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Classification: FOR CODE: 149999

Language: English

London
Journals Press

LJP Copyright ID: 573333
Print ISSN: 2515-5784
Online ISSN: 2515-5792

London Journal of Research in Humanities and Social Sciences

Volume 21 | Issue 4 | Compilation 1.0

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Author α: Professor and Director, Madras School of Economics, Gandhi Mandapam Road, Chennai 600 085 (India).
σ : Assistant Professor, Gulati Institute of Finance and Taxation, Sreekariyam,Thiruvananthapuram – 695017.

I. INTRODUCTION

The Public debt sustainability issue has always been paramount in the macroeconomic analysis of fiscal policy. Conceptually, sustainable public debt is given as long as the debt does not increase at a rate, reaching beyond the limit of the government to service it (IMF 2011). That is, it is basically about good housekeeping. Three theoretical views exist on the debt/deficit financing in the literature: (i) Classical (Ricardian equivalence theorem) view which asserts that fiscal deficit does not matter except for smoothing the adjustment to expenditure or revenue shocks. If a government reduces its taxes without adjusting its present or future expenditures, the budget deficits today lead to higher taxes in the future; (ii) Keynesian view that considers a growth stimulated effect of deficit financing. The debt is not an issue when the government raises its borrowing largely from domestic market because public deficit implies a reallocation of resources from taxpayers to bondholders (Greiner and Fincke 2009); and (iii) Neo-classical view, which considers that fiscal deficit is detrimental to investment and economic growth. Thus, the economists' views differ on whether deficit financing is good or bad or neutral for an economy (Rangarajan and Srivastava, 2005).

In order to assess the debt sustainability, past studies followed the traditional approach. They utilized the popular Domar (1944) condition, which states that "as long as the real economic growth is greater than the real interest rate, the government can have a positive primary deficit such that its debt will not rise and so the debt is sustainable."Later, this approach was extended with additional indicators like liquidity, creditworthiness, fiscal burden, fiscal space, etc., and renamed as "Indicator Approach" (see Blanchard et al. 1991; Pattnaik et al. 2003; Rajaraman et al. 2005; and Kaur et al. 2014). However, many criticized the traditional approach as it depends on a year-on-year basis. It does not validate whether the government's intertemporal budget is satisfied.

After the seminal contribution by Hamilton and Flavin (1986), three alternative empirical approaches have emerged in the literature: (i) *Unit Root approach,* which suggests that debt is sustainable if it is a stationary series (Trehan and Walsh 1991; Uctum et al. 2006); (ii) *Cointegration approach* that requires that public debt and primary surplus variables or public revenue and public expenditure variables need to be co-integrated (Hakkio and Rush 1991; Jha and Sharma 2004);[1] and (iii) *Bohn's model-based*

approach, which considers that a government needs to take corrective actions in future by increasing its primary surplus if it has a considerable deficit today. Otherwise, the debt is not sustainable (Greiner and Fincke 2009). The advantage of this approach is that it provides a straightforward and powerful method to conduct nonstructural empirical tests (D'Erasmo et al.,2016). These tests use the time series data on the primary balance, debt, and control variables and estimate linear/nonlinear fiscal reaction functions, which map the response of the primary balance to change in public debt, conditional on the control variables.

If the response of primary balance to public debt is positive and statistically significant, the debt is sustainable. This implies that the initial stock of debt is equal to the sum of present discounted values of primary balances. The Intertemporal Budget Constraint (IBC)[2] is satisfied if the discounted sum of end-period debt converges to zero. The positive reaction coefficient ensures this convergence. Among these three approaches, the Bohn model became popular because of its statistical property. The extended versions of this approach include time-varying coefficients (estimated using the penalized spline technique),[3] panel data context, etc. Many researchers have widely used the Bohn model and its extended versions to verify whether the public debt levels in various countries are sustainable or not (e.g., Bohn (1998) for USA, Haber, and Neck (2006) for Austria, Greiner and Kauermann (2008) for European countries, Greiner and Fincke (2009) for the USA, Euro countries and developing countries, Abiad and Ostry (2005) for 31 emerging economies using panel framework and Tiwari (2012) for India). See Fincke and Greiner (2011) and D'Erasmoet al. (2016) for a review of these studies.

As the debt sustainability issue is also relevant for sub-national governments like states, a few studies have dealt with debt sustainability at the sub-national level. For instance, Fincke and Greiner (2011) use the Bohn framework (time series data) and spline technique to evaluate the debt sustainability of individual states in Germany. Employing a panel version (fixed effects model and not spline technique) of the Bohn framework, Mahdavi (2014) analyzes the debt sustainability of 48 American states from 1961 to 2008. Table 1 summarizes some of the existing empirical evidence (using the Bohn model) on debt sustainability.

A few earlier studies like Dholokia et al. (2004), Rajaraman et al. (2005), and Maurya (2015) used the traditional indicator approach to evaluate the debt sustainability of Indian states. Kaur et al. (2014) use the panel data for 20 major Indian states from 1980-81 to 2012-13 and find evidence of the sustainable debt position of all states together (on average). Renjith and Shanmugam (2018) explored the public debt sustainability issue of 20 major Indian states using the Bohn framework and regular panel data estimation procedures for the period 2005–2006 to 2014–2015. The study results indicated that debt policies are successful in sustaining the debt situation of Indian states; however, at the disaggregated level, the debt is sustainable only in 12 states.

Nevertheless, the debt situation in each state may vary over time. For instance, the debt relative to GSDP (Gross State Domestic Product) was 16.93 percent in Maharashtra and 49.30 percent in Jammu and Kashmir in 2018-19, while it was16.52 percent in Chhattisgarh and 51.07 percent in Himachal Pradesh in 2007-08. Therefore, it is essential to analyze the time-varying response of the primary balance ratio to the debt ratio of the individual states. This study attempts to analyze debt sustainability at the individual state level in India with time-varying effects.

