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Kerala's debt position: A prolonged subject of discussion

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Introduction

The extended discourse in Kerala has primarily centered around its elevated fiscal deficit and the growing burden of debt. This issue has been under scrutiny, particularly since the early 2000s when Kerala's debt crossed the 30 percent threshold relative to its Gross State Domestic Product (GSDP). However, the implementation of the Fiscal Responsibility and Budget Management (FRBM) Act and other strategies aimed at fiscal consolidation helped mitigate the escalating debt challenge, reducing the intensity of discussions. In 2012, Kerala was once again in the spotlight when the Government of India (GOI) identified it (Times of India 2012), along with Punjab and West Bengal, as fiscally unsound among the states falling within the general category (Das 2015). This categorization was based on the debt-GSDP ratio, which had been on an upward trajectory for Kerala. Yet, it is noteworthy that Kerala's debt-GSDP ratio has not displayed an exponential pattern over the past 25 years, apart from the exceptional year of the COVID-19 pandemic. According to the RBI's assessment in 2022, Kerala has once again attracted attention due to its designation as one of the most financially unsustainable states. This classification is primarily based on its performance during the year of the COVID-19 pandemic.

Nonetheless, it's important to note that academic discussions and research endeavors have only partially delved into the factual dimensions of Kerala's debt situation. The ongoing discourse has also been shaped by significant political considerations. Many scholarly studies have lent support to the political arguments put forth in these discussions. Notably, there has been a tendency to misconstrue the absolute debt figures, leading to a misperception of the actual situation. The most recent development in expanding the scope of this debate involves moving beyond the traditional debt metrics. This evolution includes the incorporation of off-budget liabilities and an exploration of associated accounting practices.

Against this backdrop, we aim to provide interpretations of certain viewpoints raised by scholars regarding Kerala's public debt. The rest of the study is structured as follows: Section 2 delves into Kerala's debt patterns over the past 25 years. In Section 3, we undertake a thorough analysis of the sustainability issues investigated by various scholars, subsequently offering critiques of the study conducted by RBI (2022). Moving forward, Section 4 sheds light on potential future directions. Finally, the study concludes with summarizing remarks in Section 6.

Debt obligations of the state

Table 1 presents the debt status of Kerala spanning from 2000-01 to 2021-22. The data reveals a consistent linear increase in the absolute value of public debt, progressing from 25,721 crores to 3,57,391 crores. Throughout this period, the ratio of outstanding debt to the Gross State Domestic Product (GSDP) oscillated between 28.11% and 38.33%, a range consistently surpassing the benchmarks stipulated by the KFR Act, 2003, and the finance commission. Notably, except for the pandemic-impacted period of 2021-22, Kerala consistently maintained a debt-to-GSDP ratio surpassing the 25% threshold due to its deliberate focus on directing investments towards social infrastructure. However, it's worth noting that the upsurge in the debt-GSDP ratio during the pandemic primarily stems from the denominator effect - a decline in GSDP - rather than signifying inherent fiscal mismanagement.

To maintain a stable level of debt and maintain Intertemporal budget constraint (IBC),[1] the key requirement is that the increase in debt should be slower than the growth rate of the state's GDP, (RBI, 2014). However, excluding the period spanning from 2004-05 to 2012, which saw fiscal consolidation efforts, the Kerala government has failed to meet this criterion in any given year. This is a matter of significant concern, as the escalating debt burden is attributable to the rapid pace of debt accumulation. This, in turn, has led to the need for

[1] In order to meet the IBC, the outstanding debt at present must align with the present value of future primary surpluses, as emphasized by Greiner and Fincke (2015).

repeated borrowing to service the existing debt. Encouragingly, there has been a positive development in this regard in the recent trend observed in 2021-22.

Throughout the period, the predominant factor driving the state's yearly outstanding debt has consistently been Open Market Loans. This significantly contributes to the interest payments, which constitute over 15 percent of both the state's revenue expenditure and revenue receipts. To address this challenge, the state could explore options such as obtaining loans from favourable interest rate markets, seeking central government financial assistance, and utilizing lower interest rate sources within the public account.

Table 1: Debt Profile of Kerala from 2000-01 to 2021-22

Year	Total Outstanding Debt (in Crores)	GSDP (Current) (in Crores)	Rate of Growth of Public Debt (%)	Rate of Growth of GSDP (%)	Total Debt as % of GSDP
2000-01	25721	91505	18.66	5.05	28.11
2001-02	29025	98135	12.85	7.25	29.58
2002-03	33782	109433	16.39	11.51	30.87
2003-04	39231	121779	16.13	11.28	32.21
2004-05	43,697	138858	11.38	14.02	31.47
2005-06	47832	159324	9.46	14.74	30.02
2006-07	52,161	179051	9.05	12.38	29.13
2007-08	58,108	203916	11.40	13.89	28.50
2008-09	66,097	236099	13.75	15.78	28.00
2009-10	74,223	270114	12.29	14.41	27.48
2010-11	82420	307109	11.04	13.70	26.84
2011-12	93,132	364048	13.00	18.54	25.58
2012-13	108477	412313	16.48	13.26	26.31
2013-14	124081	465041	14.38	12.79	26.68
2014-15	141947	512564	14.40	10.22	27.69
2015-16	160539	561994	13.10	9.64	28.57
2016-17	189769	634886	18.21	12.97	29.89
2017-18	214518	701588	13.04	10.51	30.58
2018-19	241615	788286	12.63	12.36	30.65
2019-20	265327	812935	9.81	3.13	32.64
2020-21	308386	771724	16.23	-5.07	39.96
2021-22	357393	932470	15.89	20.83	38.33

