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Sharp rise in guarantees outstanding of some states, especially to non-revenue generating projects, poses future fiscal risk

NOVEMBER 2021

Aditi Nayar
+91 124 4545 385
aditin@icraindia.com

Neetika Shridhar
+91 124 4545 305
neetika.shridhar@icraindia.com

Jaspreet Kaur
+91 124 4545 853
jaspreet.kaur@icraindia.com



SUMMARY



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Exhibit: Stock of guarantees for 27 states (Rs. Trillion)

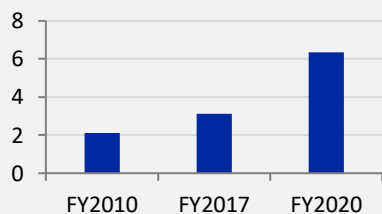
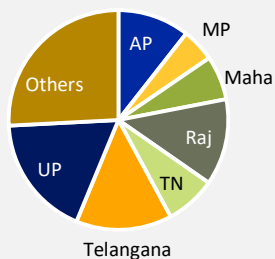


Exhibit: State-wise share of guarantee stock at end-March 2020



The state governments extend guarantees to state-level entities to enable them to borrow funds from various sources. Unlike the borrowing limit for debt, which is fixed by the Government of India (GoI), state governments appear to have the flexibility to fix their guarantee limits. The stock of guarantees outstanding of Andhra Pradesh (AP), Maharashtra, Tamil Nadu (TN), Rajasthan, Telangana and Uttar Pradesh (UP) has risen sharply since FY2017. The increase in guarantees outstanding, especially to non-revenue generating projects that are highly likely to be serviced by the states themselves in the future, poses a fiscal risk, particularly given the modest contributions made by several states to their guarantee redemption funds (GRF).

Some states had extended considerable guarantees before the onset of the pandemic: Guarantees extended by 27 states tripled to Rs. 6.3 trillion as on March 31, 2020, i.e. prior to the Covid-19 pandemic, which was equivalent to 3.1% of gross domestic product (GDP). The guarantees outstanding of AP, Madhya Pradesh (MP), Maharashtra, Rajasthan, TN, Telangana and UP accounted for three-fourths of the total guarantees outstanding as on March 31, 2020. Additionally, the guarantees outstanding of Punjab, Chhattisgarh, UP, AP, Rajasthan and Telangana stood at 5-10% of their gross state domestic product (GSDP) as on March 31, 2020, much higher than the state average of 3.1% of GDP.

States have the discretion to set their own guarantee ceilings, and the flexibility to modify the same: Unlike the annual borrowing limit for debt, which is set by the GoI, the states appear to have the flexibility to set and modify their own guarantee ceilings. This allows them to extend fresh guarantees within a short period of time without any approvals or significant oversight from the GoI or the Reserve Bank of India (RBI).

Sharp increase in stock of guarantees of some state governments: The data on guarantees for FY2021 (available for few states in their FY2022 Budgets) reveals a sharp increase in the stock of guarantees of AP and Telangana from the year-ago level, led by guarantees extended to entities in the irrigation and agriculture sectors, for projects that are likely to be non-revenue generating in nature. Additionally, TN, UP and Maharashtra are likely to have extended considerable guarantees in FY2021 to their power entities, related to the GoI's liquidity scheme for the power sector. There is anecdotal evidence of a rise in guarantees of some states in FY2022, in a bit to hasten project implementation, amid pockets of liquidity stress at the state-level. Without the availability of adequate data, it is unclear how much of the rise in guarantees in the current year is related to non-revenue generating projects, which would eventually end up being serviced by the respective state governments, making them an actual and not a contingent liability.