This study's main contribution is that it utilizes the panel data version of the Bohn model ("within" specification) and the regular penalized spline (p-spline) estimation procedure for testing sustainability of public debt of each of 20 Major Indian states during 2007-08 to 2018-19. It is worth noticing that most of the earlier studies extended the basic Bohn model either by employing penalized spline technique (capturing non-linearity) or broaden the observations with panel framework. Still so far, no study attempted

to club both extensions together. Here lies the scope of this paper. Since the data supported the fixed effects panel data model, which is in general estimated with Ordinary Least Squares (OLS) method, this study uses the panel framework, but estimate the model with regular p-spline method. Further, it shows how the time-varying coefficients or reaction coefficients associated with the debt-GSDP ratio of each sample state evolve study period [4]with the use of the p-spline estimation procedure.

This study proceeds as follows. Section 2 briefly describes the debt scenarios of the Indian states, and Section 3 explains the model, the data and the estimation procedures used in the study. While Section4 discusses the empirical results, and the final section 5 provides the concluding remarks of the study.

II. PUBLIC DEBT SCENARIO OF INDIAN STATES

Indian Constitution (1950) has provided for a two-tier federal system of Governments: centre (or national) and states and assigned separate tax powers and expenditure responsibilities. As it allocates all mobile and more buoyant taxes to the centre and more expenditure functions to the states, this led to the excess central revenues relative to its spending responsibility and the larger deficits of the states because their expenditures exceed the own revenues. This is known as the vertical fiscal gap (Rangarajan and Srivastava 2008). To mitigate this vertical imbalance, the Indian Constitution has allowed for transferring resources from the centre to the states through tax devolution (or sharing), grant-in-aid, and centrally sponsored schemes (Rao 2005).

Both Governments borrow when their revenues are not enough to meet the growing expenditure needs. Since the state governments can borrow from limited sources, they have problems in borrowing based on their requirements, and debt servicing. The states in general borrow mostly from internal sources, which include market loans and bonds, ways and means of advances from the central bank, loans from banks and other institutions, provident funds etc., while external debts of the states are subject to a ceiling and approval from the centre.

On the other side, the annual debt requirements depend on the interest payments on the accumulated debt. The extent of these commitments every year is the reflection of primary balance. It is the amount of additional borrowings of the government to meet expenses other than the interest payments (primary deficit) or the pressure of the government on the interest obligations on earlier borrowings (primary surplus). Therefore, the primary balance is the root cause for all forms of deficits.

In some years, governments use fiscal stimuli, often financed by excess borrowing, to expand their activities above the trend levels in India. There are two motivations for this. The first one is to play a countercyclical role to minimize the impact or volatility of the cyclicality of growth. In contrast the second one derives from the government's expansionary intervention for a political motive. The first is a response to economic cycles, and the second is a cause of the political cycle driven by the timing of elections (Srivastava 2012). Many past studies have shown that since independence, trend in primary deficit-GDP ratio indicates the cyclical nature and public debt-GDP ratio exhibits the secular upward nature (Rangarajan and Srivastava 2005).

Since 1995, there has been a sharp deterioration in the debt-deficit situations of both centre and state governments in India, mainly because of the revision of pay scales for government employees (Rajaraman et al. 2005). To improve the fiscal situation, the centre adopted a rule-based fiscal framework called the Fiscal Responsibility and Budget Management (FRBM) Act in 2003-04. It specifies a complete removable of revenue deficit and reduction of fiscal deficit to 3 percent of the GDP with an annual reduction rate of 0.3 percent and 0.5 percent, respectively, and target should be achieved within a given period (initially by 2008-09). Following the centre, most states also enacted their own FRBM rules during 2003-07. Although these efforts brought some initial

success, the situation again worsened after the global slowdown in 2007-08.

The primary balance account showed the success. All states together had a primary surplus of 0.36 percent of GDP in 2006-07. Of course, other fiscal consolidation measures also helped. For instances, (i) Debt Swap Scheme introduced by the centre mitigated the burden of interest payments on the states, which allowed them to swap high-cost loans against open market borrowings and small savings during 2002-03 to 2004-05; (ii) Debt Consolidation and Relief Facility, which is the combination of two subsidiary schemes i.e., debt consolidation and debt write-off, based on the recommendations of 12th Finance Commission during 2005-06 to 2009-10;[5]and (iii) Debt ceilings in terms of GSDP by all the states in pursuance of 13th Finance Commission recommendations.

But in 2009-10, all states' primary deficit was -1.22 percent of GDP, and the combined primary deficit of states and centre was -4.53 percent. The total liabilities of the states increased from Rs. 13283 billion in 2008 to Rs 52584 billion in 2020 (RBI 2021). Although the aggregate debt position of the state governments recently improved significantly in line with the FRBM Review Committee (2017), which recommended the debt to GDP ratio target of 20% for the state governments, the debt-GSDP ratio crossed 25 percent level in many states in 2019-20.[6] Slow economic growth in recent years, introduction of Goods and Services Tax (GST), implementation of Seventh Pay Commission's recommendations, etc already added fuel to the debt accumulation process in each state and it seems that the debt situation in those states may deteriorate further in coming years. Given the above trend on deficit and debt, it is essential to check whether state government debts are on a sustainable path in India.