Source: https://cag.gov.in/en/state-accounts-report?defuat_state_id=77(Debt) &
https://mospi.gov.in/ data (GSDP)

Debt sustainability analyses for Kerala: A critical review

Kerala, as a state, has been subject to thorough analysis by scholars from various fields, encompassing academicians, politicians, and media analysts. This comprehensive scrutiny has resulted in a range of conclusions, given the diverse perspectives involved. Many studies underscore that Kerala is marked by pronounced fiscal disparities (RBI, 2013; Kaur et al. 2018; Das, 2015). While metrics such as revenue deficit, fiscal deficit, and the ratio of public debt to GSDP in Kerala tend to surpass the average figures observed among all states, it is important to note that the state's expenditure pattern portrays a distinct emphasis on recurring social service expenditures. Throughout its history, Kerala has consistently prioritized investments in social infrastructure, leading to a significant commitment in this regard (Isaac and Ramkumar, 2006).

Indeed, the current state of Kerala's fiscal situation is influenced by the historical burden of past public interventions. However, there exists a lack of consensus among scholars regarding whether the state should adopt a pessimistic or optimistic approach to deficit financing. Drawing from an interdisciplinary framework, historical context, and political economy perspectives, the optimistic viewpoint suggests that Kerala should maintain its deficit financing nature, focusing instead on strengthening fiscal/debt management to ensure compliance with intertemporal budget constraints (Joseph and Kumar, 2022). Conversely, the pessimistic stance argues for the state to cut back on social and committed expenditures, following arbitrary targets to mitigate the burden of increasing debt on future generations (RBI 2022). Amidst these contrasting views, some studies adopt a realistic standpoint, acknowledging that although Kerala displays signs of fiscal stress, the state has the potential to regain equilibrium in the future (Das, 2013). Empirical investigations further compound the complexity, yielding mixed results. Certain studies contend that Kerala's fiscal situation is unsustainable (RBI, 2022; Shanmugam and Renjith, 2021)), while others suggest a weaker form of sustainability (Renjith, 2022). This diversity of perspectives underscores the intricate nature of Kerala's fiscal dynamics and the ongoing discourse among scholars regarding the most appropriate approach to address its fiscal challenges.

Taking a realistic stand, this study further critiques RBI's (2022) risk analysis, particularly its assessment that Kerala is among India's most fiscally vulnerable states. First of all, RBI's call for contractionary policy for states is inappropriate, as active state intervention is crucial during economic shocks, necessitating increased public expenditure and borrowing to restore performance and demand, which in turn raises the public debt ratio. The comparison of Kerala with Sri Lanka's debt crisis is flawed, as Indian states are governed by Article 293 of the Indian constitution. The pandemic's impact justifies Kerala's fiscal concerns, but using the pandemic year's debt-GSDP ratio overlooks varying effects on states. Kerala saw a 9% GSDP loss, Maharashtra, Haryana, and Odisha followed. Issues include state and indicator choice, unexplained result disparities, and methodological limitations. A conclusive statement based on statistical insignificance is unwarranted, as it suggests less alarm in increased debt's impact on primary balances. Lastly, clarity is lacking on the reference period and methodology used for projections of primary deficit, debt-GSDP ratio, real interest rate, and real GDP growth.

While critiquing specific existing findings, this study acknowledges that the current debt-GSDP ratio is indeed concerning. It goes on to explore Kerala's debt position, evaluating whether the state is significantly distant from a sustainable position. The study aims to identify methods for managing the state's debt without undermining essential social and public interventions, paving the way for the exploration detailed in the next section.