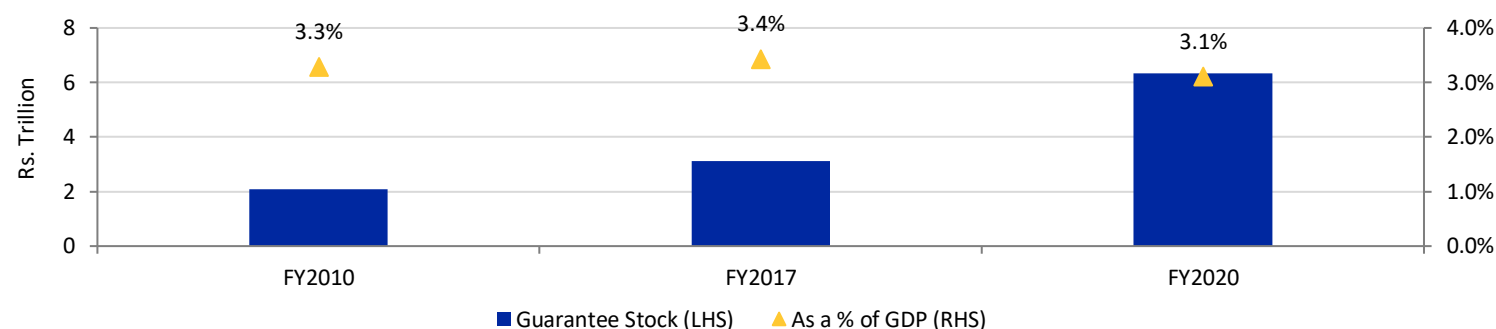
Contribution to the Guarantee Redemption Fund (GRF) of most of the states' trails the RBI recommended limit: Several states including, Chhattisgarh, Karnataka, Kerala, Punjab, Rajasthan, TN and UP had not set up a GRF at end-March 2021, while the balance in the GRF of AP, Telangana and Maharashtra as on that date, trailed the minimum recommended level (3.0% of their stock of guarantees at the end of the previous year). Moreover, the lack of clarity on the rigorousness of the procedures being followed by each state government with regard to monitoring guarantees underscores the risk of potential default on state-government guaranteed obligations.

States' stock of guarantees tripled in a decade

Guarantees extended by seven state governments accounted for three-fourth of the total stock of guarantees of all states at end-March 2020

Sharp increase in stock of guarantees between FY2010-FY2020, led by some state governments: Guarantees extended by state governments are dominated by entities in the power sector, irrigation, agriculture and urban development sectors. The aggregate guarantees extended by the 27 state governments (data for Goa is not available) to their state-level entities tripled to Rs. 6.3 trillion at end-March 2020, i.e. pre-pandemic, from Rs. 2.1 trillion at end-March 2010 (refer Exhibit 1), while remaining relatively stable as a percentage of GDP.

Exhibit 1: Aggregate guarantee stock of 27 state governments



Source: RBI; Comptroller and Auditor General of India (CAG); National Statistical Organisation (NSO); State Budgets; ICRA Research

However, there was substantial variation in the size of the guarantees outstanding of the 27 states at the end of this 10-year period, both in absolute terms and as a percentage of GSDP, indicating a difference in the policies pursued by the state governments with regard to extension of guarantees.