III. MODEL, DATA, AND ESTIMATION

In order to analyze the debt sustainability of Indian states, this study specifies the following fiscal reaction function based on Bohn Framework:

$$s_{it} = \phi_0 + \psi d_{it-1} + \phi_1 yvar_{it} + \phi_2 gvar_{it} + \ _i + \ _t + \epsilon_{it} \quad (1)$$

where s_{it} is the primary balance to GSDP ratio in i th state in year t, d_{it-1} is the debt to GSDP ratio of state i in $t-1$year (the use of lagged debt ratio avoids the endogeneity issue). This model rests on tax smoothing hypothesis, which implies that the governments use public deficits to keep tax rates constant, minimizing the excess burden of taxation. Therefore, the government can use its revenues to finance the regular expenditures and deficits to finance the unexpected expenditures. Hence, this study considers a business cycle variable, namely *yvar*, which accounts for fluctuations in revenues, and another business cycle variable *gvar*, which accounts for fluctuations in primary expenditures as non-debt determinants of primary balance, as in other studies. It calculates the *yvar* by subtracting the long-term trend of GSDP (computed using the Hodrick-Prescott (HP) Filter and the real GSDP series) from its actual values. Similarly, it computes the *gvar* as realized value minus the trend value of real primary expenditure with later again estimated by the HP Filter. The term $_i$ is unobserved heterogeneity of the i^{th} state and the term $_t$ is time (year) effects, and they control state specific and time specific factors which may influence the dependent variable.

This model also rests on the fact that discounting public debt with a given interest rate is crucial to test whether a given time path of debt is sustainable. As future interest rates are unknown, the debt sustainability tests need to be independent of the discounting factor used to compute the present value of debt. If the primary surplus to GSDP ratio is a positive function of debt to GSDP ratio, then the above condition is met indirectly. The rationale behind the test is that such policy ensures that the debt to GSDP ratio is a mean-reverting process.

The above panel version of the Bohn model can be estimated using either fixed effects or random effects estimation techniques. The Hausman statistics can choose the appropriate technique. In the initial analysis, the Hausman statistics (=34.3) supports the fixed effects model, and so the equation is specified equivalently with "within" specification as:

$$s_{it} - \overline{s}_i = \psi\,(d_{it-1} - \overline{d}_i) + \phi_1\,(yvar_{it} - \overline{yvar}_i) + \phi_2\left(gvar_{it} - \overline{gvar}_i\right) + \epsilon_{it} - \overline{\epsilon}_i \qquad (2)$$

where all variables are in their mean differences. This within estimation has wiped out the individual and time effects, and it can be estimated using OLS. The estimation parameter ψ will give us on average whether the debt situation in all states is sustainable or not. Many Past studies hence used this approach. Since our objective is to evaluate the debt sustainability in each state, we can modify the equation (2) as:

$$s_{it} - \overline{s}_i = \sum \psi_{it}\,(d_{it-1} - \overline{d}_i) * D_i + \phi_1\,(yvar_{it} - \overline{yvar}_i) + \phi_2\,(gvar_{it} - \overline{gvar}_i) + \epsilon_{it} \qquad (3)$$

where D_i's are state-specific dummies. D_i= 1 if state i *and* 0 otherwise. As respective state dummies interact with debt variables, we can get state-specific debt coefficient, ψ. Besides, we would like to obtain the time-varying ψ for each state. Therefore, we can estimate equation (3) using the p-spline (which is more robust than OLS) procedure.[7]Thus, with this innovative approach, which mix panel within specification and penalized spline procedure, we can get state-specific and time-varying response coefficient ψ_{it}. Notice that the lagged debt variable avoids endogeinity problem evolved over time for each state.

The study draws the data for the period 2007-08 to 2018-19 from various published sources. It compiles the GSDP data (real and nominal) for 20 major Indian states from the Central Statistical Organization (CSO), and other fiscal variables from Comptroller and Auditor General (CAG) of India Audit Reports and Finance Accounts of the sample states. The total observations included in the final analysis are 240.

The sample states account for more than 90 percent of the population of India.[8]The choice of this latest period is due to the following facts. Firstly, this period represents a fiscal control era due to the enactment of the FRBM act. Secondly availability of a comparable new base (2011-12) GSDP series restricts from using the data after 2000. Thirdly, as debt accumulates fiscal deficit (net debt) every year, the recent trend is more relevant. Finally, many past studies have used a few years' data when employing a panel framework.

Column 2 of Table 2 shows the descriptive statistics of the study variables. We use GSDP deflator of the respective states to convert the nominal fiscal variables into real. Both Levin, Lin, Chu (LLC), and ImPesaran Shin (IPS) panel unit root tests confirm that all variables used in the study are stationary, i.e., they are I(0).

IV. EMPIRICAL RESULTS

Column 3 of Table 2 shows the penalized spline estimation results of the fiscal policy reaction function (3). As expected, the primary expenditures variable *gvar* has a negative coefficient, and the business cycle variable *yvar* has a positive coefficient. Both these coefficients are statistically significant at 1 percent level. These results imply that, on average, the primary spending above its normal value has reduced the primary surplus of the Indian states and the GSDP growth above normal value has increased the primary surplus.

The variable of our interest is the debt-GSDP ratio. As expected, this reaction coefficient is

positive and statistically significant for four states (Assam (ASM), Bihar (BIH), Madhya Pradesh (MP), and Odisha (ODI) at 5 percent level. These results indicate that the public debt is sustainable in these 4 Indian states. For Himachal Pradesh (HP) and West Bengal (WB), the reaction coefficient is negative and significant only at 10 percent level. For Andhra Pradesh (AP), Chhattisgarh (CHA), Gujarat (GUJ), Jammu and Kashmir (JK), Karnataka (KAR), Kerala (KER), Maharashtra (MAH), Punjab (PB), Rajasthan (RAJ), and Uttar Pradesh (UP), the reaction coefficient is positive. However, it is not significant even at 10 percent level of significance. In Haryana (HAR), Jharkhand (JHA), Tamil Nadu (TN), and Uttarakhand (UTK), this coefficient is negative and is not statistically significant. Thus, the debt is not sustainable in these 16 states. These 16 states deserve policy attention.

