From Policy to Performance

Analyzing India's Subnational Fiscal Rules

For the 16th Finance Commission of India

September 2025

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Design and Layout: Clay Brains Designs LLP.

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Acknowledgments

This technical paper is part of a series of studies prepared by World Bank staff at the request of the 16th Finance Commission, Government of India. The policy discussions, analyses, and recommendations in this technical paper have been developed based on extensive discussions and consultations with the 16th Finance Commission.

Special thanks are due to Dr. Arvind Panagariya (Chairman, 16th Finance Commission) for his guidance and support. The paper has also been enriched by the active engagement, discussions, and deliberations with the members of the 16th Finance Commission; Mr. Ritvik Pandey (Secretary, 16th Finance Commission); Mr. K. K. Mishra (Joint Secretary, 16th Finance Commission); Ms. Amrutha Varshini Palla (Joint Director, 16th Finance Commission); and Mr. Aditya Pant (Deputy Director, 16th Finance Commission).

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It has benefited greatly from the feedback and contributions of Emilia Skrok (Practice Manager), Aurelien Kruse (Lead Economist), Fran Ulrich Ruch (Senior Economist), and Farah Zahir (Senior Economist).

Abbreviations

CSS	Centrally Sponsored Schemes
DCRF	Debt Consolidation and Relief Facility
DSA	Debt Sustainability Analysis
EU	European Union
FC	Finance Commission
FD	Fiscal Deficit
FRL	Fiscal Responsibility Laws
FR	Fiscal Rules
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GSDP	Gross State Domestic Product
IFI	Independent Fiscal Institution
INR	Indian Rupee
LDFEFM	Ley de Disciplina Financiera de las Entidades Federativas y los Municipios
LRF	Brazil's Fiscal Responsibility Law
MXN	Mexcian Peso
MoSPI	Ministry of Statistics and Program Implementation
PD	Primary Deficit
RD	Revenue Deficit
SDL	State Development Loan
SNG	Subnational Government
SGP	Stability and Growth Pact
UDAY	Ujjwal Discom Assurance Yojana
VAT	Value Added Tax

Executive summary

Several states are still grappling with high levels of public debt despite the introduction of subnational fiscal rules in the 2000s. In response to the incentives provided by the 12th Finance Commission (FC), most states enacted Fiscal Responsibility Laws (FRLs) between 2005 and 2010, incorporating specific numerical fiscal deficit, revenue deficit, and overall debt targets. The central government also began to exercise control over the states' annual borrowing limits based on the fiscal glide paths recommended by successive FCs. State-level aggregate debt and fiscal deficits declined until 2015, but the trend reversed thereafter, largely due to significant new borrowing by certain states.

This paper analyzes the performance of subnational fiscal rules in India by addressing the following questions:

- Has the adoption of subnational fiscal rules contributed to achieving fiscal discipline?
- Why are some states still facing high levels of debt?
- What can India learn from international experiences with subnational fiscal frameworks?
- How can the existing subnational fiscal framework in India be improved?

The key messages of this paper can be summarized as follows:

1. **Overall, subnational deficits and debt as a share of GDP improved after the adoption of Fiscal Responsibility Laws (FRLs).** Regression analysis indicates that, on average, the adoption of FRLs was associated with (statistically) significant improvements in subnational fiscal deficit indicators. However, this fiscal consolidation was largely achieved at the cost of growth-enhancing capital expenditure and development-related revenue spending. Additional revenue also played a key role, supported by several structural and macroeconomic factors. These included sustained economic growth—averaging nearly 8 percent between 2003 and 2008, compared to 5.5 percent in the preceding five years—,the introduction of the Value Added Tax (VAT) in April 2025[1], and a substantial 10-percentage-point increase in states' share of the divisible pool of central taxes recommended by the 14th FC. Additionally, the debt relief measures introduced by the 12th FC helped reduce state-level debt and interest burdens to some extent.

2. **An analysis of the macroeconomic and fiscal performance of seven states (selected by the 16th FC) shows that rising debt was driven by the realization of contingent liabilities, off-budget borrowing, and high levels of committed spending.** In Kerala and Andhra Pradesh, the levels of debt relative to Gross State Domestic Product (GSDP) have risen because of off-budget borrowings that exceed the annual borrowing limits set by the central government. This increase is primarily attributed to relatively high levels of spending in these state. Similarly, West Bengal has also experienced elevated spending, but relatively higher devolved taxes have helped keep its borrowing below the annual borrowing limits over the past decade. In other states, rising debt levels have largely resulted from the realization of significant contingent liabilities in sectors such as power, or in Punjab's case, food procurement. This sharp one-time increase in debt has been exacerbated in states like Punjab and Rajasthan by the relatively high rigidity of their spending commitments.

1 Das-Gupta, A. (2012), "An Assessment of the Revenue impact of State-Level VAT in India", Economic and Political Weekly, XLVII (10). This study shows that the impact of VAT introduction across various states during this period had a positive impact on revenue in most jurisdictions.

3. **Lessons from Brazil, Mexico, and the European Union (EU) can enhance India's subnational fiscal rules.** Clear, enforceable frameworks with strict borrowing limits could be considered, akin to Brazil's Fiscal Responsibility Law. It is essential to avoid overly complex and non-transparent systems, as highlighted by the evolving fiscal rules in the EU. Implementing fiscal rules that can adapt to the changing fiscal positions of states, like Mexico's "traffic light" system, enables adjustments based on current conditions. Timely and transparent reporting, demonstrated by Mexico's debt registration system, ensures that stakeholders have access to up-to-date debt information. Additionally, protecting public investment during fiscal consolidation, as recommended by the EU, prevents the neglect of critical infrastructure. Finally, addressing structural expenditure pressures, as Brazil has faced, is crucial for effectively managing long-term commitments.

4. **The current subnational fiscal framework can be improved by (i) allowing different borrowing limits for states based on their fiscal positions, (ii) enhancing the institutional framework, (iii) considering debt restructuring for highly indebted states, and (iv) implementing medium -term structural reforms.**

   - A traffic light system for annual borrowing limits can enhance the fiscal framework's ability to respond to the states' changing fiscal conditions. To ensure that states with high debt remain on a fiscally sustainable path, the annual borrowing limit for "high risk" states should be decreased, while allowing "sustainable" states to borrow more. However, this transition must be gradual to give states adequate time to reduce their fiscal deficits.
   - Strengthening the institutional framework around fiscal rules is crucial to enhance the traffic light system's effectiveness and ensure fiscal sustainability. Harmonizing accounting standards, establishing clear escape clauses, and systematically reporting government arrears and contingent liabilities will help in reducing fiscal risks. Compliance monitoring should be enhanced through the Department of Expenditure or a permanent FC secretariat. States can be incentivized to comply with fiscal deficit targets by linking programs, such as interest-free loans, to adherence with fiscal rules.
   - The central government could consider restructuring the debt of states with very high levels of debt and persistently high deficits, provided that the states agree to a fiscal adjustment program that disciplines future spending.
   - Additional structural reforms are essential in the medium term to enhance the fiscal framework. These reforms include: implementing accrual accounting; establishing an independent fiscal institution; reviewing pensions, public sector salaries, and benefits; rationalizing Centrally Sponsored Schemes (CSS); and reassessing intergovernmental fiscal transfers to balance revenue assignments and spending responsibilities of states.

Introduction

Subnational borrowing plays a crucial role in financing development. State governments in India face significant fiscal pressures from rising demands for infrastructure, public services, and social welfare. Borrowing is an essential tool for meeting these financing needs, especially in states with limited revenue-generating capacity or those facing economic challenges. Responsible borrowing practices can enable subnational governments to continue to invest in long-term growth and enhance public welfare, while avoiding the risk of fiscal insolvency and macroeconomic instability.

Controlling subnational borrowing is vital for ensuring fiscal sustainability. While borrowing can facilitate essential investments, excessive or poorly managed borrowing by subnational entities poses substantial risks to the overall fiscal health of both individual states and the general government. Uncontrolled borrowing can result in unsustainable debt levels and higher interest burdens, potentially leading to national fiscal crises. Therefore, it is crucial to adopt mechanisms that effectively control borrowing, ensuring that fiscal deficits and debt levels remain manageable.

Fiscal rules, defined by numerical targets, can effectively control subnational borrowing. These rules typically set limits on deficits and or debt levels, providing a transparent and enforceable framework to guide fiscal decisions. By establishing clear guidelines, fiscal rules can help subnational governments exercise fiscal discipline and avoid excessive borrowing. Numerical targets ensure that borrowing decisions are driven by the objective of maintaining long-term fiscal sustainability rather than short-term political considerations.

For numerical subnational fiscal rules to be effective, they should be tailored to each state's economic context and be simple to ensure proper enforcement. Numerical fiscal rules should be clear, simple, and minimize the potential for creative accounting, while remaining enforceable. They should align with each state's specific fiscal and economic contexts. They should include escape clauses to accommodate economic fluctuations and natural disasters without compromising long-term sustainability. Additionally, these rules require strong mechanisms for regular monitoring and transparent reporting, with corrective actions for non-compliance. Independent oversight is critical to ensure subnational governments adhere to fiscal targets. In designing these rules, it is also important to account for structural factors, such as the vertical fiscal gap (the gap between state's spending responsibilities and ability to raise own-source revenue), expenditure rigidities, and earmarked revenues.

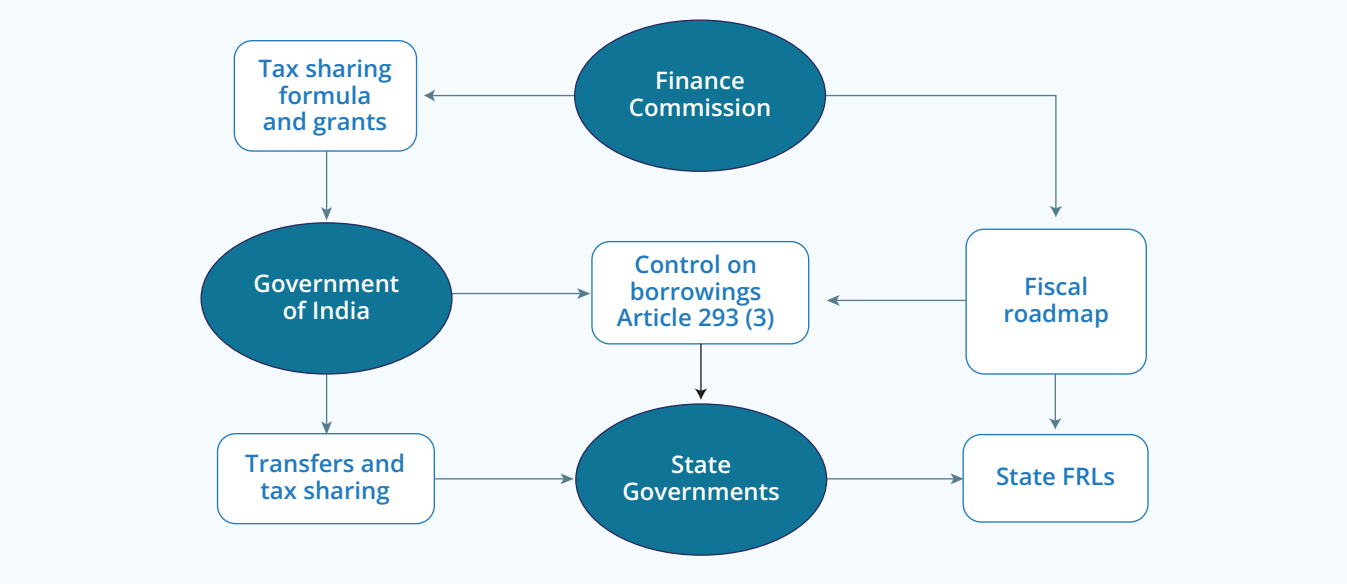
This paper analyzes the performance of subnational fiscal rules in India. Following the recommendations of the 12th FC, Indian states adopted Fiscal Responsibility Laws (FRLs) that incorporated two main fiscal rules: a fiscal deficit rule and a revenue deficit rule. Some states also introduced debt targets. These reforms were aimed at addressing the rising fiscal imbalances at the states level in the early 2000s, including large fiscal deficits, increasing debt levels, and rising interest payments. However, some states continue to struggle with high debt levels today. The objective of this paper is to: (i) assess whether the adoption of fiscal rules has helped states achieve fiscal discipline, starting with a discussion of India's subnational fiscal architecture (Section 1); (ii) explore the reasons why some states are still grappling with high debt levels (Section 2); (iii) provide an overview of international experiences with subnational fiscal frameworks to draw lessons for India (Section 3); and (iv) propose recommendations for strengthening India's existing subnational fiscal framework (Section 4).

SECTION 1

India's subnational fiscal framework and the impact of fiscal rules on fiscal consolidation

FCs and the central government significantly influence subnational fiscal behavior. Every five years, the FC establishes a tax-sharing formula to allocate resources from the divisible tax pool to states. From the 11th to the 13th FC, these formulae assigned weights to 'fiscal discipline' in determining the tax share of states. The FC also assesses the fiscal position of states and recommends a fiscal trajectory (or a fiscal roadmap) that lays out the fiscal and revenue deficit targets that the states are expected to achieve over a period of 5 years. Since the 12th FC, the central government stopped mediating market loans, leading to a significant increase in the share of domestic market borrowings in state liabilities. Loans from the centre (as a share of total state liabilities) decreased from 15.8 in percent in 2005 to 3.5 percent in 2019, while that of market borrowings increased from 21.1 percent to 53.3 percent[2]. Under Article 293(3) of the Constitution, a state must seek permission from the central government for any borrowings as long it is indebted to the latter[3]. Consequently, the central government sets an annual borrowing cap for states—consistent with the deficit target recommended by successive FCs[4]. This imposes a strict budget constraint on the states, as market borrowings generally cannot exceed this limit[5]. The Reserve Bank of India (RBI), as the debt manager, oversees the issuance of state government securities (or state development loans) throughout the year. Figure 1 summarizes the institutional channels influencing subnational FRs.

Figure 1: The FC and central government can use several instruments to influence the states' fiscal behavior



Source: World Bank.

2 This trend was also helped by most states opting out of financing from the national small saving fund (NSSF) following the recommendations of the 14th FC that states be excluded from the operations of the NSSF.