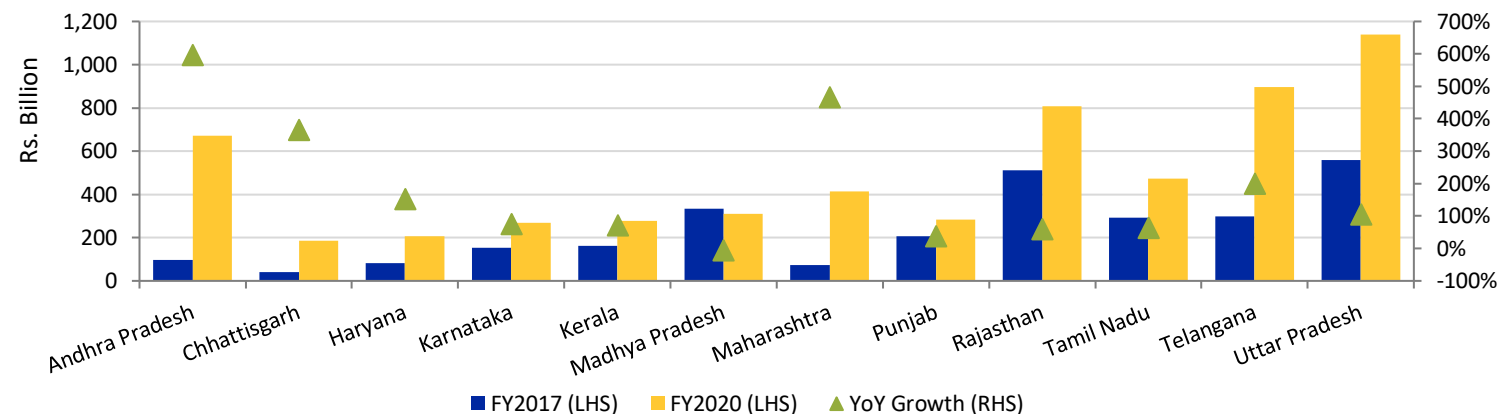
The stock of guarantees outstanding of eight states was under Rs. 15 billion each, while for another seven states the amount was between Rs. 15-150 billion each at end-March 2020. Five states had a balance of guarantees of Rs. 150-300 billion at end-March 2020; this sub-set includes Chhattisgarh (Rs. 185 billion), Haryana (Rs. 207 billion), Karnataka (Rs. 268 billion), Kerala (Rs. 278 billion) and Punjab (Rs. 282 billion; refer Exhibit 2). **The guarantees outstanding of seven states, namely, MP (Rs. 309 billion), Maharashtra (Rs. 413 billion), TN (Rs. 473 billion), AP (Rs. 672 billion), Rajasthan (Rs. 806 billion), Telangana (Rs. 896 billion) and UP (Rs. 1.1 trillion) at end-March 2020 were considerable, in a range of Rs. 300 billion-Rs. 1.1 trillion at end-March 2020. Notably, these seven states accounted for three-fourths of the total guarantees outstanding of Rs. 6.3 trillion as on March 31, 2020. In this note, we are focusing on the 12 states, whose balance of guarantees exceeded Rs. 150 billion at end-March 2020.**

The guarantees outstanding more than doubled between FY2017 and FY2020 for half of these 12 states, namely UP (growth of 104%), Telangana (+199%), Haryana (+152%), Chhattisgarh (+363%), Maharashtra (+465%) and AP (+595%).

Guarantees outstanding more-than-doubled between FY2017 and FY2020 for AP, Chhattisgarh, Haryana, Maharashtra, Telangana, and UP

States have the discretion to set and modify their own guarantee ceilings, which allows them the choice to extend considerable fresh guarantees to their entities within a short period of time

Exhibit 2: State-wise stock of guarantees in FY2017 and FY2020



Source: RBI; CAG; State Budgets; ICRA Research

States have the discretion to set their own guarantee ceilings, and the flexibility to modify the same: As per the Article 293 of the Constitution of India, each state government may pass an Act in the state legislature defining the limit of guarantees that a state government can extend to its state-owned entities. Twenty state governments had passed a Guarantee Ceiling Act as on March 2021, as per information available in the public domain, whereas Arunachal Pradesh, Bihar, Haryana, Jharkhand, Maharashtra, Meghalaya and UP had not.

The guarantee ceilings set by the aforesaid 20 state governments vary widely. Many state governments have linked the limit of total guarantees outstanding at the end of a fiscal year to a fiscal parameter, such as total revenue receipts, states own revenues, GSDP etc., whereas very few states have fixed the limit in absolute terms (refer Exhibit 3). Moreover, a few state governments have defined limits in terms of incremental guarantees that they can extend in a fiscal, which is then linked to a fiscal parameter. Risk weightages to guarantees have been included by a few states.

The linking of guarantee ceilings to different fiscal parameters by various state governments suggests that the states have the sole discretion to affix and modify the guarantee limits. For instance, certain states such as Telangana and Kerala have revised their guarantee ceilings in the recent years. Such flexibility allows the states the choice to extend considerable fresh guarantees to their entities within a short period of time, without any permission or significant oversight from the GoI or the RBI.

Exhibit 3: Guarantee ceiling and utilisation for states whose guarantees outstanding exceeded Rs. 100 billion as on March 31, 2020