The smooth interaction term, *sm(t)* with the state dummy variable, shows the deviations from the mean coefficient of the state over time. The edf, the estimated degrees of freedom, of *sm(t),* provides information on possible time dependencies in each state. These details, given in Columns (4-5) of Table 2, indicate that in 9 Indian states, the reaction coefficient has not stayed over time. For instance, Himachal Pradesh, the edf=8.133, and the smooth term is significant at 1 percent level, thereby implying time-varying reaction coefficient. Similarly, for Andhra Pradesh, Bihar, Chhattisgarh, Haryana, Himachal Pradesh, Jharkhand, Odisha, and Rajasthan, the smooth term is statistically significant at 5 percent level, and their reaction coefficients are time-varying. For Gujarat, Jammu and Kashmir, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Punjab, Tamil Nadu, Uttar Pradesh, Uttarakhand, and West Bengal, the smooth parameters are time-invariant. The goodness of fit (Adj.R-sq.) is 0.630, indicating a good fit of the model, and the Durbin Watson test statistic does not imply a correlation of the residuals.

Chart 1 shows the path of the smooth terms for all 20 Indian states.[9] The two stashed lines show the 95 percent confidence interval, and the solid line shows the point estimate of the smoothed term over time. In the curve, the larger (smaller) values above (below) zero indicate that the parameter was above (below) its average value shown in Table 2 for the state. The actual reaction coefficient of a state in a given year is the sum of the average coefficient of that state plus the value of the curve of that state for that year. For instance, for Andhra Pradesh, the average reaction coefficient is 0.0653 and the difference is below0 in 2007-08. Therefore, the actual value of the coefficient in that year is 0.0653 - (-0.02) = 0.0853. One may also observe that for Assam, the reaction of primary balance to public debt started rising over the years. However, for Andhra Pradesh, the reaction coefficient in Table 1 is not significant, i.e., debt is not sustainable. For Assam, Bihar, and Odisha, the time-varying reaction coefficients started rising after a point, and for Chhattisgarh, Haryana, Himachal Pradesh, Jharkhand, and Rajasthan, the time-varying coefficients started declining after a point. Thus, many variations in the path of reaction coefficients are mainly due to various policy initiatives of the states.

The unsustainable debt path of 16 Indian states may be due to the following reasons: (a) the late implementation of FRBM legislation in states like West Bengal, Jharkhand, Jammu and Kashmir, etc. (b) transfer dependency, particularly central grants and unconditional bailouts, that undermine states' incentives to control deficits (in the case of Assam, Gujarat, Jammu and Kashmir, Rajasthanm and Uttarakhand) (c) growing trend in the committed liability in states like Andhra Pradesh, Karnataka, Kerala, Punjab etc. (d) less capital disbursements than the budget estimates in states like Haryana, Uttar Pradesh, etc. (e) sizable reduction in the state own revenue collection in case of Gujarat, Himachal Pradesh, Jharkhand, Madhya Pradesh, Tamil Nadu, and West Bengal (f) yearly debt receipts are remarkably higher than the yearly debt repayment in the case of Maharashtra and Tamil Nadu (g) the revenue component in fiscal deficit is high in states such as Kerala, Punjab, Uttar Pradesh, and Tamil Nadu and (h) persistence of huge outstanding liabilities in the case of Jammu and

Kashmir, Punjab, Rajasthan, Uttar Pradesh, and West Bengal.

Despite the debt unsustainability situation, one may argue that higher debt may lead to higher welfare (See Ghosh, 1998, and Greiner and Fincke, 2015)[10] if the states use the borrowed amounts for investment purposes which may yield revenues in the future. According to the FRBM legislation, states' net debt each year should not exceed 3 percent of GSDP, which must be utilized for investments. To check whether the debt is welfare-enhancing, Table 3 compares the aggregate capital expenditures with public debt receipts over the study period for each state.

Accordingly, we have categorized the sample states into four groups considering the sustainability as well as welfare effects. Among these, states in A group are fiscally sound as they are both sustainable and welfare enhancing. In B group of states, although debt is sustainable, it is not welfare enhancing. If this trend continues, they may be in trouble in the long run. For states in C group, the debt is not sustainable, but it is welfare enhancing. These states need to cut their borrowings such that they attain sustainability. For the states in D group, the debt is neither sustainable nor welfare enhancing. This is the major concern and they deserve policy attention.

V. CONCLUSION

This study has analyzed the public debt sustainability issues of Indian states during 2007-08 to 2019-20 using the panel version of the Bohn model and p-spline estimation procedure. The results imply that only in four states, the debt is sustainable. Of these, only in three states', the reaction coefficient is time-varying. In the remaining 16 states, the debt is not sustainable and they need to take corrective actions to improve their debt situation. Only in 6 out of these 16 states, the reaction coefficient is time-varying and in the remaining 10 states, they are time-invarying. The variations in the path of reaction coefficients are due to various policy initiatives of the states. Although the FRBM act suggests 3 percent of the ceiling of net borrowing every year and too for investment purposes, and the FRBM review committee recommends 20 percent of state liabilities, many states violate the norms. Further, the central government also bails out many states based on the recommendations of various finance commissions. This support of the centre may be a disincentive for states to maintain fiscal discipline and control debt. Another fact is that the finance commissions use a traditional approach to suggest sustainable debt levels for each state. For instance, according to the 13th Finance Commission, the debt is sustainable in more states. Our model-based results contradict them. The Finance commissions should consider the model based approach so that the states would get reliable estimates of debt sustainability.

This study has also verified whether the debt is welfare-enhancing during the study period and for that in Andhra Pradesh, Gujarat, Haryana, Himachal Pradesh, Jammu and Kashmir, Maharashtra, Kerala, Punjab, Rajasthan, Tamil Nadu, Uttarakhand, and West Bengal, the debt is neither sustainable nor welfare enhancing. These states need policy attention. We hope that these results are useful for policymakers, academicians, international agencies, and other researchers to make appropriate strategies to improve the debt situations of Indian states where debt is not sustainable and not welfare enhancing.