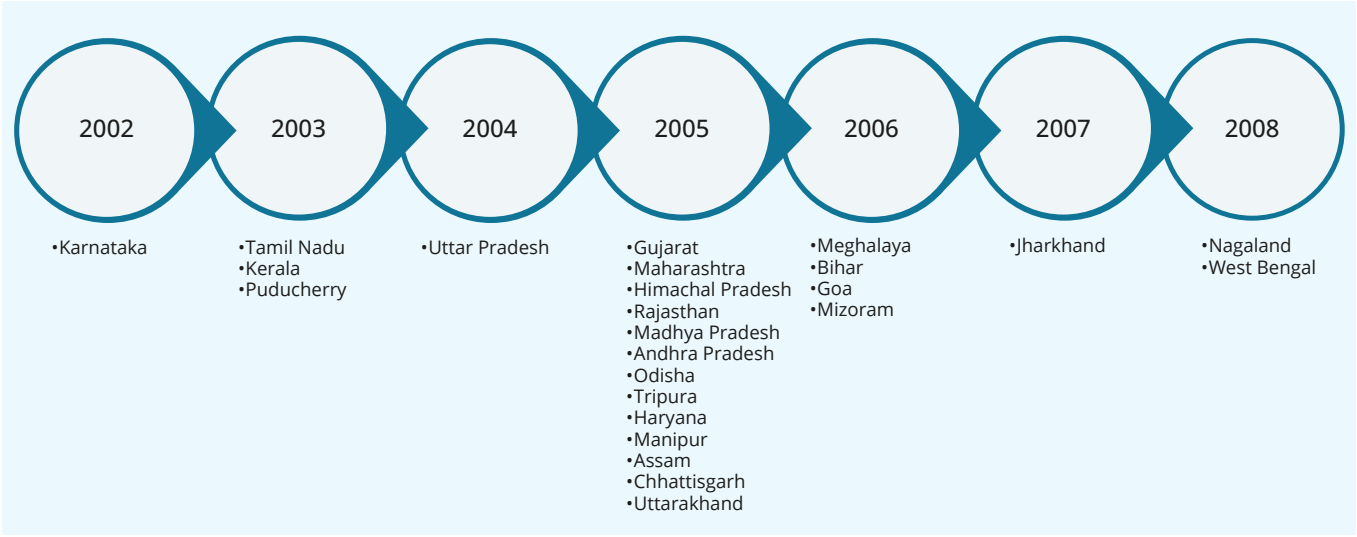
3 Article 293(1) prohibits borrowings by states from external sources.

4 This ceiling applies only to market loans. The states can still access public account liabilities for funds.

5 There are instances when this limit was relaxed, e.g., during the implementation of the UDAY scheme when the state governments were to take up a part of the losses incurred by state power utilities in their books or with the onset of the COVID-19 pandemic.

Twenty-one states enacted FRLs following incentives from the 12th FC. The 12th FC proposed two key incentives: (i) consolidating state debt owed to the Centre at the end of 2005, at a lower interest rate of 7.5 percent and to be repaid over 20 years, and (ii) a debt relief scheme tied to the reduction of revenue deficits. States burdened with high deficits were required to enact an FRL to access these benefits. By 2007, most states had done so (Figure 2). Most adopted a fiscal deficit target of 3 percent of GSDP, as recommended by the 12th FC, but set varying debt targets as a percentage of GSDP with different timeframes. Initially, some states did not set a debt target but did so later. The 12th FC also allowed states to borrow directly from the domestic market, removing the Centre's mediation. These measures aimed to strengthen subnational finances by promoting FRL enactment and direct market borrowing, using market discipline to regulate fiscal behavior.

Figure 2: Timeline of enactment of FRLs by states

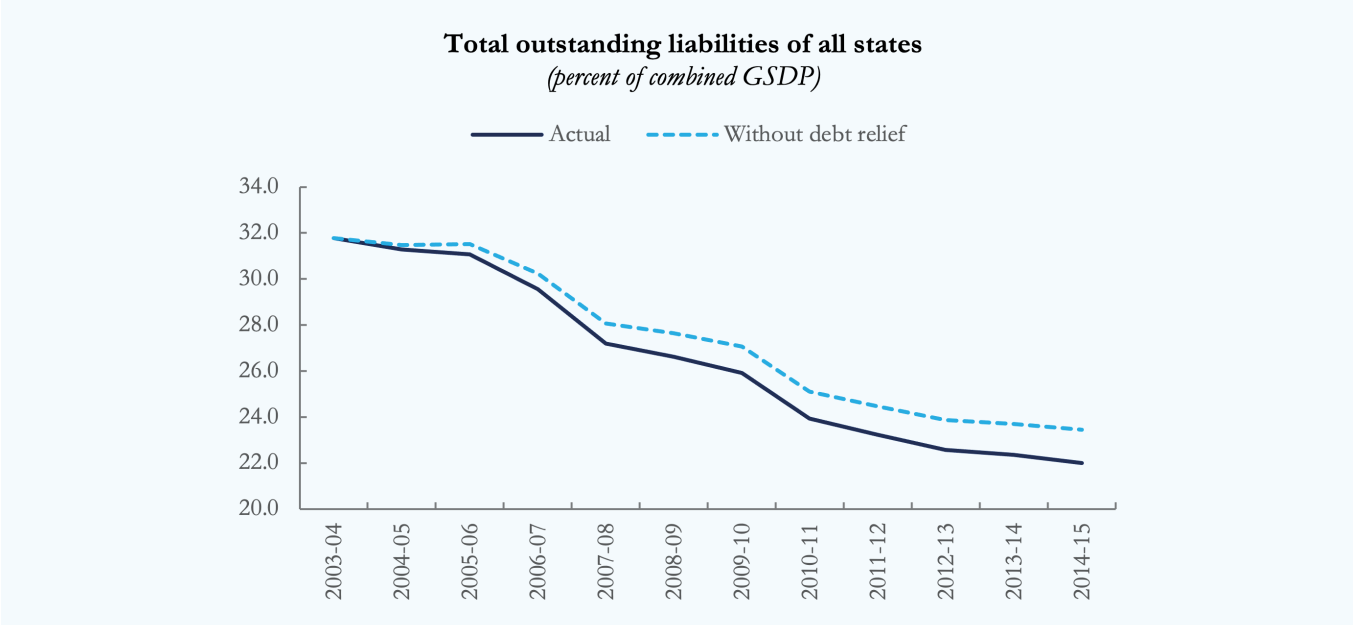


Box 1 The Debt Consolidation and Relief Facility helped reduce states' aggregate debt by 1.4 pp of GDP

To assess the impact of debt relief provided by the 12th FC, we use data from the reports of the 13th and 14th FC. From FY05/06 to FY09/10, the consolidation of outstanding Central loans amounted to Rs. 122,350 crore and as a result, the states received an aggregate interest relief of Rs. 18,690 crore during this period. Furthermore, the total debt relief granted to the states through the Debt Consolidation and Relief Facility (DCRF) amounted to Rs. 19,730 crore. Since the debt waived under the DCRF was recorded as non-tax receipts under 'miscellaneous general services' in the finance accounts, in the counterfactual we adjust both receipts and expenditure to account for this. Specifically, a third of the Rs. 18,690 crore was added to interest payments for each fiscal year between 2005 and 2007, and a third of the Rs. 19,730 crore was deducted from the revenue receipts to reflect the DCRF effect for these same years. The calendar years were chosen for adjustments as most states had enacted a fiscal rule, as per the guidance of the 12th FC, by this period (Figure 2). Using these numbers, we estimate the fiscal deficit and debt-to-GDP ratio using the standard debt dynamics equation (see Annexure). For the sake of simplicity, we assume that GDP growth rates were unaffected over the period of the analysis.

The DCRF is estimated to have reduced the aggregate debt-to-GDP ratio of all states by about 1.4 percentage points, relative to a counterfactual scenario in which debt relief and consolidation did not occur.

Figure 3: Aggregate state debt would have increased by 1.4 percent without the DCRF



Source: RBI, MoSPI and World Bank staff calculations.
Note: 2003-04=FY03/04.

While successive FCs made marginal changes, the core fiscal the core subnational fiscal framework has remained intact. The global financial crisis (GFC) led to a temporary relaxation of states' fiscal deficit targets to 4 percent of GSDP in 2010, facilitating counter-cyclical interventions, similar to the COVID-19 pandemic in 2020. States were also allowed to borrow more than 3 percent under the Ujjwal Discom Assurance Yojana (UDAY), a central government program aimed at improving the financial condition of state-owned power distribution companies and improving their financial condition by consolidating and transferring their debt to state governments. Successive FCs also made changes to the horizontal devolution formula by adjusting the weights assigned to fiscal discipline and revenue performance. The 13th FC increased the weight of fiscal discipline in its reward formula to 17.5 percent from 7.5 percent. However, the 14th FC dropped fiscal discipline from the tax devolution criteria due to difficulty in measurement and the presence of fiscal rules. The 15th FC reinstated tax effort in the formula but not fiscal discipline.

Overall, subnational deficits and debt as a share of GDP improved following the adoption of FRLs. Following the enactment of FRLs by most states by March 2006, the aggregate fiscal and revenue deficits declined as a share of the states' combined GSDP (Figure 4 and 5). This improvement was driven by steady growth, averaging nearly 8 percent between 2003 and 2008, compared to 5.5 percent in the previous five years, along with VAT reforms. All states recorded higher than projected growth during the 12th FC period[6]. While most experienced a similar upside during the 13th FC period, this pattern did not persist in the 14th FC period. However, states benefited from a substantial 10-percentage-point increase in states' share of the divisible pool of central taxes recommended by the 14th FC. In addition, states also benefited from reduced debt, although marginally (see Box 1), and interest burdens from the 12th FC's DCRF.

6 The performance of most states was stellar till the onset of the GFC hampered revenue generation.

Figure 4. Aggregate fiscal deficit of states
(percent of combined GSDP)

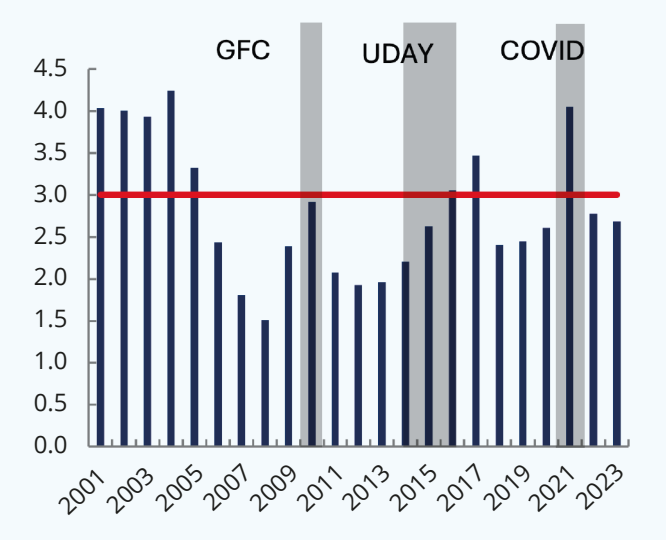
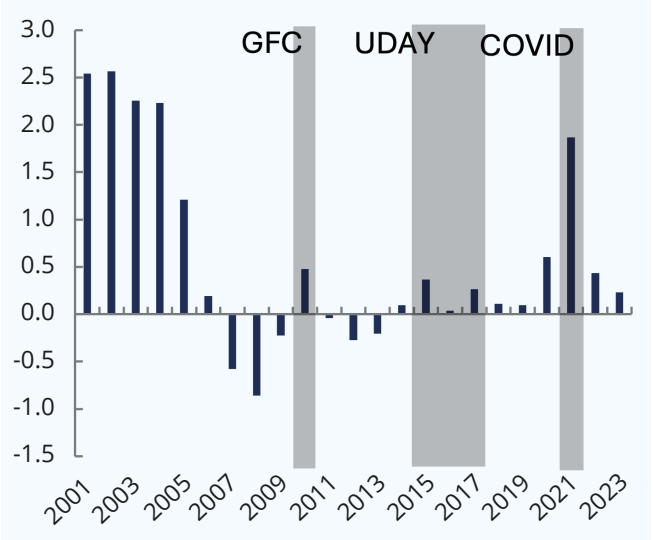
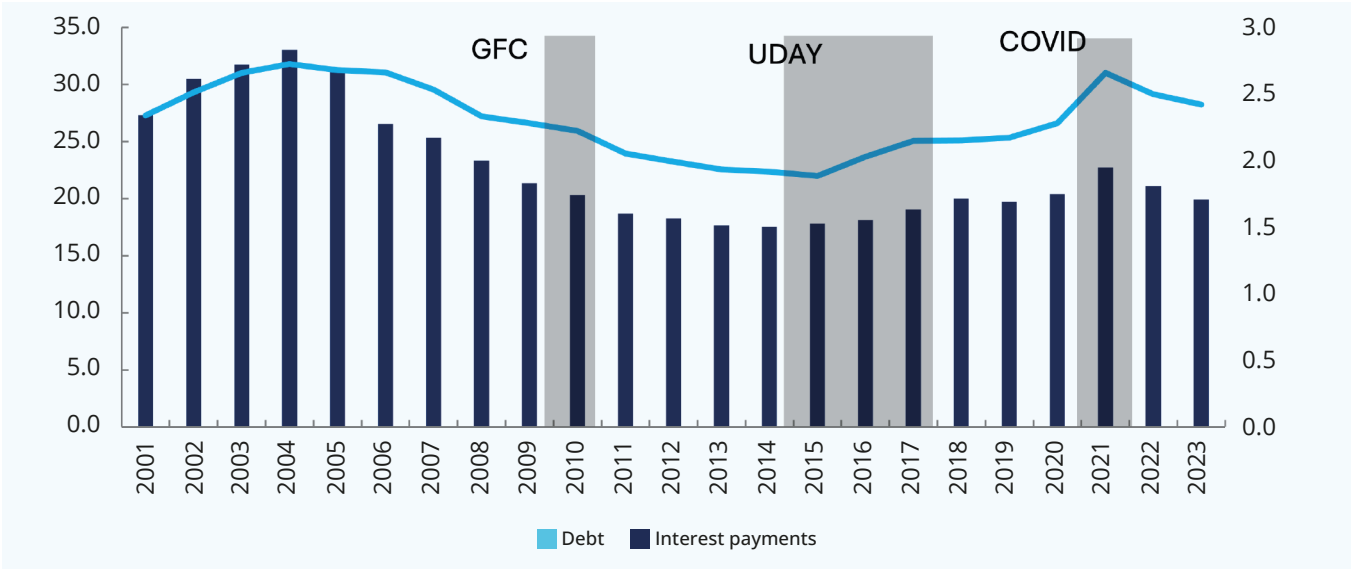


Figure 5: Aggregate revenue deficit of states
(percent of combined GSDP)



Note: 2001=FY01/02.

Figure 6: Aggregate debt and interest payments of states
(percent of combined GSDP, left axis: debt, right axis: interest payments)



Source: RBI, MoSPI and World Bank Staff calculations.
Note: 2001=FY01/02.