State	Guarantee Ceiling	Status in FY2020
AP	Incremental risk weighted guarantees shall not exceed 90% of the state's revenue receipts in the year preceding the current year	NA*
Chhattisgarh	Total guarantees extended in a financial year shall not exceed 100% of the state's own revenue receipts in the preceding year	63.4%
Haryana	No guarantee limit	
Karnataka	Total guarantees shall not exceed 80% of the state's revenue receipts in the second preceding year	18.3%
Kerala	Total guarantees shall not exceed 5% of GSDP	3.2%
MP	Total guarantees extended in a financial year shall not exceed 80% of the total revenue receipts in the preceding year	20.6%
Maharashtra	No guarantee limit	
Nagaland	Risk weighted guarantees at 1% of RR/ GSDP in the year preceding the current year, whichever is lower	NA*
Punjab	Guarantee for long term debt- 80% of previous year's revenue receipts	NA#
Rajasthan	Total guarantees shall be limited to 60% of estimated receipts in the Consolidated Fund of the state in a financial year	57.5%
TN	Total guarantees should be within 75% of revenue receipts of the previous year or 7.5% of GSDP, whichever is lower	27.4%/2.9%
Telangana	Incremental risk weighted guarantees shall not exceed 200% of the state revenue receipts in the year preceding the current year	NA*
UP	No guarantee limit	

Note: * Risk-weighted guarantees not available in public domain; # guarantees for long-term debt not available in public domain
Source: RBI; CAG; State guarantee/FRBM acts; State Budgets; NSO; ICRA research

This differs from the borrowing limit of the state governments, which is set by the Gol, and the criteria underpinning which tends to be uniform across the states. Under Article 293 (3) of Constitution of India, the state governments are required to take the Gol's permission for fresh borrowing, if they are indebted to the Gol.

The fiscal deficit target is typically recommended by a Gol-appointed Finance Commission (FC) for a period of five years and accepted or modified by the Gol. The base fiscal deficit (excluding reform-linked borrowings) is usually defined by the FC/Gol in terms of a percentage rate, which is uniformly applicable to all the state governments. This is then applied to the Gol's estimate of each state's GSDP (as per the methodology recommended by the FC) for a particular fiscal, to determine the absolute net borrowing ceiling (excluding reform-linked borrowings) for that year. The borrowing limit set in this manner by the Gol for each state, acts as a soft constraint to that year's state-wise fiscal deficit.

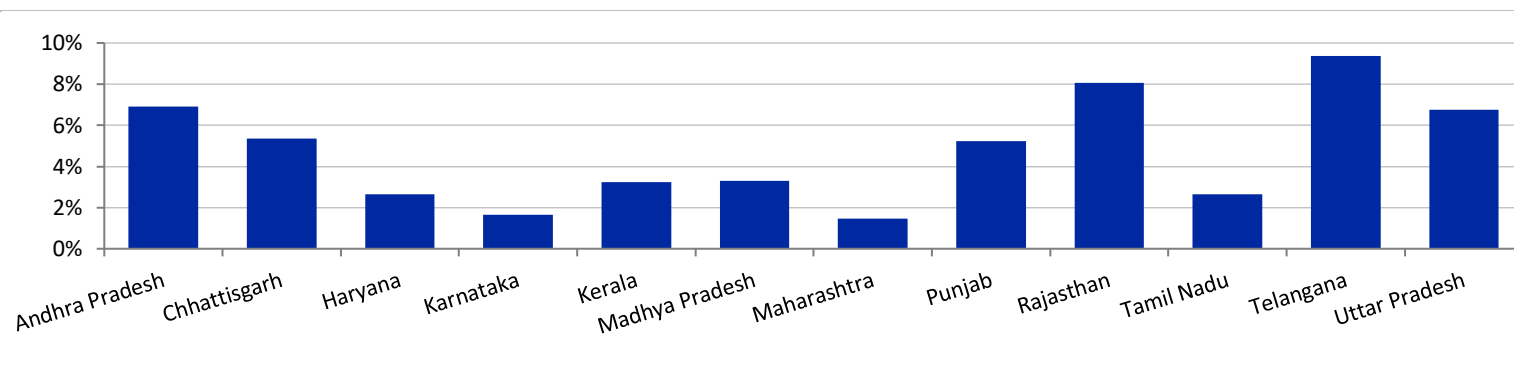
States' guarantee ceilings vary widely

The annual borrowing limit of state governments is set by the Gol, and acts as a soft constraint to the size of the states' fiscal deficit in each year

Guarantees outstanding of Punjab, Chhattisgarh, UP, AP, Rajasthan and Telangana stood at a high 5-10% of their GSDP as on March 31, 2020