ACKNOWLEDGMENTS

The authors are grateful to Dr. T.N. Srinivasan (late), Visiting Professor of IFMR, for his valuable comments and suggestions on an earlier version of the paper presented at the IFMR conference.

DECLARATION OF CONFLICTING INTERESTS

The authors declared no potential conflicts of interest concerning the research, authorship, and publication of this article.

Funding:

The author(s) received no financial support for the research, authorship, and publication of this article.

Notes:

1. See Afonso (2005) for a survey of analyses that tested debt sustainability using classical

empirical approaches, Unit root, and Cointegration.

2. The IBC is $d_t^* = \sum_{j=1}^{\infty} \frac{1}{(1+r)^j} E_t\left[s_{t+j}\right]$, *i. e*,Where d_t^* = $(1+r_t)$. d_{t-1} is the stock of debt-output ratio in the beginning of period t, $E_t[.]$ is the expectation operator conditional on the information available at time t, and s_t is the primary surplus relative to GDP. As per the IBC of the government, the present value of public debt asymptotically converges to zero. This ensures a sustainable debt policy.
3. Bertola and Drazen (1993) argue that as fiscal authorities, in general, initiate corrective actions if the disequilibria reach a given trigger point (for instance, if government expenditure reaches critical level), we need to use the time-varying coefficients approach. Fincke and Greiner (2011) used a penalized spline approach due to the fact that a liner model with time-varying coefficients can approximate any nonlinear model.
4. Fincke and Greiner (2011) provide the following justifications for using time-varying coefficients: (i) the true data generating process is not known and most likely nonlinear, and a liner model, with time-varying coefficients can approximate any nonlinear model, which is more robust than OLS and gives the estimation results that are closer to the true data generating mechanism; (ii) this will facilitate to check whether the response of the government with respect to debt varies over time; (iii) random coefficients make the short term coefficients the expectation of the long-run coefficients and so they are the best estimates for the long-run coefficients.
5. Debt consolidation provided for the consolidation of all central loans contracted by the states into new loans for 20 years to be repaid in 20 equal installments carrying a lower interest rate, if the concerned state enacts its FRBM Act. Repayments due from states during the period 2005-06 to 2009-10 on these loans were eligible for a write-off. The quantum of debt write-off relates to the absolute amount by which the state reduces its revenue deficit in each successive year during the award period. The debt write-off Scheme has also offered a complete write-off to states with zero revenue deficit in 2008-09 on debt repayment by states to centre and concession on interest rate etc, with a set of conditionalities (RBI 2013).
6. Andhra Pradesh (32.14), Assam (21.73), Bihar (33.72), Chhattisgarh (14.76), Gujarat (24.83), Haryana (20.59), Himachal Pradesh (41.25), Jammu and Kashmir (48.49), Jharkhand (23.56), Karnataka (17.71), Kerala (27.94), Madhya Pradesh (26.70), Maharashtra (19.66), Odisha (22.17), Punjab (34.57), Rajasthan (30.57), Tamil Nadu (18.92), Uttar Pradesh (35.36), Uttarakhand (22.83) and West Bengal (40.89).
7. The relationship between primary balance to GSDP and debt to GSDP may not be linear, and the linear model with time-varying coefficients can approximate any nonlinear relation. The approximation is good if it changes smoothly and so the estimation resorts to spline. For estimation purposes, it considers the parametric form: $f(d_t) = d_t \beta_d + Z(d_t) \gamma$, where Z is a high dimensional basis in d (for instance, a cubic spline basis) and γ is a corresponding coefficient. The high dimensionality restricts the use of OLS. So, it imposes a penalty term on γ, shrinking its value to 0. It obtains the estimates by minimizing penalized OLS criteria: $\sum\{s_t - d_t \beta_d - Z(d_t) \gamma\}^2 + \lambda \gamma^T P \gamma$; where λ is smoothing the penalty parameter and $\gamma^T P \gamma$ is a penalty. P matrix is chosen in accordance with the basis (see Ruppert et al., 2003 for details). λ basically steers the amount of smoothness of the function (if it is zero, then the model becomes unpenalized OLS). The fitted functions (f^*) can be written as $f_1^*(d) = H(\lambda)$, where H is the smoothing matrix. To obtain reliable fit, λ should be chosen data-driven. One possibility is the use of Generalized Cross-Validation (GCV) criterion as GGV= $\sum\left[\frac{st - f(dt)}{1 - tr(H)/n}\right]^2$; A suitable choice of λ is achieved by minimizing GCV. This procedure is same if the time varying coefficients are estimated

(See Greiner and Kauermann, 2007 for more details).

8. There are about 10 other smaller states and Union Territories (UTs). The Finance Commission uses special formulae for smaller states in allocating transfers and thereby they enjoy constitutional support. For UTs, the centre meets all the deficits. So, we are not considering these in our analysis. Also, we used unified Andhra Pradesh data in our study as the centre bifurcated the state of Andhra Pradesh into Andhra Pradesh and Telangana in 2014.
9. The standard time series spline can be estimated using Mixed GAM Computation Vehicle (MGCV) package with Automatic Smoothness Estimation in R software. In particular, Generalized Additive Model (GAM) attempts to find the appropriate smoothness for each applicable model term using prediction error criteria or likelihood-based methods and will produce the results for a single entity. Since we are pooling the data for all 20 states, we code the estimation (mod) as GAM of the dependent variable followed by non-debt explanatory variables (*yvar and gvar)* plus state-wise dummy interaction of debt variable followed by the smooth term *s* of time multiplied by dummy interaction of the stimulus (debt) variable for each state in order to get the individual-specific reaction coefficients i.e. mod = *gam(primary balance ~ yvar + gvar +* $d_{it-1}\times$ Andhra Pradesh (K_1)+ .....+ $d_{it-1}\times$ West Bengal (K_{20}) + *s(time, by =* K_1*)*+....+ *s(time, by =* K_{20}*)* on R console. Accordingly, we have generated the nonlinear effects of the reaction coefficient and plots for each of 20 States without any additional coding.
10. Greiner and Fincke (2015), using simulation technique, states that a scenario where public debt grows at the same rate as output yields low growth and welfare in the long run compared to the scenario where debt grows but less than output. That is a scenario where debt grows, but less than production leads to higher welfare than the balanced budget scenario.