The adoption of fiscal rules is associated with reductions in subnational fiscal deficits. Table 1 reports the results from regressions of the different deficit indicators on a variable capturing the implementation of fiscal rules, specifically the 3-percent deficit target (that takes the value 1 for all years starting with the year a state adopted a rule, and reverts to zero for years in which the fiscal rule was temporarily relaxed, for example, 2010) and controlling for the introduction of VAT, the lagged value of the debt to GSDP ratio, (log of) GSDP and the lagged value of the relevant deficit measure (to account for persistence in fiscal behavior)[7]. The coefficients of the FR dummy on the revenue, fiscal and primary deficits are negative and significant—the revenue,

7 These regressions also include state fixed effects (to account for time invariant differences in economic conditions across states) as well as year fixed effects (to account for aggregate time trends influencing the relationship between FRs and fiscal behavior). The data comprises a panel (unbalanced) of states over 2001-2018 (the 11th to 14th FC reward periods).

fiscal, and primary deficits, as a share of GDP, decreased by 0.6, 1.2, and 1.0 percentage point (pp) respectively[8]. However, as found in Simone and Topalava (2009), the significance of the FR dummy diminishes when central transfers and interest payments are excluded from the fiscal deficit calculations. Although the results hold when only central transfers are excluded, the coefficient is much smaller (-0.8pp) than that on the fiscal deficit itself (~1.2pp). This suggests that the increase in central transfers and the reduction in interest payments helped states to achieve the targets in the post 12th FC period[9].

Table 1: Regressions on the relationship between deficit indicators and FR adoption (2001-18) ***(Dependent variables: As share of GSDP)***

	(1)	(2)	(3)	(4)	(5)
	Revenue Deficit	Fiscal Deficit	Fiscal deficit excluding central transfers	Fiscal deficit excluding central transfers and interest payments	Primary deficit
FR dummy	-0.00653* (0.00335)	-0.0117*** (0.00368)	-0.00835* (0.00463)	-0.00715 (0.00447)	-0.0101** (0.00367)
Log GSDP	0.0267 (0.0232)	-0.0117 (0.0122)	-0.118*** (0.0382)	-0.110*** (0.0353)	-0.000690 (0.0117)
VAT dummy	-0.00674*** (0.00152)	-0.00368 (0.00479)	0.00445 (0.00976)	0.00477 (0.00885)	-0.00352 (0.00374)
Lagged Debt/GSDP	-0.00596 (0.0252)	0.0210 (0.0131)	0.0628** (0.0241)	0.0456 (0.0263)	-0.00319 (0.0158)
Lagged RD/GSDP	0.401*** (0.0793)				
Lagged FD/GSDP		0.271*** (0.0914)			
Lagged FD excl. CT/GSDP			0.472*** (0.0822)		
Lagged FD excl. CT & IP/GSDP				0.467*** (0.0877)	
Lagged PD/GSDP					0.198** (0.0868)
Constant	-0.367 (0.323)	0.189 (0.170)	1.714*** (0.543)	1.596*** (0.500)	0.0253 (0.164)
Observations	449	449	449	449	449
R-squared	0.762	0.505	0.982	0.981	0.298
State FE	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes

Note: Robust standard errors in parentheses. All specifications include state and year fixed effects. *** p<0.01, ** p<0.05, * p<0.1
FE (Fixed effect); RD (Revenue deficit); CT(Central Transfers); IP (Interest payments).

8 The specification in Table 3 is in line with that in Simone and Topalova (2009). *"India's Experience with Fiscal Rules: An Evaluation and The Way Forward,"* IMF Working Papers 2009/175, International Monetary Fund. They studied similar associations using a panel of 15 states from 1995 to 2007.

9 These results are robust to alternate specifications and across samples of states. To ensure that no bias arises from the inclusion of lagged dependent variables, different models excluding such variables were tested with no significant change in the results. Another concern on simultaneity bias (or multicollinearity introduced by the inclusion of lagged debt-to-GDP ratio with other lagged dependent variables) is addressed by running another specification that retains only the former. A change in the definition of the variables also preserves the results. For example, the results continue to hold if log GSDP is replaced by GSDP growth. The findings remain robust, although the magnitude of the effects changes to some extent over alternative specifications. Finally, the specification is run on a sample of 'non-special category' states only (because 'special category' states have very specific budget structures and fiscal arrangements with the Centre). The results are unchanged although the significance of the revenue deficit is found to be sensitive to the drop in the number of observations.

However, fiscal consolidation was largely achieved at the expense of cuts in capex and development-related revenue expenditure and the positive contribution from revenue. The analysis of episodes of consolidation over 2010-20, for all states indicates that the relatively large (non-special category) states undertook consolidations that improved the fiscal deficit by around one percentage point of GSDP on average during this period[10]. In contrast, consolidation in the smaller (special category) states were significantly larger in magnitude with the fiscal deficit improving by 2.4 percentage points of GSDP. In the larger "non-special category" states, the consolidation led to a one percentage point improvement in the fiscal deficit, on average over 2010-2020, with revenue increases contributing to 24 percent of the improvement. Yet, capital and development-related revenue expenditures were cut disproportionately during such consolidations. In smaller, "special category" states, consolidations led to an average reduction in the fiscal deficit of 2.4 percentage points with revenue increases contributing 11 percent of the reduction, but cuts in capital and development-related revenue spending contributing the most—72 percent.

Figure 7: Consolidations in non-special category states ***(average, percentage points of GSDP)***

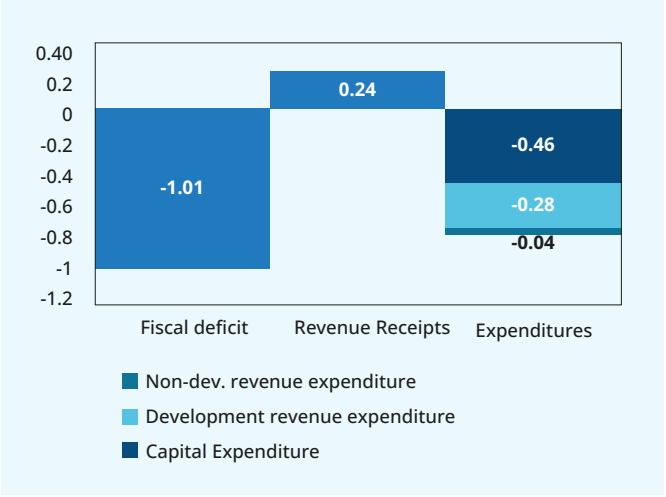
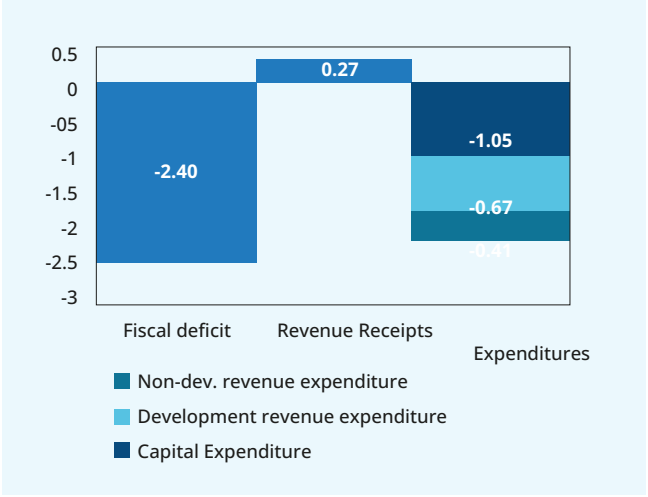


Figure 8: Consolidations in special category states ***(average, percentage points of GSDP)***



Source: World Bank staff calculations. Interpretation: On average, during consolidations in non-special category states, the fiscal deficit improved by one percentage point. Of this, 0.24 ppts contribution from revenue increase, and 0.78 ppts from reduction in expenditure. Within expenditure, capital expenditure and development-revenue expenditure were cut by 0.46 and 0.28 ppts while non-development revenue expenditure was cut by only 0.04 ppts (-0.46-0.28-0.04=-0.78).

Both rich and poor states achieved consolidation by reducing capex and development-related revenue expenditures. Using data from the Ministry of Statistics and Program Implementation (MOSPI), relatively rich states are defined as those with per-capita income above the median for all states in 2020, while relatively poor states are those with per-capita income below the median. An examination of years of consolidation from 2010 to 2020 reveals that relatively rich states improved their fiscal deficit by an average of 1.26 percentage points of GSDP during this period. Meanwhile, relatively poor states achieved an improvement of 1.81 percentage points of GSDP. In relatively rich states, revenue collections did not contribute to the

10 A year of consolidation is identified as one in which the fiscal deficit improves compared to the previous year.

improvement of the fiscal deficit during episodes of consolidation.[11] Instead, reductions in capital expenditures and development-related (revenue) expenditures accounted for more than 80 percent of the consolidation efforts. Meanwhile, in relatively poor states, increases in revenue contributed to 28 percent of the deficit reduction, while the majority—70 percent—resulted from reductions in capital and development-related revenue expenditure. Additionally, relatively rich states also reduced non-development-related revenue expenditures during consolidation episodes, unlike their poorer counterparts.

Figure 9: Consolidations in relatively rich states ***(average, percentage points of GSDP)***

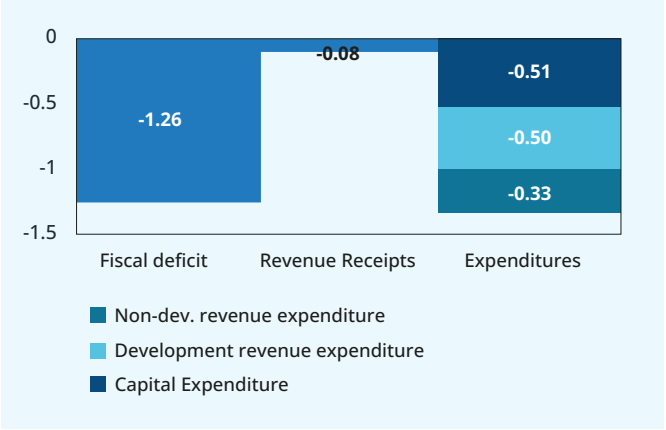
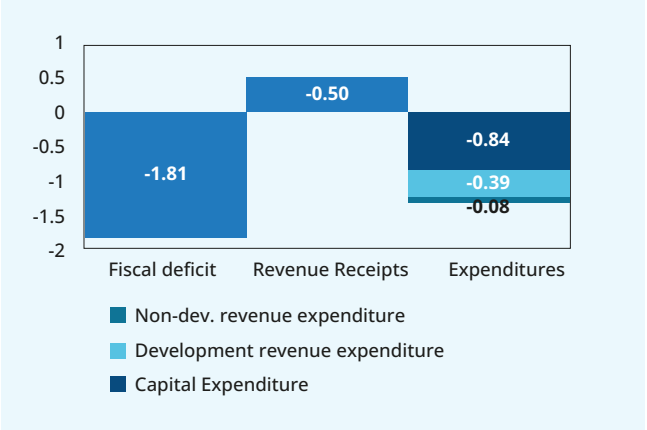


Figure 10: Consolidations in relatively poor states ***(average, percentage points of GSDP)***



Source: World Bank staff calculations.

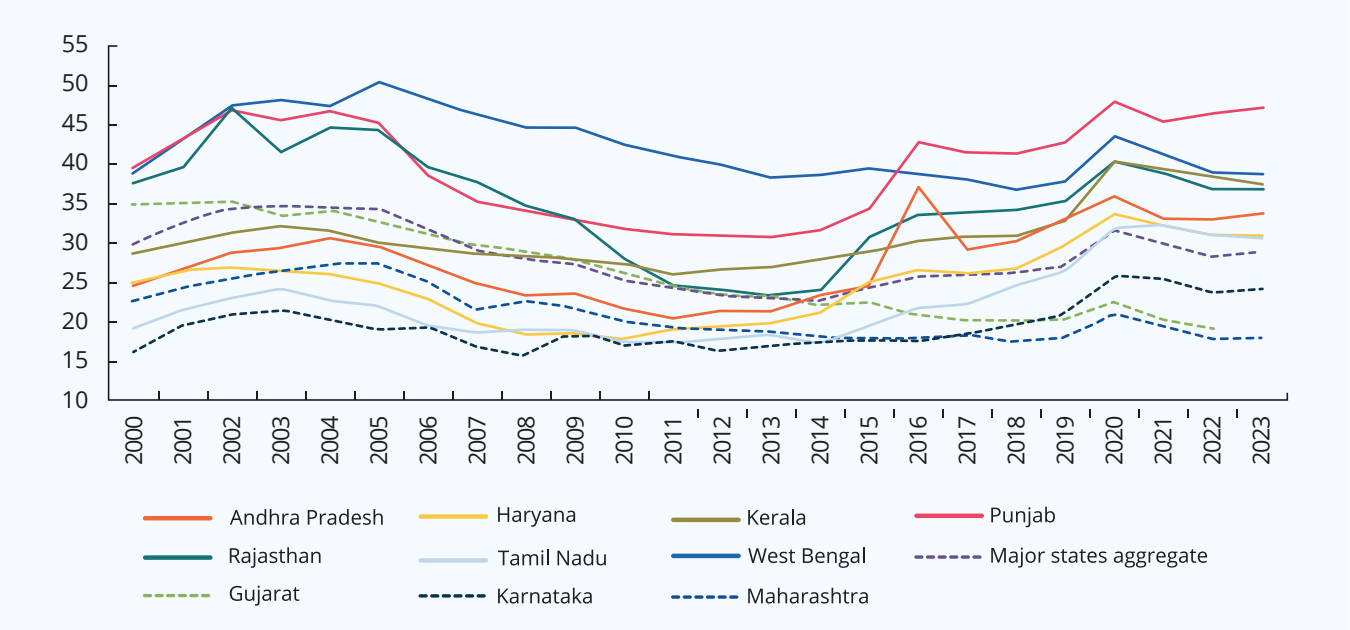
11 One possible explanation is the equalization of fiscal transfers, where lower-income states, on average, receive a higher share of central transfers compared to richer states (see the Intergovernmental Transfers and Fiscal Equalization paper).

SECTION 2

Why are some states still grappling with high debt levels?

Fiscal performance varied significantly across states despite aggregate improvements in debt and deficit indicators. Many states that started with relatively high levels of debt and fiscal deficits prior to FRLs adoption in the mid-2000s continue to have higher debt burdens. As Figure 11 shows, some states, like Gujarat, were able to meaningfully reduce debt levels from over 30 percent of GSDP to below 20 percent. Debt levels, however, have remained high for other states like Kerala, Punjab and Rajasthan. The following section discusses the macroeconomic and fiscal performance of seven major states[12]—Andhra Pradesh, Haryana, Kerala, Punjab, Rajasthan, Tamil Nadu, and West Bengal—and benchmarks their performance against the average for all major states[13], and three states with better fiscal positions: Gujarat, Karnataka, and Maharashtra. The goal of this discussion is to identify the factors contributing to the increasing debt levels of these seven states.

Figure 11: Debt levels have not converged across states over the last two decades
(total outstanding debt, percent of GSDP)



Source: RBI, MoSPI and World Bank staff calculations.
Note: For Andhra Pradesh, data until 2015 is based on the nominal GSDP and debt of the undivided state of Andhra Pradesh (including Telangana) and based on data for the bifurcated state thereafter. 2000=FY00/01.