Several states' guarantees exceed 5.0% of GSDP: For assessing the comparative performance of the states on leverage indicators, ICRA analyses the guarantees outstanding of state governments as a proportion of GSDP (if NSO's estimate is not available, then we use our own estimate of GSDP). Out of the 12 states in the sub-set considered in this note, **guarantees of six states exceeded 5.0% of GSDP (refer Exhibit 4) as on end-March 2020. This sub-set includes, Punjab (5.2%), Chhattisgarh (5.4%), UP (6.9%), AP (6.9%), Rajasthan (8.1%), and Telangana (9.4%).** However, the stock of guarantees of Maharashtra (1.5%), Karnataka (1.6%) and Haryana (2.7%), Kerala (3.2%), MP (3.3%) and TN (2.6%) was relatively moderate in a range of 1.5-3.3% of GSDP as on March 31, 2020.

Exhibit 4: State-wise guarantee stock as a proportion of GSDP in FY2020



Source: RBI; CAG; State Budgets; NSO; ICRA Research

Contribution to the GRF of most states trails the RBI recommended limit: As per the guidelines issued by the RBI, state governments are required to set up a GRF with a minimum initial contribution of 1.0% of guarantees outstanding at the end of the previous fiscal. The RBI guidelines further recommend that state governments should increase the investment in the GRF to a minimum level of 3.0% of the stock of guarantees as at the end of the previous year, and gradually increase it to a more desirable 5.0% level.

As per information available from the RBI, 11 of the 27 state governments had not set up a GRF at end-March 2021, including Chhattisgarh, Karnataka, Kerala, Punjab, Rajasthan, TN and UP out of our sub-set of 12 states, leaving them vulnerable in the event of unexpected guarantee devolvement. The magnitude of the investment in the GRF as on March 2021 by the remaining 16 state governments varied widely. Out of our sub-set, the balance in the GRF of AP, Telangana and Maharashtra was less than 3.0% of their stock of guarantees as on March 31, 2020 (refer Exhibit 5). Out of our sample, only Haryana and MP had an adequate balance in its GRF, equivalent to 6.1% and 3.1%, respectively, of their stock of guarantees on end-March 2020.

Seven of the 12 states in our sub-set had not set up a GRF, and the balance for another three was lower than the threshold of 5.0% recommended by the RBI as on March 31, 2021, heightening vulnerability in the event of unexpected guarantee devolvement

Data published in the FY2022 Budgets of AP and Telangana reveals sharp increase in guarantees in absolute terms in FY2021.

Exhibit 5: State-wise balance in GRF as at end-March 2021 as a proportion of guarantees outstanding in FY2020

No GRF	Less than 3%	Between 3-5%	Greater than 5%
Bihar, Chhattisgarh , Himachal Pradesh, Jharkhand, Karnataka, Kerala, Punjab, Rajasthan , Sikkim, TN and UP	Nagaland, Tripura, AP, Telangana and Maharashtra	MP and Meghalaya	Arunachal Pradesh, Odisha, Assam, Mizoram, Uttarakhand, Manipur, Gujarat, West Bengal and Haryana

Source: RBI Monthly Bulletin; CAG; State Budgets; ICRA Research

Guarantees likely to have risen further in FY2021 and FY2022: The estimate of guarantees outstanding as on March 2021 is available for only five of the 12 state governments in our sample from their FY2022 Budgets (most of which were published prior to March 31, 2021; refer Exhibit 6). **AP's stock of guarantees outstanding increased by a sharp 36% to Rs. 914 billion at end-March 2021 from Rs. 672 billion at end-March 2020. Nearly a third of this increase was led by guarantees extended by the state government to an entity in the food and civil supplies department, which is likely to be towards non-revenue generating projects. Moreover, the share of guarantees outstanding of the food and civil supplies department as on March 31, 2021 was the highest in AP's total guarantees outstanding on that date.**

Similarly, Telangana estimated its guarantees outstanding to increase by 17% to a substantial Rs. 1.1 trillion at end-March 2021 from Rs. 896 billion at end-March 2020 led by a rise in guarantees extended to entities in the irrigation and power sector. Nearly 58% of the total guarantees outstanding as on March 31, 2021, had been extended by the state government to entities in the irrigation sector, which are typically towards projects that are non-revenue generating in nature.