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Table 1: Some Existing Empirical Evidence (using Bohn model) on Debt Sustainability

Study	Country	Data Period	Methodology	Sustainability?
Bohn (1998)	US	Annual; 1916-1995	OLS	Sustainable
Abiad&Ostry (2005)	31Emerging countries	Annual; 1990-2002	Panel GLS, Arellano Bond	Sustainable
Bohn (2005)	US	Annual ; 1792-2003	OLS	Sustainable
Haber & Neck (2006)	Austria	Annual; 1960-2003	OLS	Sustainable
Greiner et al. (2007)	US & 4 EU countries	Annual; 1960-2003	OLS	Sustainable (except US)
Kia (2008)	Iran &turkey	Annual ; 1970-2003 &1967–2001	OLS	Not sustainable
Greiner &Kauermann (2008)	Germany & Italy	Annual; 1960-2003	p-spline	Sustainable (only Germany)
De mello (2008)	Brazil (central & sub-national)	Monthly (1995:1-2004:7)	OLS	Sustainable
Adams et al. (2010)	33 countries	Annual; 1990-2008	panel GLS	Sustainable
Doi et al. (2011)	Japan	Quarterly; 1980:I - 2010:I	markov-switching	Not sustainable
Fincke& Greiner (2011a)	Euro countries	Annual; 1971-2009	p-spline	Sustainable (except Greece and Italy)
Fincke&Griener (2011b)	11 German federal states	Annual; (1975-2006)	p-spline	Sustainable (except Berlin)
Tiwari (2012)	India	Annual; 1970-2009	p-spline	Not Sustainable
Kaur & Mukherjee (2012)	India	Annual;1980-81 to 2012-13	OLS	Sustainable
Jose (2013)	India	Annual; 1983-2010	OLS	Sustainable
Mahdavi (2014)	48 US states	Annual; 1961-08	Panel FE	Sustainable
Kaur et al. (2014)	20 Indian states	Annual; 1980-2013	Panel FE	Sustainable
Shastri and Sahrawat (2015)	India	Annual; 1980-2013	ARDL	Not sustainable
Belguith and Gabsi (2017)	Tunisia	Annual; 1965-2013	p-spline	Sustainable
Ranjith &Shanmugham (2018)	Indian States	Annual; 2004-05 to 2015-16	Panel FE	11 states are Sustainable

Table 2: Penalized Spline Estimation Results of Fiscal Policy Reaction Function for the Indian States during 2007-08 to 2018-19

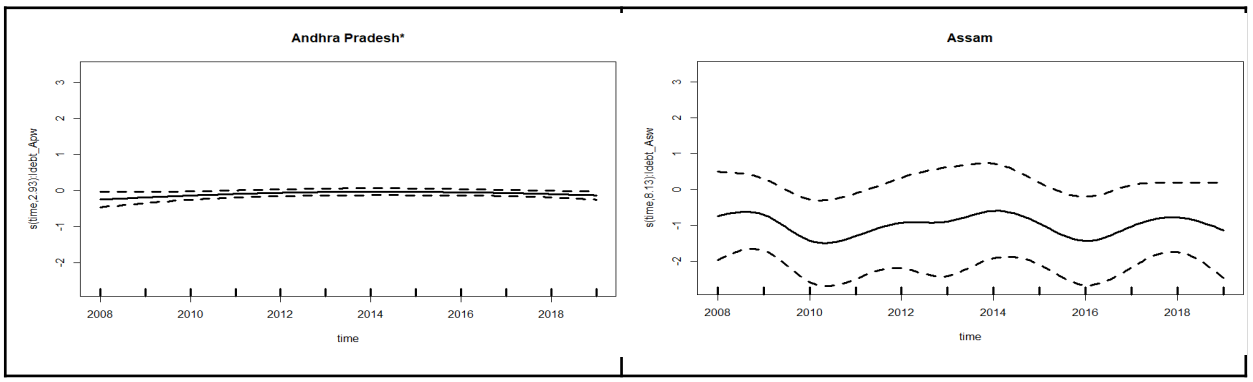
Variables	Mean (S.D)	Coefficient (t-value)	Smooth Term	edf.	F (p-value)
(1)	(2)	(3)	(4)	(5)	(6)
s_{it}	-0.7457 (1.564)	-	-	-	-
$s_{it} - \bar{s}_i$	-0.00001 (1.365)	-	-	-	-
d_{it-1}	27.8815 (10.315)	-	-	-	-
$d_{it-1} - \bar{d}_i$	0.0231 (5.376)	-	-	-	-
yvar	-1086.8240 (17858.510)	0.00001 (2.899)	-	-	-
gvar	-191.1497 (5612.579)	-0.0001 (-11.324)	-	-	-
$(d_{it-1} - \bar{d}_i) \times$ *Dummy for AP*		0.0653 (1.422)	*sm(t)*:AP	2.926	2.708 (0.040)
$(d_{it-1} - \bar{d}_i) \times$ *Dummy for ASM*		1.2100 (2.164)	*sm(t)*: ASM	8.133	3.004 (0.002)
$(d_{it-1} - \bar{d}_i) \times$ *Dummy for BIH*		0.0650 (2.320)	*sm(t)*:BIH	1.500	8.355 (0.022)
$(d_{it-1} - \bar{d}_i) \times$ *Dummy for CHA*		0.5545 (0.787)	*sm(t)*: CHA	5.279	2.276 (0.038)
$(d_{it-1} - \bar{d}_i) \times$ *Dummy for GUJ*		0.0005 (0.014)	*sm(t)*: GUJ	1.500	0.001 (0.999)
$(d_{it-1} - \bar{d}_i) \times$ *Dummy for HAR*		-0.2140 (-1.013)	*sm(t)*: HAR	2.757	2.354 (0.084)
$(d_{it-1} - \bar{d}_i) \times$ *Dummy for HP*		-0.9257 (-1.735)	*sm(t)*: HP	8.850	10.605 (0.000)
$(d_{it-1} - \bar{d}_i) \times$ *Dummy for JK*		0.1049 (1.402)	*sm(t)*: JK	1.500	0.435 (0.447)
$(d_{it-1} - \bar{d}_i) \times$ *Dummy for JHA*		-0.3982 (-0.678)	*sm(t)*: JHA	5.255	2.331 (0.092)
$(d_{it-1} - \bar{d}_i) \times$ *Dummy for KAR*		0.0106 (0.052)	*sm(t)*: KAR	1.500	0.481 (0.660)
$(d_{it-1} - \bar{d}_i) \times$ *Dummy for KER*		0.1192 (1.218)	*sm(t)*: KER	1.500	0.751 (0.307)
$(d_{it-1} - \bar{d}_i) \times$ *Dummy for MP*		0.0784 (2.333)	*sm(t)*: MP	1.500	2.144 (0.121)
$(d_{it-1} - \bar{d}_i) \times$ *Dummy for MAH*		0.3085 (0.775)	*sm(t)*: MAH	3.129	0.524 (0.609)
$(d_{it-1} - \bar{d}_i) \times$ *Dummy for ODI*		0.1122 (3.977)	*sm(t)*: ODI	1.500	10.809 (0.002)
$(d_{it-1} - \bar{d}_i) \times$ *Dummy for PUN*		0.0515 (0.896)	*sm(t)*: PUN	1.658	0.831 (0.486)
$(d_{it-1} - \bar{d}_i) \times$ *Dummy for RAJ*		0.0594 (0.313)	*sm(t)*: RAJ	3.739	2.415 (0.097)
$(d_{it-1} - \bar{d}_i) \times$ *Dummy for TN*		-0.0705 (-0.589)	*sm(t)*: TN	1.500	0.649 (0.606)
$(d_{it-1} - \bar{d}_i) \times$ *Dummy for UP*		0.0710 (0.640)	*sm(t)*: UP	2.285	0.325 (0.691)
$(d_{it-1} - \bar{d}_i) \times$ *Dummy for UTK*		-0.0999 (-0.473)	*sm(t)*: UTK	2.269	0.292 (0.739)
$(d_{it-1} - \bar{d}_i) \times$ *Dummy for WB*		-0.0424 (-1.674)	*sm(t)*: WB	1.500	0.439 (0.446)
(Intercept)		-0.0109 (-0.122)			