Between FY10/11 and FY19/20, the seven selected states ran higher revenue deficits and fiscal deficits on average, compared with the aggregate for all major states. An initial step was to compare the annual average revenue and fiscal deficits against their respective broader targets of zero percent and three percent of GSDP. Accordingly, all seven states on average had a revenue deficit, ranging from 0.5 percent of GSDP in Rajasthan to over 2 percent in Kerala, compared with a near revenue balance across all major states and small surpluses in states like Gujarat and Karnataka. Similarly, on average, all these states except Tamil Nadu had fiscal deficits of over 3 percent of GSDP, compared with 2.6 percent across major states and as low as 1.5 percent in Maharashtra. Revenue and fiscal deficits remained relatively high for these seven states during the post-COVID period.

12 These seven states were selected by the 16th FC.

13 Major states include Andhra Pradesh, Bihar, Chhattisgarh, Gujarat, Haryana, Jharkhand, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Odisha, Punjab, Rajasthan, Tamil Nadu, Telangana, Uttar Pradesh and West Bengal.

Figure 12: The selected states had a much higher revenue deficit than other major states...
(revenue deficit, percent of GSDP)

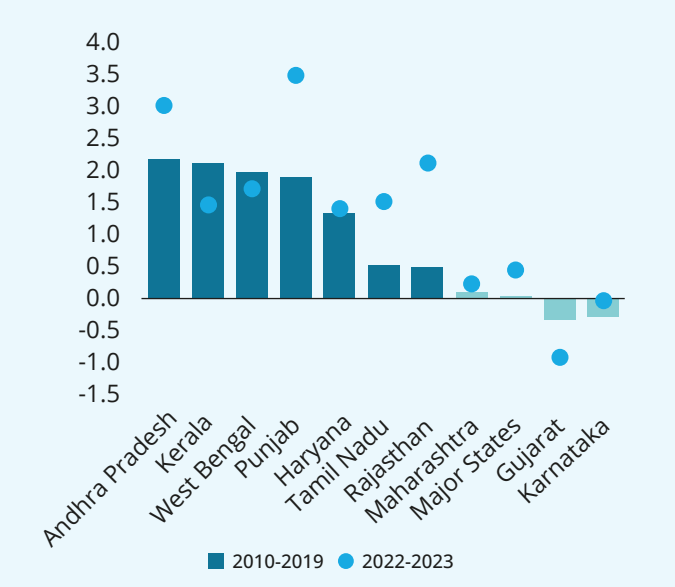
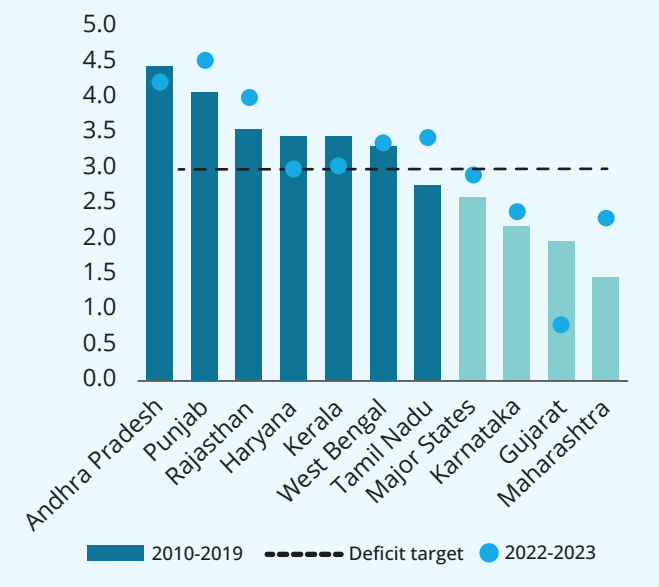


Figure 13: ...and a fiscal deficit of over 3 percent
(fiscal deficit, percent of GSDP)



Source: RBI, MoSPI and World Bank staff calculations.
Note: A negative number indicates a revenue/fiscal surplus. Data for AP starts from 2015 after the bifurcation of the state. 2010-2019 refers to the average from FY10/11 to FY19/20, and 2022-2023 refers to the average from FY22/23 to FY23/24.

A significant factor contributing to the high debt levels in these states is the realization of contingent liabilities. As a second step, an assessment of the states' deviation from the fiscal glide path recommended by successive FCs[14] shows that the seven states differed in terms of the frequency, magnitude and sources of deviation. The assessment is limited to deviations in the fiscal deficit as these are enforced through the annual borrowing limits under Article 293(3) whereas there is no effective mechanism to enforce the revenue deficit target. Among the selected states, West Bengal deviated from the fiscal deficit target only in the first two years post-adoption of fiscal responsibility legislation; since then, its fiscal deficit has been within the allowed borrowing limit, except in 2019. Andhra Pradesh, Haryana, Punjab, Rajasthan and Tamil Nadu deviated from the target in 2015 and 2016, when they took on a share of the liabilities of highly indebted power distribution companies under the UDAY scheme. The magnitude of UDAY debt varied from 1.2 percent of GSDP in Andhra Pradesh to around 3 percent of GSDP in Haryana, Punjab and Rajasthan. During the same period, Punjab also converted a cash credit limit for its food procurement agencies into market loans, adding debt amounting to nearly 7 percent of GSDP, as a result Punjab's fiscal deficit increased to over 12 percent in 2016. Post-Covid, Punjab's debt soared, and its growing interest burden pushed the fiscal deficit beyond recommended levels. Rajasthan has also shown a pattern of deviation from the fiscal deficit path in the 2018-2023 period.

14 The assessment of deviation from fiscal rules by the selected states is based on the fiscal deficit path recommended by successive FCs. While most of the states adopted fiscal responsibility legislations in 2005-06 following recommendations of the 12th FC as precondition for availing the Debt Consolidation and Relief Facility, compliance to a fiscal deficit of 3 percent GSDP was expected to become binding in 2008-2009. These limits were however adjusted in response to external shocks to the economy, including the 2008 Global Financial Crisis and the Covid-19 pandemic. Also, the 13th FC provided different adjustment paths of fiscal prudence for fiscally stressed states, namely, Kerala, Punjab and West Bengal with a borrowing limit/ fiscal deficit of 3.5 percent of GSDP for fiscal years 2011-12 and 2012-13. The analysis also accounts for different adjustments paths established by the 13th FC for fiscally stressed states—namely Kerala, Punjab, and West Bengal—allowing them a borrowing limit/fiscal deficit of 3.5 percent of GSDP for the fiscal years 2011-12 and 2012-13. The 15th FC recommended an annual borrowing limit of 4.5 percent in 2020-21, 4 percent in 2021-22, 3.5 percent in 2022-23 and 3 percent thereafter, with an additional 0.5 percent conditional on to promote power sector reforms.

Figure 14: West Bengal has complied with FCs recommended target since 2014…
(deviation from recommended fiscal deficit, percentage points of GSDP)

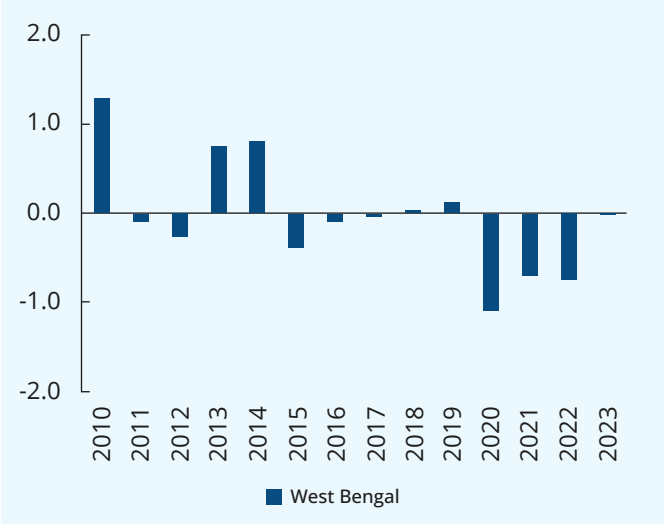
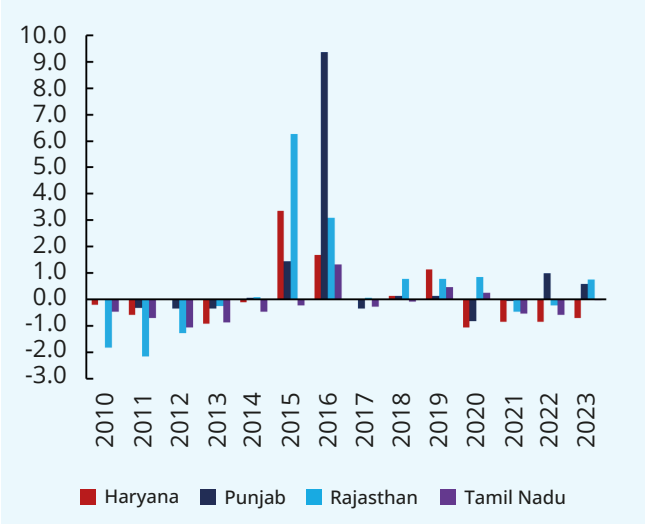


Figure 15: …while Haryana, Punjab, Rajasthan and Tamil Nadu had two large deviations
(deviation from recommended fiscal deficit, percentage points of GSDP)



Source: RBI, MoSPI and World Bank staff calculations.
Note: A positive number indicates that the fiscal deficit exceeded the fiscal deficit recommended by the FC. 2010=FY10/11.

States that showed a pattern of repeated deviation from the fiscal rule have also accumulated significant off-budget liabilities. Both Andhra Pradesh and Kerala have repeatedly exceeded the prescribed borrowing limit by around 1 percentage point and 0.5 percentage points respectively starting from FY15/16. As a result, they had also accumulated off-budget liabilities (borrowings undertaken by public sector enterprises or publicly owned SPVs but serviced and repaid by the state government) of around 8 percent of GSDP and 3 percent, as of FY22/23. This has contributed to the deterioration in their fiscal positions.

Figure 16: Andhra Pradesh and Kerala have shown a pattern of repeated deviation…
(deviation from recommended fiscal deficit, percentage points of GSDP)

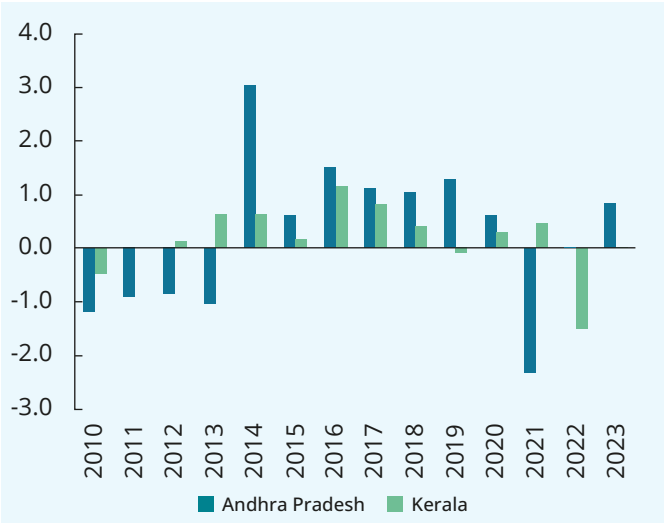
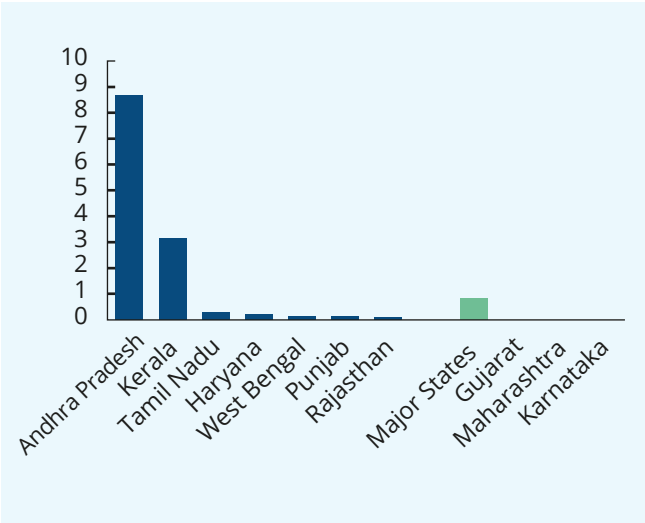


Figure 17: …which has resulted in the accumulation of off-budget liabilities
(off budget liabilities, percent of GSDP, end-2022-23)



Source: RBI, MoSPI, FC reports, World Bank staff calculations.
Note: 2010=FY10/11.

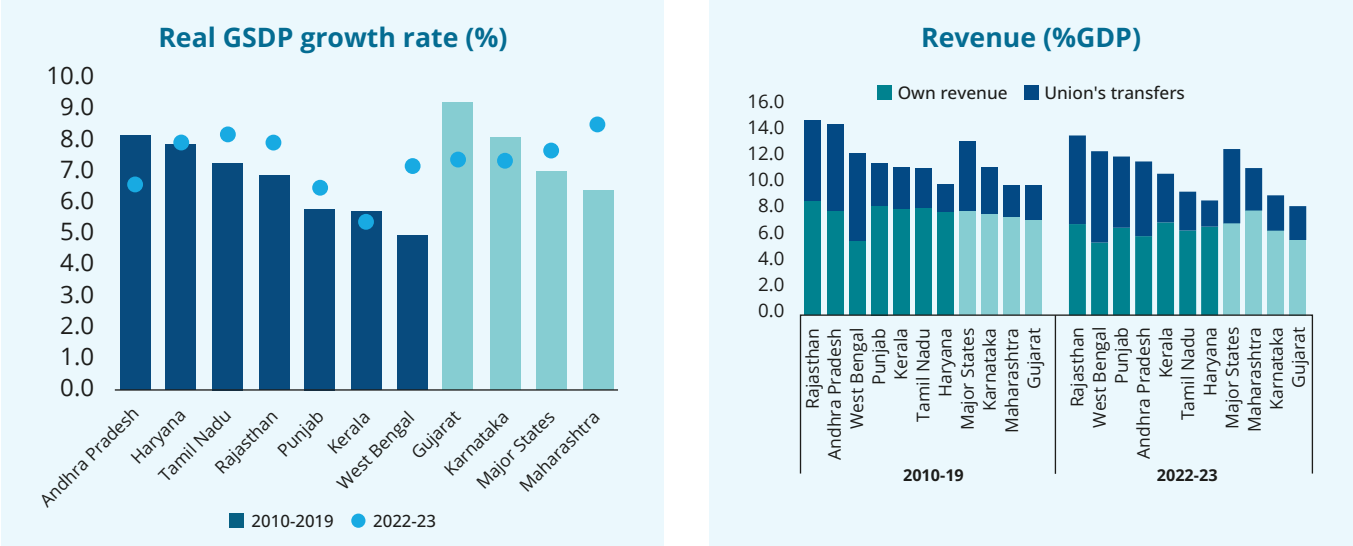
Among the selected states, Punjab, Kerala and West Bengal have been growing relatively slower. Between 2010 and 2019, these three states have grown at a relatively slower pace of around 5-5.8 percent year-on-year compared with the major state average of 7.0 percent and much slower than high performing states like Gujarat, which grew at 9 percent on average. This has contributed to the accumulation of debt as a share of GSDP as the growth-interest rate dynamics for these states have been less favorable.

