity that eventually increases the revenue receipts of the government from which it is able to repay the interest and principal amount of the debt. Thus, the strategy for states should be to achieve higher growth rate.

Higher interest payment share in revenues of state governments raises fear of fi-

nancial crises: The total outstanding liabilities of West Bengal are nearly ₹2 lakh crore in 2011, as per RBI, for which interest payments accounts for nearly 60% of government revenues, which means that after paying interest on debt, West Bengal will face a huge cash crunch. The interest payment share in revenue receipts of West Bengal has grown by 7.76% annually while the GDP has grown at the rate of just 6.02% for 2006-11. Fear of financial crisis, thus, faces West Bengal (graph 2).

High interest payments make the financial system unstable, represent poor financial health, restrict public expenditure and investments in economic activities and puts the state on a slower growth

track. We need more fiscal reforms and proper credit rating for states to assess their repaying capacity. The rating should consider government debt, fiscal deficit, gross savings, demand, economic growth of all primary, secondary and tertiary sectors, and previous debt history to assess the condition and avoid the situation of excessive debt.

The states need to follow different strategies to tackle their financial condition to achieve higher growth and reduce debt burden. On the basis of debt and growth to be followed, states can be classified into four categories (see graph) and suggest economic strategy they need to follow.

(The author is with Institute for Competitiveness)