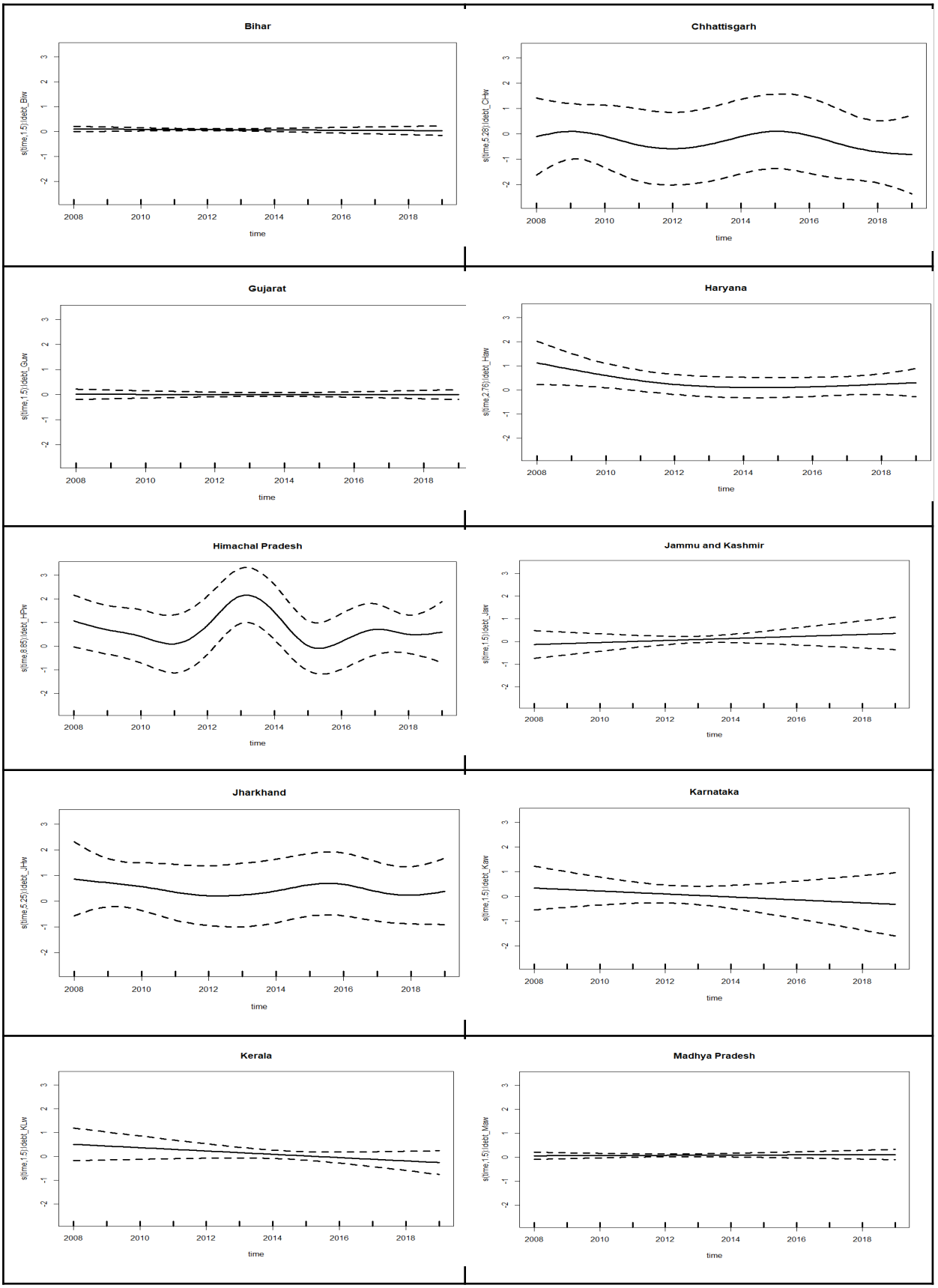
Adj.R^2 (GCV)	0.630 (0.9887)
D-W Stat.	2.0201