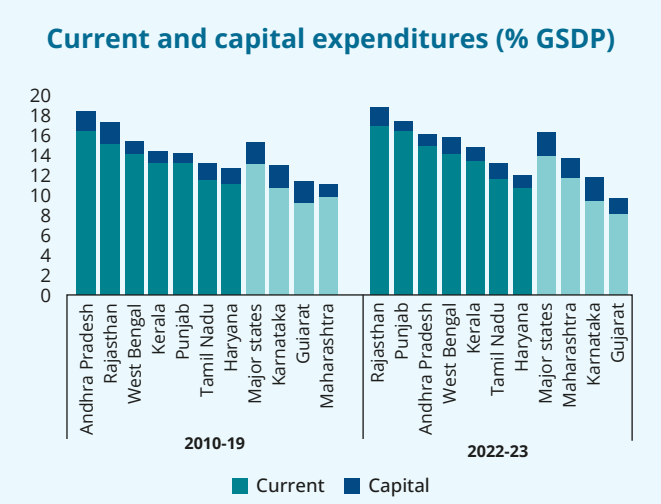
Punjab, Kerala, Tamil Nadu and Haryana received smaller transfers from the central government while West Bengal generated less of its own revenue. Punjab, Kerala, Tamil Nadu, and Haryana receive lower devolved tax amounts than the average major state due to smaller populations and higher per-capita incomes; their shares in the horizontal devolution formula have declined over time. West Bengal received a large share of its revenues in the form of transfers from the central government but its own revenues, at 5.7 percent of GSDP are much lower than the 8 percent average for major states.

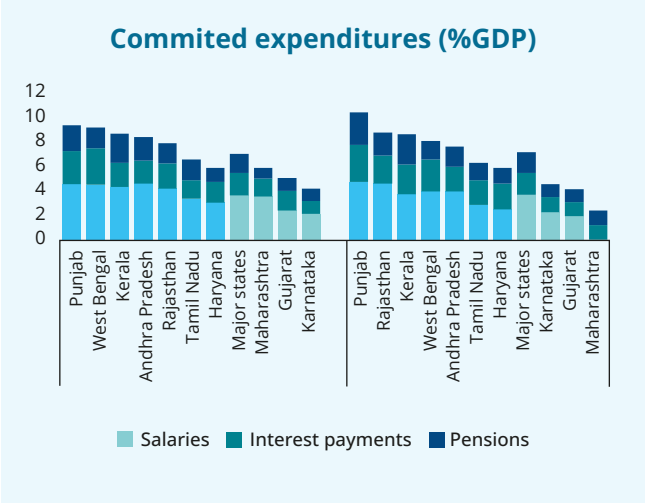
A larger salary and pension bill as well as relatively high levels of debt servicing have pushed up committed spending in Punjab, West Bengal, Kerala, Andhra Pradesh and Rajasthan. Government salaries exceeded 4 percent of GSDP in all four of these states, compared with about 3.6 percent in major states; pensions were similarly higher across these states. Moreover, three of these states, Punjab, Rajasthan and West Bengal also switched back to a defined benefit pension plan (Old Pension Scheme) for government servants from the defined contribution plan (New Pension Scheme) introduced in 2005-2006. The interest burden for these five states is also higher than the 1.8 percent of GSDP average for major states, from 2 percent in Kerala and Rajasthan to as much as 3 percent in Punjab and West Bengal.

Consequently, spending composition skews towards current expenditure, leaving minimal fiscal space for public investment. Andhra Pradesh, Rajasthan and West Bengal have higher levels of current spending as a share of GSDP at over 14 percent, compared with major states at 13 percent on average. This, coupled with lower revenue mobilization, has contributed to the relatively large revenue deficits in these states. Punjab, Kerala and West Bengal also have a relatively low level of public investment at around 1-1.2 percent of GSDP, compared with the major state average of 2 percent which has contributed to the deceleration in GSDP growth.

Figure 18: The macroeconomic and fiscal profile of most of the selected states is weaker than the average and the benchmark states Gujarat, Maharashtra and Karnataka







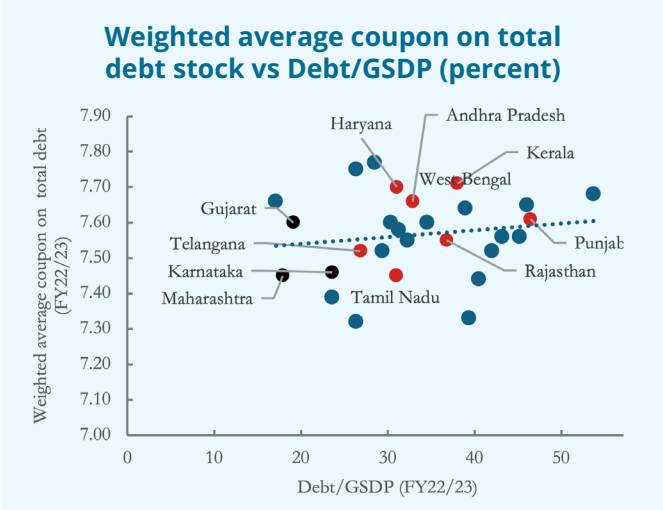
Source: RBI, MoSPI and World Bank staff calculations.

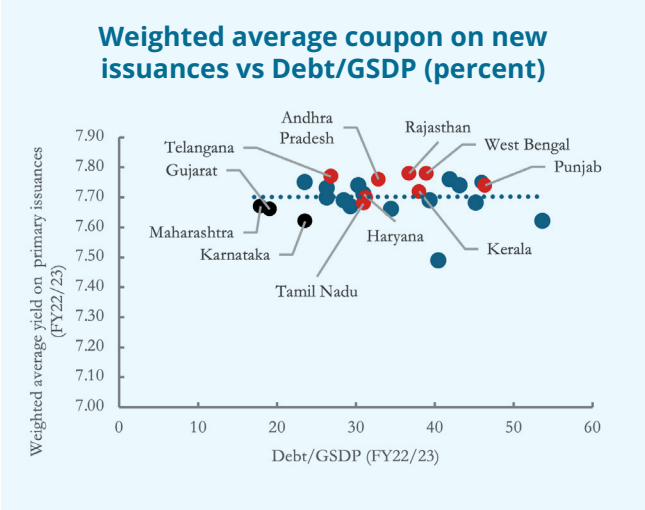
Note: Salaries data for Maharashtra is not available for FY22/23 and FY23/24. 2010-2019 refers to the average from FY10/11 to FY19/20, and 2022-2023 refers to the average from FY22/23 to FY23/24.

The analysis indicates that rising contingent liabilities, slow growth, and high committed spending have increased debt levels among the selected states. Only in Kerala and Andhra Pradesh, debt levels have grown as a share of GSDP due to non-compliance with the recommended debt path and accumulation of off-budget borrowings. The underlying reasons for the non-compliance are the relatively high level of spending by both states that exceed their revenue collection. The same is true for West Bengal although its borrowing has remained below the recommended levels for the past decade. In the other selected states, debt levels have mainly gone up due to the realization of large contingent liabilities in the power sector and in Punjab's case food procurement. The sharp one-off increase in debt has been compounded in states like Punjab and Rajasthan by the relatively high level of rigidity in their spending in the form of committed spending.

Fiscal deterioration does not significantly raise borrowing costs for states. Markets inadequately price fiscal performance differences between states due to the implicit sovereign guarantee for state development loans (SDLs) and the central bank's coordinated sales of SDLs for several states. In fact, the weighted average yield on the debt stock of well performing states like Gujarat is equivalent to that of Punjab, which has much higher debt levels. The yields on new issuances of SDLs are also seemingly unrelated with a state's debt levels. States with higher debt can continue borrowing like less indebted states, which undermines fiscal discipline.

Figure 19: There is no correlation between a state's debt stock and the cost of borrowing from the market





Source: RBI, MoSPI, Ministry of Finance and World Bank staff calculations.
Note: The weighted average coupon for new issuances reflects the average interest rate on recently issued debt, while the weighted average coupon for the total debt stock indicates the average interest rate on all outstanding debt.

SECTION 3

International experiences of subnational fiscal frameworks

Designing fiscal rules for subnational governments (SNGs) requires a delicate balance. On one hand, simplicity and transparency call for a uniform "one-size-fits-all" approach. On the other hand, the diverse fiscal conditions of SNGs demands flexibility and tailored thresholds, necessitating more complex arrangements. Drawing on international experience is crucial for designing effective fiscal policies for SNGs. Countries around the world have faced similar challenges in balancing simplicity and transparency with the need for flexibility and differentiation in fiscal rules. Studying these diverse approaches enables policymakers to pinpoint best practices, avoid common pitfalls, and customize solutions for their specific contexts.

This section delves into the design, implementation, and enforcement of fiscal rules in Brazil, Mexico, and the European Union (EU), offering valuable insights for India. Brazil faced repeated debt crises for SNGs during the 1980s and 1990s, prompting the creation of a robust control system for managing indebtedness. This system included fiscal adjustment programs for SNGs, conditioned bailouts from the federal government, fiscal rules, and borrowing constraints. This framework was effective for nearly two decades. However, unresolved structural pressures on SNGs' public finances and a severe downturn triggered a new debt crisis in the late 2010s. Mexico's approach features a flexible fiscal rule that adapts to varying fiscal conditions through a traffic light system. This innovative system has successfully managed SNGs' indebtedness both on average and at the individual level. The EU's experience highlights the ongoing challenge of balancing simplicity and transparency with the need for flexibility and complexity in fiscal governance.

Brazil

In response to repeated fiscal crises involving SNGs in the 1980s and 1990s, Brazil implemented a series of fiscal reforms aimed at controlling SNGs' indebtedness. The 1997 fiscal adjustment program, which included debt renegotiation contracts and the establishment of the Fiscal Responsibility Law (LRF) in 2000, was particularly effective. These reforms enforced strict borrowing limits, set caps on debt service, and required SNGs to comply with fiscal adjustment programs. Consequently, Brazil experienced significant improvements in fiscal discipline and robust primary surpluses. There was also a substantial reduction in subnational debt over the following fifteen years.

However, the system faced several challenges including creative accounting, procyclicality and a failure to address structural expenditure pressures. The cap on debt service payments led to a build-up of capitalized unpaid debt service, and fiscal indicators were highly procyclical, reflecting revenue performance rather than genuine fiscal improvements. Structural expenditure pressures, creative accounting practices, and the "magnet effect" of fiscal rules (the tendency to increase debt and deficits to the threshold or target level) also posed problems. The deep recession of 2015-16 exposed these issues, leading to deteriorating fiscal balances and the accumulation of debt service arrears.

In 2018, a new debt renegotiation agreement aimed to address some of these challenges. The agreement included retroactive interest rate reductions and a new repayment schedule for all SNGs. In addition, a new fiscal recovery regime was set up for states with severe debt distress, enabling participant states to suspend debt services for 3 years in exchange of very stringent fiscal adjustment plans. In addition, the CAPAG *(Capacidade de Pagamento)* rating system was updated and converted into a traffic light system. The National Treasury improved transparency by harmonizing accounting standards and publishing aggregate and state-level data, enforcing timely data submission, and standardizing expenditure classifications, especially for personnel, in agreement with the Court of Accounts (Bornhorst, 2019).

Mexico

Following the 2008 global financial crisis, SNG debt levels in Mexico increased but remained low as a share of GDP. SNG debt levels rose from MXN 190 billion (1.6 percent of GDP) in 2007 to MXN 580 billion (2.9 percent of GDP) in 2017. Although SNG debt levels have not posed macro-systemic risks at the country level, some Mexican SNGs experienced fiscal distress. This threatened their ability to deliver essential services, invest in public goods, and bolster economic growth and welfare. The global financial crisis of 2008 led to poor revenue performance and increased recurrent expenditure pressures, resulting in declining fiscal balances and rising debt levels. Consequently, the number of state governments with debt levels exceeding 50 percent of non-earmarked revenue (NER) rose significantly between 2008 and 2016.

The adoption of the Fiscal Responsibility Law for SNGs *(Ley de Disciplina Financiera de las Entidades Federativas y los Municipios, LDFEFM)* in 2016 marked a significant transformation in the regulatory framework for SNG debt in Mexico. The law established hierarchical controls on subnational indebtedness, complementing market mechanisms developed in the 2000s. The new institutional framework includes the LDFEFM and three complementary regulations. These consist of a "traffic light" system, a public debt registration system, and guidelines for contracting debt at the lowest possible cost. Additionally, it provides access to guaranteed federal debt for debt-restructuring operations between SNGs and creditors under fiscal-adjustment agreements.

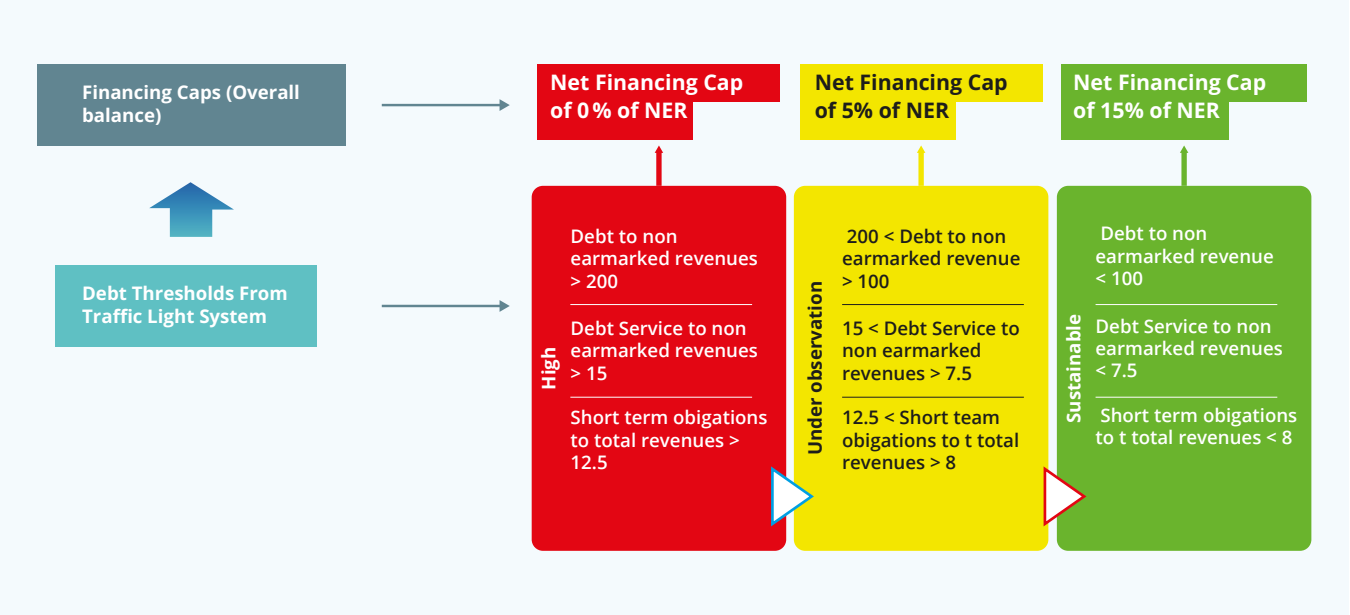
The LDFEFM and its ancillary laws included complementary provisions to reduce the likelihood of fiscal distress in the future. The LDFEFM established several rules for SNG fiscal management, including: (i) the "golden rule," which states that borrowing should finance productive public investment rather than current spending; (ii) a cap on the annual growth of personnel expenditures; (iii) provisions for using excess revenues to finance anticipated debt repayments or accumulate in a natural disaster fund; (iv) provisions for cutting spending on non-productive expenditure items when actual revenues fall below projected levels; and (v) an escape clause that allows temporary suspension of fiscal rules in the event of a natural disaster or severe economic slowdown.