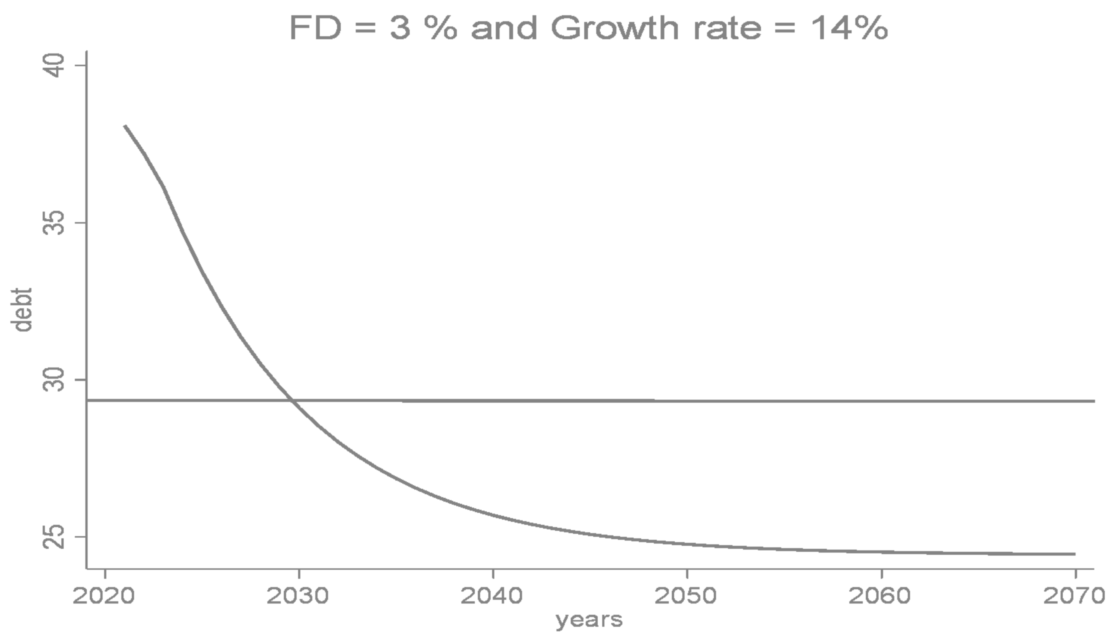
Can Kerala’s debt position be intervened upon?

We tackled this question through three exercises: (i) assessing the sustainability of Kerala's debt and the extent to which we deviate from a sustainable position, (ii) determining the level at which state debt spurs economic growth, and (iii) devising a strategic approach to achieve a sustainable debt position by manipulating fiscal indicators. Employing discrete threshold regression model and Bohn's Suatainability Framework,[2] we established the sustainability threshold for the debt-GDP ratio. Our findings indicate that the state's sustainable debt position is 27.8 percent of GSDP, necessitating a subsequent 10 percent point reduction from the present level in the upcoming years (see Appendix Table 1). Applying the ARDL model, we identified a nonlinear relation between public debt and economic growth. Our analysis revealed that up to a debt level of 27.8 percent, debt positively influences growth in the state, while beyond this threshold, it becomes a hindrance to growth. Furthermore, through a simulation exercise, we formulated strategies to achieve a debt position of 27.8 percent using the framework proposed by Rangarajan and Srivastava (2005). The initial values considered were: (i) a debt-to-GSDP ratio of 38.33 percent for 2022-23; (ii) a fiscal deficit of 3.6 percent

[2] See Shanmugam and Renjith (2022) for the details

for 2022-23 and 3.5 percent for 2023-24; and (iii) a growth rate of 12 percent for 2021-22. By targeting an average growth of 14% along with a 3 percent fiscal deficit, or a growth of 12% with a 2.5 percent fiscal deficit, we project reaching the 27.8 percent threshold level by 2032 (see Appendix Fig.1).

Appendix Figure 1: Simulation Results



Source: Authors' estimation

In summary, the state's debt position is currently outside the sustainable zone; however, it has the capability to restore it to a sustainable level of 27.8 percent. It is imperative for the state to avoid compromising critical public interventions through indiscriminate debt reduction. The key lies in enhancing debt management practices. This entails ensuring that debt utilization is driven by specific needs and aligns with sustainability benchmarks. By adopting such a comprehensive approach, the state can strike a balance between managing its debt responsibly and upholding its essential public initiatives.

Conclusions and policy suggestions

This study contributes to the ongoing discourse surrounding Kerala's debt position, a topic of sustained debate. Similar to other studies, we acknowledge that the current stance surpasses sustainable limits. However, our approach diverges from existing observations that emphasize curtailing essential public interventions. Instead, we identified a sustainable threshold at 27.8 percent for the state and devised strategies to attain this position. By aiming for an average growth of 14% alongside a 3 percent fiscal deficit, or a growth of 12% with a 2.5 percent fiscal deficit, we anticipate reaching the 27.8 percent target by 2032. Maintaining the integrity of crucial public interventions is of utmost importance for the state. Therefore, we advocate for the improvement of debt management practices, aiming to strike a harmonious balance between responsible debt management and the preservation of essential public initiatives.

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Appendix

Appendix Table1.Threshold Regression Results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
D_{t-1} < 27.9 (region 1)				
lagged debt- GSDP	0.67	0.006	11.35	0.000
27.9 < D_{t-1} (region 2)				
Lagged debt- GSDP	0.4	0.005	8.543	0.000
Non threshold variables				
Output Gap	0.0001	0.0003	3.33	0.001
Expenditure Gap	-0.00001	0.00008	-1.73	0.082
R-squared	0.39	Mean dependent var	1.31	
Adjusted R-squared	0.33	S.D. dependent var	0.72	
S.E. of regression	0.59	Akaike info criterion	1.89	
Sum squared resid	13.18	Schwarz criterion	2.06	
Log likelihood	-34.92	Hannan-Quinn criterion	1.95	
F-statistic	12.5	Durbin-Watson stat	0.99	
Prob(F-statistic)	0.00			

Source: Authors' estimation