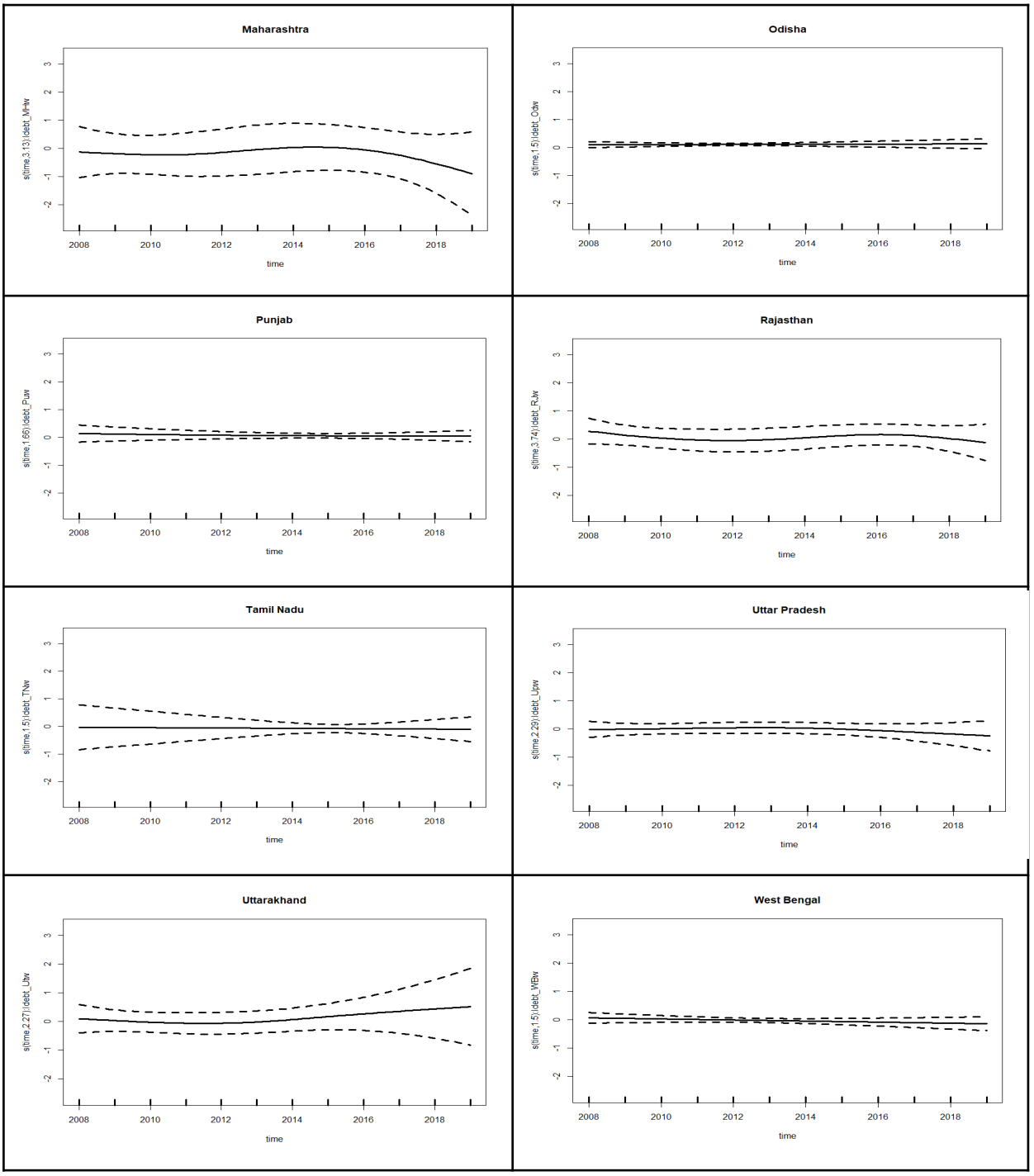
Table 3: Welfare Effects of Debt Policies of Indian States (2003-04 to 2014-15)

State	Borrowed Funds/ Capital Expenditure
(A) Both sustainable and welfare-enhancing	
Odisha	0.4418
Chhattisgarh	0.6158
Bihar	0.7313
(B) Not sustainable but welfare-enhancing	
Karnataka	0.7870
Uttar Pradesh	0.7974
Jharkhand	0.8047
Madhya Pradesh	0.9309
(C) Sustainable but not welfare-enhancing	
Assam	1.2197
(D) Neither sustainable nor welfare-enhancing	
Gujarat	1.2214
Andhra Pradesh	1.2950
Maharashtra	1.3775
Rajasthan	1.4539
Uttarakhand	1.5194
Tamil Nadu	1.6187
Jammu and Kashmir	1.6569
Himachal Pradesh	1.8956
Haryana	2.7693
Kerala	3.8913
West Bengal	8.9574
Punjab	9.7758

Chart 1: Deviations of sm(t) from the respective Average Coefficient ψ for Indian States







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