The reform was accompanied by the creation of a debt registration system and regulations for contracting debt. The subnational debt recording system improved transparency by providing detailed, timely information on SNG debt stocks, borrowing operations, interest rates, maturities, and debt-service flows. This system ensures that all stakeholders have access to reliable, up-to-date information on the debt obligations of each state and municipality. The revised framework also mandated SNGs to contract debt through competitive auctions with a minimum number of participants. It included guidelines for defining borrowing costs, selecting offers with the lowest costs, and publishing the details of the offers received and the outcome of the selection process. It also required that the budget preparation process adhere to the fiscal balance and expenditure limits established by the LDFEFM. Furthermore, SNGs must adopt standardized rules for public financial accounting and develop medium-term fiscal frameworks.

The LDFEFM allowed for debt restructuring for highly indebted SNGs, provided that a fiscal adjustment agreement was in place. The law defined the conditions for using federal guarantees linked to fiscal-adjustment agreements to support debt restructuring. These guarantees aimed to enhance the federal government's capacity to influence SNGs' fiscal performance and reduce borrowing costs.

The LDFEFM also included a fiscal-balance rule that imposes financing caps based on debt thresholds defined in the "traffic light" system. This system classifies SNG indebtedness as sustainable (green), in observation (yellow), or high (red) based on three debt indicators. Each classification imposes a ceiling on net financing, which is expected to prevent excessive indebtedness automatically.

Figure 20: The traffic light system enables setting different borrowing thresholds according to variant fiscal conditions



Source: "Mexico: Ensuring Subnational Fiscal Sustainability", World Bank (2019).

The LDFEFM and its supporting regulations create a strong framework to control subnational indebtedness. This main fiscal rule is both simple and transparent, offering clear guidance for fiscal policy implementation. The "traffic light" system sets financing ceilings and informs creditors and taxpayers about the fiscal solvency of SNGs. The public debt record system provides reliable, updated information for market participants. Regulations mandating that debt be contracted under optimal market conditions enhance transparency and lower financing costs. Furthermore, federal guarantees for debt restructuring are expected to strengthen the federal government's control over the finances of highly indebted SNGs and help reduce the frequency of future debt restructuring episodes. Finally, the LDFEFM also contains important budget-preparation and execution rules, such as the mandatory inclusion of medium-term fiscal frameworks in SNG budget laws, which is expected to improve fiscal planning and enhance expenditure efficiency.

The LDFEFM traffic light system effectively reduced indebtedness and improved fiscal balances. Despite the recent crises caused by the COVID-19 pandemic and the spikes in food and energy prices related to the war in Ukraine, the system has managed to prevent excessive indebtedness during these extreme economic challenges. This achievement is particularly noteworthy, as many countries were compelled to suspend their fiscal frameworks to support health systems, individuals, and businesses during the pandemic (Del Castillo and Bral, 2024[15] and de Mello and Ter-Minassian, 2022[16]).

15 Del Castillo, E. and Cabral, R., 2024. Subnational public debt sustainability in Mexico: Is the new fiscal rule working? European Journal of Political Economy. Volume 82.

16 De Mello, L. and Ter-Minassian, T., 2022. Improving subnational governments' resilience in the wake of the COVID-19 pandemic. OECD Working Papers on Fiscal Federalism. No 37.

The European Union (EU)

Over the last 30 years, the EU fiscal framework has evolved from a simple, one-size-fits-all model to a more flexible, tailored approach. Initially, the Maastricht Treaty of 1992 established critical fiscal thresholds, capping public debt at 60 percent of GDP and fiscal deficits at 3 percent of GDP. While these rules aimed to enhance credibility, they often led to procyclical policies and failed to account for country- specific shocks. Reforms like the Stability and Growth Pact (SGP) in 1997 and subsequent adjustments introduced medium-term objectives and structural balance concepts to provide more flexibility, but also added complexity and reduced transparency.

Historically, compliance with the EU fiscal rules has been modest, with pressures for modification arising from their inception. The rigidity of the debt and deficit rules led to frequent violations by several countries, and the overall compliance record was only slightly above 50 percent[17] . The increasing complexity of the rules, aimed at making them adaptable to specific country circumstances, paradoxically resulted in less transparency and difficulty in monitoring compliance. The COVID-19 pandemic further exposed the limitations of the framework as member states had to implement aggressive fiscal expansions, leading to a temporary suspension of the rules.

The new EU fiscal framework introduced in 2024 seeks to address past shortcomings by maintaining the 3 percent of GDP deficit and 60 percent of GDP debt caps but facilitating convergence to these targets through country-specific debt sustainability analyses (DSAs). The new fiscal policy target shifted to a single indicator: net public expenditure, replacing the structural balance and real government expenditure growth. This framework ensures that debt levels remain on a plausibly downward path and allows for fiscal adjustments to be spread over four to seven years, incentivizing public investment and economic growth. However, the process to calculate target values remains complex and involves multiple steps.

One of the main objectives of the fiscal framework as updated in April 2024 is to safeguard public investment during fiscal consolidation, as past consolidation efforts often led to cuts. The framework incentivises investment by allowing an extension of the fiscal adjustment period from four to seven years, thereby easing the pace of consolidation. To qualify for this extension, governments must propose reforms and investments that collectively foster economic growth, enhance fiscal sustainability, and align with EU priorities and country-specific recommendations.

The evolution of the EU fiscal framework over the last 30 years highlights the trade- offs between simplicity and flexibility. The EU fiscal rules evolved from a simple, but rigid, procyclical and one-size-fits-all approach to a more flexible approach, that is non-procyclical and tailored for specific fiscal conditions of each member states. However, this improvement has come at the cost of rising complexity, monitoring challenges and less transparency. A balanced approach that includes clear, transparent rules with built-in flexibility to account for country-specific conditions and economic cycles can enhance both compliance and fiscal stability.

17 Larch, Martin, and Wouter van der Wielen. 2023. "Numerical Compliance with EU Fiscal Rules: Facts and Figures from a New Database." Intereconomics 58 (1).

Key lessons from international experiences:

- **Establish clear and enforceable fiscal rules:** Countries should implement robust frameworks with strict borrowing limits and debt service caps to ensure fiscal discipline, as demonstrated by Brazil's Fiscal Responsibility Law (LRF).
- **Avoid overly complex and non-transparent frameworks:** While tailored approaches can address specific fiscal conditions, they can also lead to complexity and reduce transparency, as seen in the European Union's evolving fiscal rules.
- **Incorporate flexibility based on states' fiscal position:** Fiscal rules should be flexible to accommodate adjustments based on states' fiscal situations, such as Mexico's "traffic light" system, which adapts borrowing limits according to fiscal health indicators.
- **Ensure timely and transparent reporting:** A reliable debt registration system, like in Mexico, enhances transparency and allows stakeholders to access up-to-date information on subnational debt levels and borrowing operations.
- **Protect public investment during fiscal consolidation:** The EU's updated framework incentivizes public investment by extending fiscal adjustment periods, ensuring that fiscal consolidation does not come at the expense of essential public infrastructure.
- **Address structural expenditure pressures:** Implement measures to manage long-term expenditure commitments effectively, avoiding issues such as Brazil's structural expenditure pressures that contributed to fiscal distress during economic downturns.

SECTION 4

Way forward: proposals to enhance the current framework

India's subnational fiscal rules framework is clear and enforceable but its one-size-fits-all approach ignores heterogeneity in fiscal conditions across states. The current fiscal framework has two well-defined targets – a revenue balance and a fiscal deficit below 3 percent of GSDP. However, the revenue balance rule is only a de jure limitation, while the only de facto limitation on states' finances is the fiscal deficit rule which is enforced through the annual borrowing limit under Article 293 (3) of the Constitution. Moreover, the annual borrowing limit is not linked to a medium-term debt anchor and is applied uniformly across states, with only a few exceptions. The example of the seven selected states previously discussed illustrates that states with high debt levels prior to the implementation of FRLs had maintained those elevated debt levels, even after nearly two decades of having fiscal rules in place. Lowering public debt levels across all states would require adopting a medium-term debt anchor and redesigning the fiscal framework such that the central government can lower the borrowing limit for highly indebted states. It is also important that the fiscal framework have clearly defined metrics and thresholds on which to base the differentiated borrowing limits to avoid ad-hoc changes.

The subnational institutional and accounting framework is prone to rigid spending and can obscure the states' true fiscal health. Many states face constraints, including budget rigidity related to salaries, interest payments, and pensions, as well as politically sensitive spending such as subsidies. Additionally, they have mandatory expenditures, for instance, tied to centrally sponsored schemes. Some states rely heavily on central transfers due to a significant vertical fiscal gap, which arises from an imbalance between their revenue assignments and spending responsibilities. These constraints can prevent states from complying with fiscal rules. The inconsistency and low quality of public accounting led to varying definitions of off-budget borrowing across states, while cash-based accounting fails to reflect the true fiscal health of states. In the absence of a clearly defined escape clause, borrowing limits for states are adjusted on an ad-hoc basis according to FC recommendations, which may weaken the transparency and predictability of the subnational fiscal framework.

Adapting the traffic light system to tailor borrowing limits to states' fiscal positions

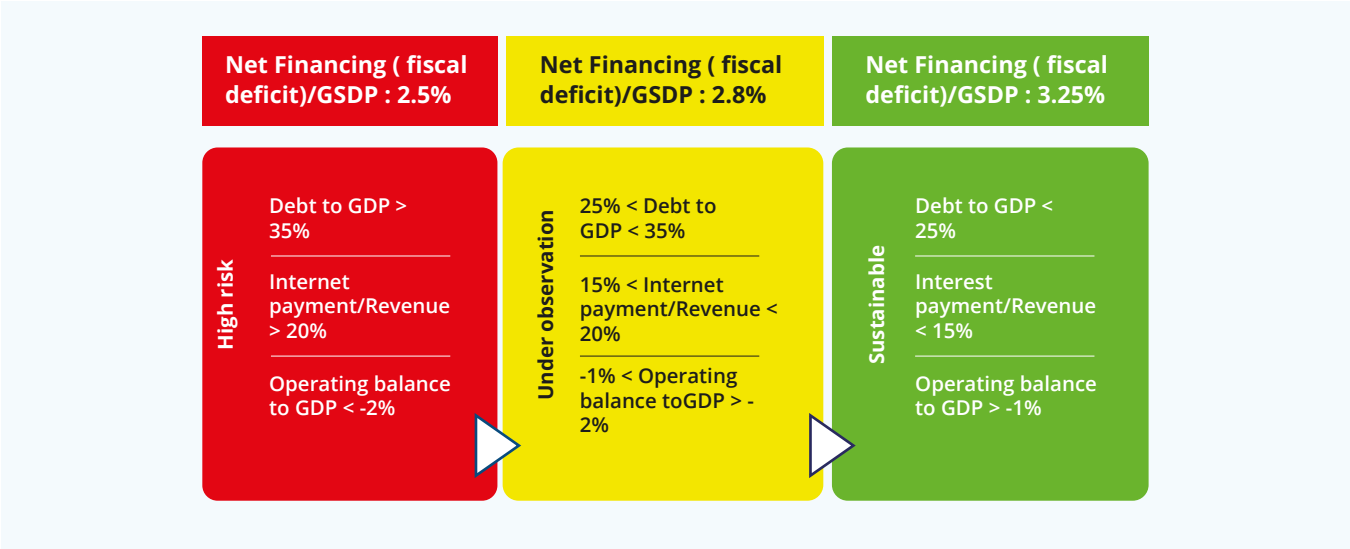
Mexico's traffic light system can be adapted to the Indian context to bring in an element of differentiation across states. Using some elements of the existing fiscal framework like the center's ability to restrict the states' annual borrowing limits and the established practice of successive FC's recommending a fiscal glide path for states, the 16th FC has an opportunity to introduce some differentiation in borrowing limits across states with reference to their past fiscal performance and level of indebtedness. Adopting a traffic light system like Mexico, based on objective quantitative indicators and linked to a medium-term debt anchor can help reduce debt levels in highly indebted states.

The traffic light system is based on quantifiable indicators that measure a state's fiscal sustainability and solvency. For the sake of simplicity, the traffic light system should be based on two or three clearly defined indicators that correlate well with fiscal sustainability and solvency of a state. As an illustrative example, we describe a traffic light system based on three indicators – total outstanding liabilities (including off-budget borrowings), a three-year average of revenue balance, expressed as a share of GSDP, and interest payments expressed as a share of non-grant revenue[18]. In terms of assigning the final ratings, any state that has a debt-to-GSDP ratio of over 35 percent is classified as "high risk" while states that have debt-to-GSDP

18 Total revenue excluding grants from the central government, a large share of which are earmarked for specific programs or purposes.

ratio below 25 percent, interest payment/non-grant revenue below 15 percent and revenue deficit to GSDP ratio smaller than 1 percent are classified as "sustainable". States that have debt below 35 percent of GSDP and are not below all three thresholds are classified as "under observation". Based on FY24/25 data, among the major states, Andhra Pradesh, Bihar, Kerala, Punjab, Rajasthan, Telangana and West Bengal are classified as "high risk" states while Gujarat, Maharashtra and Odisha are classified as "sustainable" (see Table A1 in the Annex).

Figure 21: A proposed traffic light system for Indian states



Source: World Bank staff.

Using the traffic light system to decide states' annual borrowing limits can expedite debt reduction. To ensure that highly indebted states remain on a fiscally sustainable glide path and that all states eventually reduce their debt to a medium-term debt anchor (in this case 25 percent of GSDP) we propose reducing the annual borrowing limit of "high risk" states to 2.5 percent, "under observation" states to 2.8 percent and allowing "sustainable" states to borrow 3.25 percent. However, considering that many "high risk" states may have fiscal deficits that are higher than 2.5 percent, we propose a glide path that allows them to gradually reduce their fiscal deficits by the end of the 16th FC period. We suggest similar glide paths for states that are "under observation" and assume that "sustainable" states take advantage of their full borrowing limit. Given the unique fiscal position of "special category" north-eastern and hilly states, we assume that their annual borrowing limit will remain at 3 percent of GSDP. Aggregate debt declines faster under this proposal than under a baseline scenario, in which all states have a uniform borrowing limit of 3 percent of GSDP starting in FY26/27. Aggregate debt would decline even faster in a scenario in which the borrowing limit for "sustainable" states is restricted to 3 percent of GSDP, instead of 3.25 percent. Figure 22 shows the individual fiscal glide paths and resultant debt paths. A full description of the methodology and assumptions for individual states is included in the annex.

The projected debt paths are highly sensitive to growth assumptions and fiscal glide paths. Sensitivity checks of the debt paths for the most indebted states indicate that the decline in debt as a share of GSDP would be much slower if projected growth is just 2 percentage points lower than the 15-year historical average

assumed in the baseline (Figure 30). Similarly, the pace of debt reduction will depend on the pace of fiscal consolidation. While a more conservative and politically feasible fiscal consolidation has been considered in the baseline, sensitivity checks indicate that debt reduction would vary significantly with the intensity of fiscal consolidation (Table 2). Some states with very high levels of debt would take well over 25 years to reduce debt below 25 percent of GSDP if their annual fiscal deficit remained at 3 percent of GSDP, but if they managed to limit their fiscal deficit to 2 percent, they would be able to reduce debt below 25 percent in 12-15 years.

Table 2. The time taken to reduce debt below 25 percent varies significantly depending on the fiscal deficit each year

State	3 percent	2.5 percent	2 percent	1.5 percent
Andhra Pradesh	> 25 years	20 years	12 years	9 years
Bihar	20 years	8 years	6 years	4 years
Kerala	> 25 years	22 years	11 years	7 years
Punjab	> 25 years	> 25 years	16 years	11 years
Rajasthan	17 years	8 years	5 years	4 years
Telangana	17 years	8 years	5 years	4 years
West Bengal	> 25 years	15 years	8 years	6 years

Figure 22: The aggregate fiscal deficit falls to 2.8 percent under the traffic light system...
(percent of GDP)

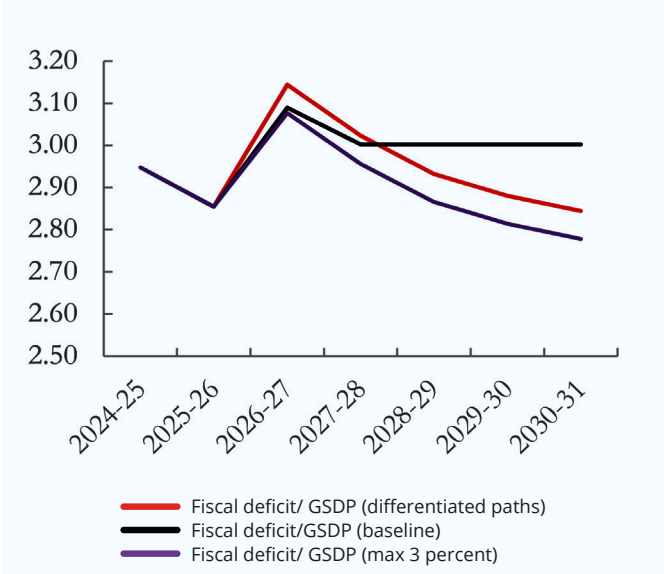
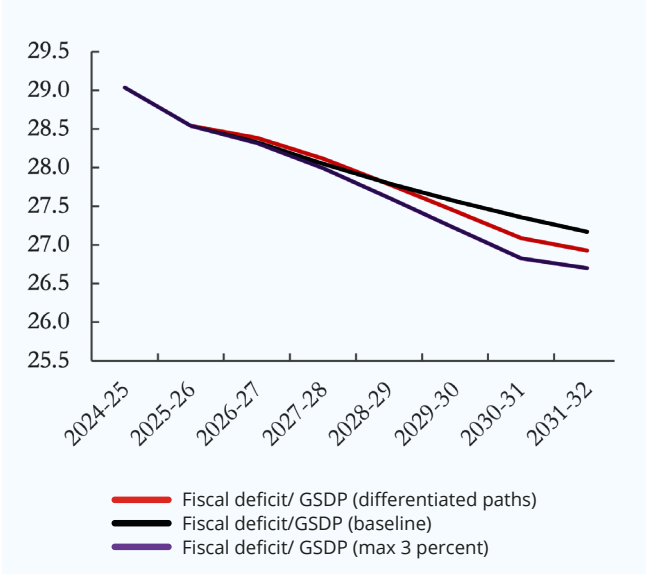


Figure 23: ...and the aggregate debt-to-GDP ratio reduces by 0.3 to 0.5 percentage points
(percent of GDP)



Source: World Bank staff calculations.
Note: 2024-25=FY24/25.

Figure 24: Proposed fiscal glide paths for "high risk" states
(fiscal deficit, percent of GSDP)

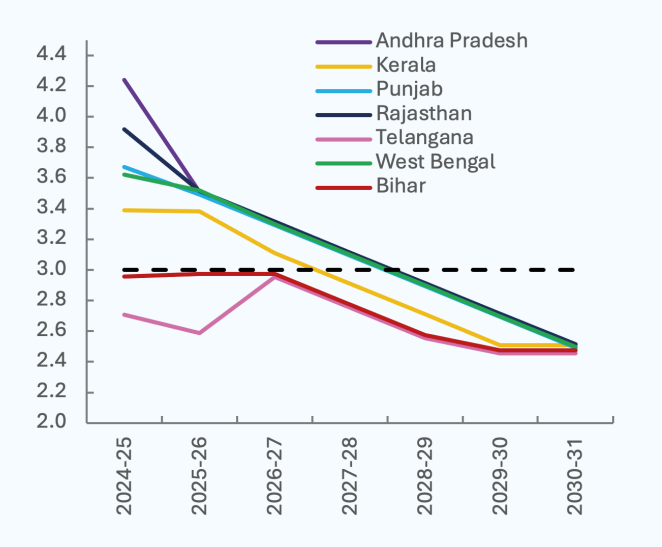


Figure 25: Debt paths for "high risk" states
(total outstanding liabilities including off-budget borrowing, percent of GSDP)

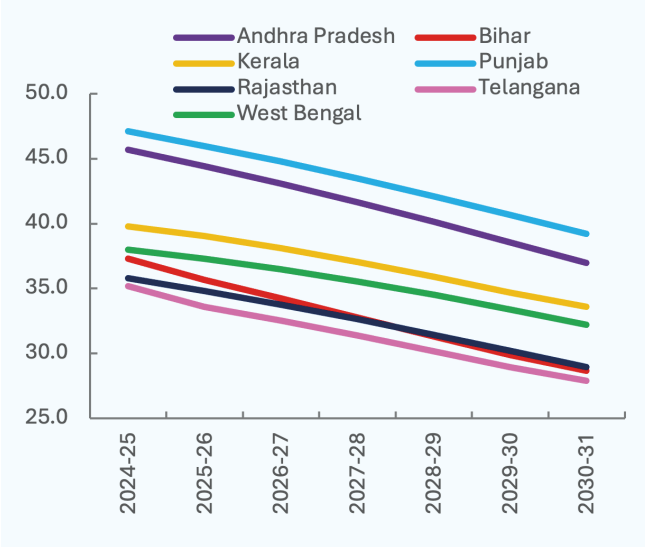


Figure 26: Proposed fiscal glide paths for "under observation" states
(fiscal deficit, percent of GSDP)

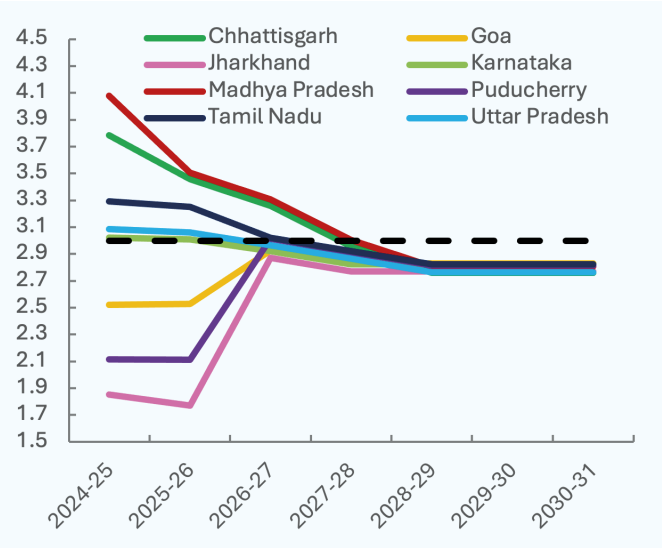
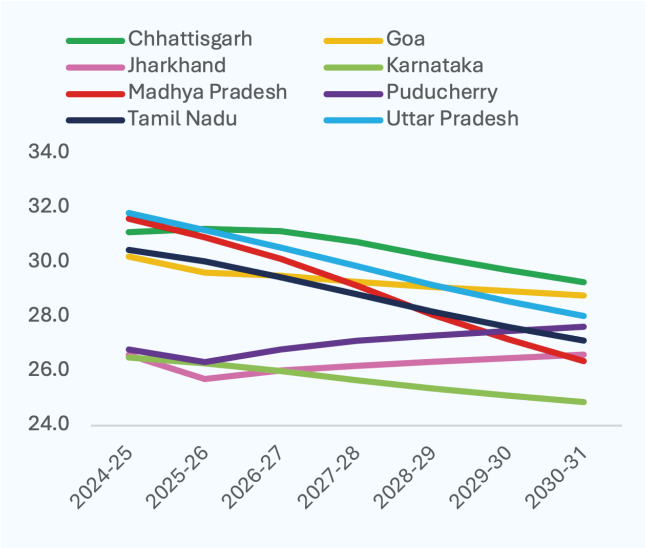


Figure 27: Debt paths for "under observation" states
(total outstanding liabilities including off-budget borrowing, percent of GSDP)



Note: 2024-25=FY24/25.

Figure 28: Proposed fiscal glide paths for "sustainable" states

(fiscal deficit, percent of GSDP)

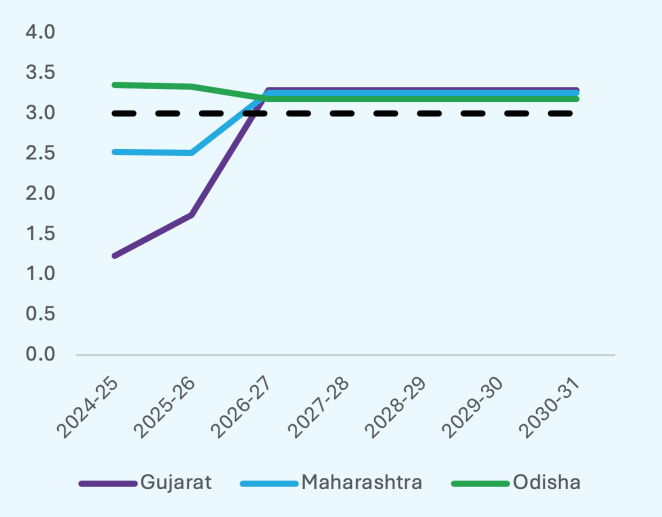
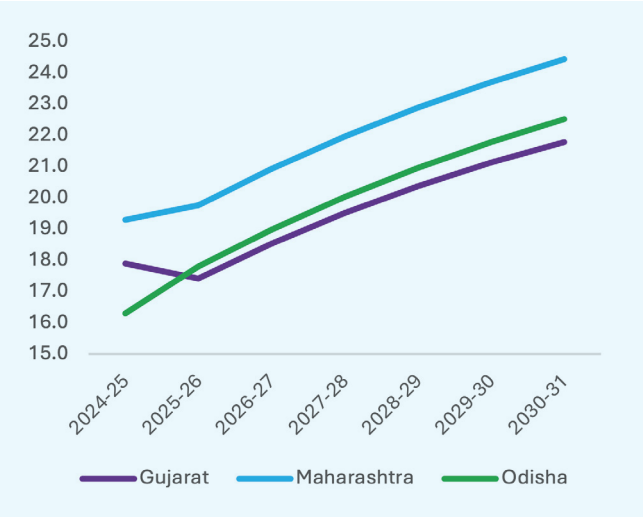


Figure 29: Debt paths for "sustainable" state

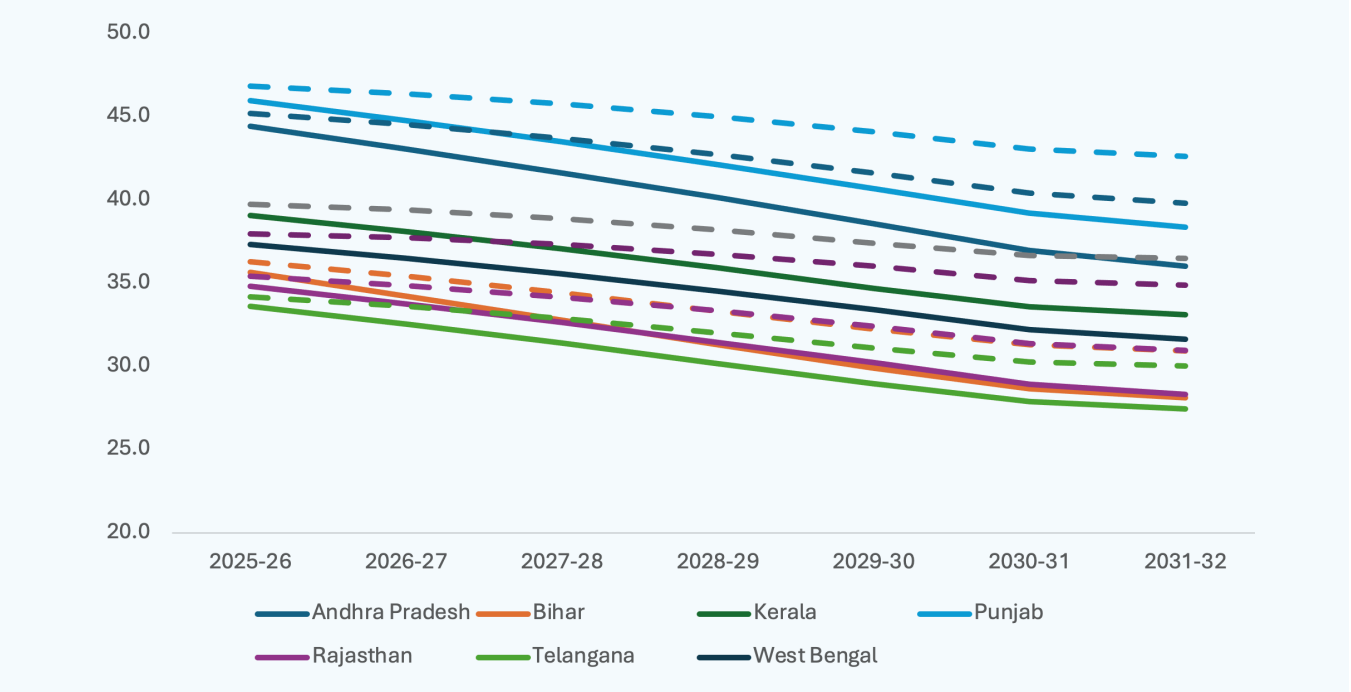
(total outstanding liabilities including off-budget borrowing, percent of GSDP)



Source: World Bank staff calculations.

Note: The fiscal glide paths are based on the assumption that states that are above the borrowing limit will reduce their fiscal deficit to 3.5 percent in 2025-26, and then gradually align with the borrowing limit proposed in the traffic light system before the end of the 16th FC period. However, states that are below the borrowing limit are expected to start using all the available fiscal space from the first year of the 16th FC. The debt projections are based on the assumption that the states are growing at their historical (15 years) average rate and the interest rate remains stable at the effective interest rate level observed in 2024-25. 2024-25=FY24/25.

Figure 30. The projected glide paths are highly sensitive to GSDP growth projections, especially for the most indebted states



Note: Dashed lines represent debt paths under an alternative scenario where growth in GSDP is 2 percentage points lower in the projection period than the baseline. 2024-25=FY24/25.

Enhancing the institutional framework

To ensure the success of the traffic light system, it is essential to strengthen the institutional framework for fiscal rules. This includes harmonizing accounting and reporting standards, particularly for off-budget borrowing, and establishing well-defined escape clauses to allow for temporary deviations from targets under extraordinary circumstances.[19] It is also crucial to introduce systematic reporting of government arrears and contingent liabilities, including state-guaranteed debt. Additionally, the monitoring of compliance with fiscal rules should be enhanced through the Department of Expenditure or by establishing a permanent secretariat for the FC. Finally, states can be incentivized to comply with the fiscal deficit targets by linking programs like the interest- free loans from the central government for capital spending to the states' track record of compliance with fiscal rules.[20]

Considering a debt relief program and implementing medium-term structural reforms.

States with high levels of debt and deficits could be permitted to restructure their debt, similar to the approach taken by the 12th FC, provided they implement fiscal adjustment programs. States facing significant structural deficits and heavy debt servicing burdens may be allowed to restructure their debt or receive one-time financial transfers, on the condition that they undertake measures to reduce discretionary spending and increase revenue.

Medium-term structural reforms are crucial for enhancing fiscal sustainability and ensuring compliance with fiscal rules. To increase public investment while lowering borrowing limits, stricter enforcement of revenue balance targets (under the traffic light system) is necessary. Unlike fiscal deficit targets, the recommended revenue deficit targets set by successive FCs have not been enforced, leading to borrowings to finance recurring expenditures. Implementing an accrual accounting system and establishing an independent fiscal institution (IFI) would enhance the accuracy of the state's fiscal data, improve fiscal health assessments, and facilitate the monitoring of fiscal rules. Additionally, reviewing state pensions and public wage benefits is essential for reducing budget rigidities. This involves capping the annual growth of the wage bill and removing redundant positions. Increasing flexibility in central transfers, particularly by rationalizing Centrally Sponsored Schemes (CSS), which are rigid, is also important. Furthermore, reassessing the intergovernmental transfers system to balance revenue assignments and spending responsibilities is crucial. These reforms will ensure a more sustainable and compliant fiscal framework.

19 Based on international experiences, escape clauses should include clearly defined triggers, a process for returning to the established rule, a control mechanism, and effective communication. In Jamaica, the escape clause can be activated only in the event of a natural disaster, an emergency, or severe economic contraction (defined as a 2 percent decline in GDP within a quarter). This proposal must be verified by the supreme audit institution and approved by both Houses of Parliament. In Panama, the escape clause includes a three-year time limit for returning to compliance with the fiscal rule. Meanwhile, in the European Union, the activation of the escape clause is accompanied by a "reimbursement plan" to repay any additional borrowing incurred during the crisis, following a fiscal adjustment plan.

20 International experience indicates that incentives offering benefits for compliance and costs for non-compliance are more effective than those based solely on costs. Therefore, the proposed incentive would involve providing interest-free central loans (benefits) to states that adhere to fiscal rules, while imposing interest charges (costs) on states that do not comply, proportional to the extent of their deviations.

Annexure

Table A1. State-level fiscal indicators and traffic light ratings

	Debt / GSDP	Interest payment/ Revenue	Operating balance (3 yr average)/GSDP	Rating
Andhra Pradesh	45.7	16.8	-2.4	
Assam	27.5	11.3	-0.3	
Bihar	37.3	11.7	-1.5	
Chhattisgarh	31.1	7.0	-0.3	
Goa	30.2	10.1	1.5	
Gujarat	17.9	13.1	0.8	
Haryana	30.4	22.3	-1.1	
Himachal Pradesh	45.2	21.6	-2.4	
Jharkhand	26.6	7.5	3.1	
Karnataka	26.5	15.8	-0.3	
Kerala	39.8	22.4	-1.5	
Madhya Pradesh	31.6	12.5	0.5	
Maharashtra	19.3	12.6	-0.3	
Manipur	36.7	9.4	8.5	
Meghalaya	39.0	8.7	4.4	
Mizoram	31.6	7.1	0.8	
Nagaland	40.0	14.9	1.8	
NCT Delhi	1.3	4.4	0.7	
Odisha	16.3	3.2	2.5	
Puducherry	26.8	11.9	0.1	
Punjab	47.1	25.7	-3.0	
Rajasthan	35.8	16.5	-1.6	
Sikkim	35.0	11.6	1.2	
Tamil Nadu	30.5	22.3	-1.3	
Telangana	35.2	8.7	0.2	
Tripura	27.9	11.5	1.2	
Uttar Pradesh	31.8	10.4	2.3	
Uttarakhand	24.2	16.1	1.1	
West Bengal	38.0	22.4	-1.5	

Note: Debt includes the stock of off-budget borrowing as of end-FY22/23.

Table A2. State-level baseline fiscal indicators for debt projection — Part I

FY2024-25 (in INR crores)	Revenue receipts	Non-grant revenue	Revenue expenditure	Capital outlay	Net lending	Interest payments	Nominal GDP
Andhra Pradesh	201186	170852	235917	32713	1286	28756	1621202
Assam	114165	85241	110092	26596	-2210	9597	647212
Bihar	227238	175077	225677	29416	801	20526	969229
Chhattisgarh	126050	112550	124840	22300	150	7931	561052
Goa	21750	20243	19888	4853	-8	2050	118290
Gujarat	247445	228662	219832	75689	-13950	29954	2762212
Haryana	122198	112686	134456	16281	-464	25142	1214610
Himachal Pradesh	42181	28893	46667	6270	1	6255	226977
Jharkhand	110900	93939	91832	23987	4481	7055	507020
Karnataka	263428	248128	290531	52903	2724	39234	2737568
Kerala	139798	128266	166501	15663	1020	28694	1280139
Madhya Pradesh	263817	218926	261644	61633	2630	27400	1522076
Maharashtra	501938	449223	519514	85292	5012	56727	4274043
Manipur	27720	11704	20628	8616	-2	1101	54271
Meghalaya	23545	14174	19653	5870	22	1236	59347
Mizoram	12420	8567	11822	1954	-23	605	44941
Nagaland	18035	9192	16893	2591	-1	1367	50492
NCT Delhi	64521	60129	60911	5919	3876	2666	1221623
Odisha	211505	173737	183563	58195	1645	5500	950677
Puducherry	10634	6915	10970	776	1	823	52661
Punjab	104586	92838	127134	7445	-178	23900	812131
Rajasthan	264787	228103	290219	44216	35	37538	1779428
Sikkim	10749	7930	10250	3338	1	918	54394
Tamil Nadu	303814	280459	348289	47681	11730	62456	3154094
Telangana	224802	203166	220945	33487	16066	17730	1688160
Tripura	22983	12884	21171	6065	-23	1486	95367
Uttar Pradesh	610101	516636	532655	154747	5930	53712	2697623
Uttarakhand	60677	41144	55816	13780	374	6636	394248
West Bengal	236438	201754	268203	35866	433	45269	1879462

Table A3. State-level baseline fiscal indicators for debt projection — Part II

	Total liabilities (excluding off-budget, INR crore)	Total liabilities (including off-budget, INR crore)	15-year average nominal growth rate (percent)	Effective interest rate (percent)
Andhra Pradesh	562557	740889	12.5	5.1
Assam	177983	177983	12.6	5.4
Bihar	361522	361522	13.2	5.7
Chhattisgarh	163266	174487	11.7	4.9
Goa	35724	35724	10.8	5.7
Gujarat	494436	494436	13.3	6.1
Haryana	369242	369242	13.3	6.8
Himachal Pradesh	102594	102594	11.4	6.1
Jharkhand	134867	134867	10.5	5.2
Karnataka	725456	725456	13.1	5.4
Kerala	471091	509495	11.4	6.1
Madhya Pradesh	480976	480976	14.3	5.7
Maharashtra	812068	824890	11.1	7.0
Manipur	19917	19917	11.5	5.5
Meghalaya	23145	23145	9.9	5.3
Mizoram	14201	14201	14.5	4.3
Nagaland	20197	20197	11.7	6.8
NCT Delhi	15881	15881	11.9	16.8
Odisha	154960	154960	12.2	3.5
Puducherry	14113	14113	10.1	5.8
Punjab	378453	382514	10.2	6.3
Rajasthan	637035	637035	13.5	5.9
Sikkim	19038	19038	19.0	4.8
Tamil Nadu	955691	960422	12.8	6.5
Telangana	442298	594232	14.2	4.0
Tripura	26607	26607	13.1	5.6
Uttar Pradesh	857844	857844	12.2	6.3
Uttarakhand	95408	95408	12.2	7.0
West Bengal	714196	714196	11.6	6.3

Table A4. State-level fiscal glide paths

(fiscal deficit, percent of GSDP)	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30	2030-31
Andhra Pradesh	4.2	3.5	3.3	3.1	2.9	2.7	2.5
Assam	3.1	3.5	3.3	3.0	3.0	3.0	3.0
Bihar	3.0	3.0	3.0	2.8	2.6	2.5	2.5
Chhattisgarh	3.8	3.5	3.3	3.0	2.8	2.8	2.8
Goa	2.5	2.5	2.9	2.8	2.8	2.8	2.8
Gujarat	1.2	1.7	3.0	3.0	3.0	3.0	3.0
Haryana	2.3	2.3	2.9	2.8	2.8	2.8	2.8
Himachal Pradesh	4.7	3.5	3.3	3.0	3.0	3.0	3.0
Jharkhand	1.9	1.8	2.9	2.8	2.8	2.8	2.8
Karnataka	3.0	3.0	2.9	2.8	2.8	2.8	2.8
Kerala	3.4	3.4	3.1	2.9	2.7	2.5	2.5
Madhya Pradesh	4.1	3.5	3.3	3.0	2.8	2.8	2.8
Maharashtra	2.5	2.5	3.0	3.0	3.0	3.0	3.0
Manipur	2.8	2.8	3.0	3.0	3.0	3.0	3.0
Meghalaya	3.4	3.3	3.0	3.0	3.0	3.0	3.0
Mizoram	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Nagaland	2.9	2.9	3.0	3.0	3.0	3.0	3.0
NCT Delhi	0.5	0.2	3.0	3.0	3.0	3.0	3.0
Odisha	3.4	3.3	3.0	3.0	3.0	3.0	3.0
Puducherry	2.1	2.1	3.0	2.9	2.8	2.8	2.8
Punjab	3.7	3.5	3.3	3.1	2.9	2.7	2.5
Rajasthan	3.9	3.5	3.3	3.1	2.9	2.7	2.5
Sikkim	5.2	3.5	3.3	3.0	3.0	3.0	3.0
Tamil Nadu	3.3	3.3	3.0	2.9	2.8	2.8	2.8
Telangana	2.7	2.6	3.0	2.8	2.6	2.5	2.5
Tripura	4.4	3.5	3.3	3.0	3.0	3.0	3.0
Uttar Pradesh	3.1	3.1	3.0	2.9	2.8	2.8	2.8
Uttarakhand	2.4	2.3	3.0	3.0	3.0	3.0	3.0
West Bengal	3.6	3.5	3.3	3.1	2.9	2.7	2.5

Table A5. State-level debt projection (including off-budget)

(percent of GSDP)	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30	2030-31
Andhra Pradesh	45.7	44.4	43.1	41.6	40.1	38.6	37.0
Assam	27.5	27.7	27.7	27.5	27.2	27.0	26.8
Bihar	37.3	35.7	34.2	32.8	31.3	29.9	28.7
Chhattisgarh	31.1	31.2	31.1	30.8	30.2	29.7	29.3
Goa	30.2	29.6	29.5	29.3	29.1	28.9	28.8
Gujarat	17.9	17.4	18.3	19.0	19.7	20.3	20.8
Haryana	30.4	28.9	28.3	27.6	27.0	26.4	26.0
Himachal Pradesh	45.2	43.8	42.4	40.9	39.5	38.2	37.1
Jharkhand	26.6	25.7	26.0	26.2	26.3	26.5	26.6
Karnataka	26.5	26.3	26.0	25.7	25.4	25.1	24.9
Kerala	39.8	39.1	38.1	37.1	35.9	34.7	33.6
Madhya Pradesh	31.6	30.9	30.1	29.1	28.1	27.2	26.4
Maharashtra	19.3	19.8	20.7	21.5	22.2	22.9	23.4
Manipur	36.7	35.5	34.7	33.9	33.2	32.6	32.1
Meghalaya	39.0	38.6	38.0	37.4	36.9	36.4	36.0
Mizoram	31.6	30.4	29.4	28.6	27.8	27.1	26.6
Nagaland	40.0	38.4	37.1	35.9	34.9	34.0	33.1
NCT Delhi	1.3	1.3	4.2	6.6	8.8	10.7	12.4
Odisha	16.3	17.8	18.8	19.7	20.4	21.1	21.7
Puducherry	26.8	26.3	26.8	27.1	27.3	27.5	27.6
Punjab	47.1	46.0	44.8	43.5	42.1	40.7	39.2
Rajasthan	35.8	34.8	33.8	32.6	31.5	30.2	28.9
Sikkim	35.0	32.7	30.5	28.4	26.7	25.2	24.0
Tamil Nadu	30.5	30.0	29.5	28.8	28.2	27.6	27.1
Telangana	35.2	33.6	32.5	31.4	30.2	29.0	27.9
Tripura	27.9	27.9	27.8	27.3	26.9	26.6	26.3
Uttar Pradesh	31.8	31.2	30.5	29.9	29.2	28.6	28.0
Uttarakhand	24.2	23.7	23.9	24.1	24.3	24.4	24.5
West Bengal	38.0	37.3	36.5	35.6	34.5	33.4	32.2

Methodology for debt projections

The debt projections for each state are based on the debt dynamics equation below:

$$\Delta d_t = \frac{i-g}{1+g} \times d_{t-1} + pb_t$$

Where,

- Δd_t = Change in the debt-to-GSDP ratio in period t
- d_t = Debt-to-GSDP ratio at the end of period t
- i = Nominal interest rate on government debt
- g = Nominal GSDP growth rate
- pb_t = Primary balance as a share of GSDP (deficit is negative)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