Rajasthan indicated a mild rise in its stock of guarantees to Rs. 827 billion at end-March 2021 from Rs. 806 billion at end-March 2020, led by the power sector. Accordingly, the guarantees outstanding as a proportion of GSDP (NSO estimate) of AP, Rajasthan and Telangana increased further to an estimated 9.3%, 8.6% and 10.7% at end-March 2021.

Moreover, MP estimated an increase in its guarantees to Rs. 370 billion (4.0% of GSDP) at end-March 2021 from Rs. 309 billion at end-March 2020, led by the food and civil supplies department. Out of the total guarantees extended by MP as on March 31, 2021, nearly two thirds were to MP food and civil supplies department, which is likely to be towards non-revenue generating expenditure.

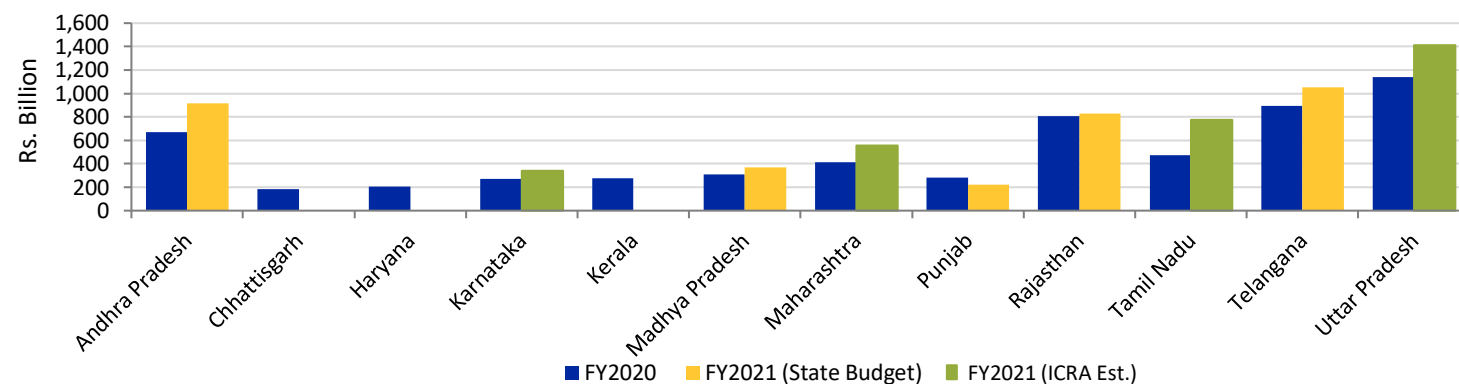
In contrast, the guarantees outstanding estimated by Punjab at end-March 2021 eased marginally to Rs. 223 billion (4.2% of GSDP) from Rs. 228 billion at end-March 2020.

Guarantees of TN, UP, Maharashtra likely to have increased in FY2021 led by power sector

There is anecdotal evidence of a further considerable extension of guarantees by some states in the current fiscal

Many guarantees are actual and not contingent liabilities of states; servicing of guaranteed obligation could widen the deficits of some state governments in the future; ICRA assesses leverage inclusive of guarantees

Exhibit 6: State-wise guarantee stock in FY2020 and estimates for FY2021



Source: RBI; CAG; State Budgets; ICRA Research

We expect some states to have extended substantial guarantees to their power sector entities in FY2021. The Gol’s liquidity scheme for the power sector approved in FY2021, requires the state governments to guarantee the concessional loans, which the state Discoms are eligible to avail from designated Corporations for clearing their dues to the power producers. As per publicly available information, Rajasthan (Rs. 41 billion), AP (Rs. 68 billion), Karnataka (Rs. 72 billion), Telangana (Rs. 127 billion), Maharashtra (Rs. 143 billion), UP (Rs. 274 billion) and TN (Rs. 302 billion) had agreed to extend guarantees to their Discoms in FY2021. This is expected to have led to a further rise in the stock of guarantees of these states as on March 31, 2021. To get a sense of the magnitude of the stock at end-March 2021, we have added the guarantees extended to the power sector entities under the Gol’s liquidity’s scheme by Karnataka, TN, Maharashtra and UP in FY2021, to their guarantees outstanding of as on March 2020. This suggests a rise in their stock of guarantees to Rs. 341 billion, Rs. 775 billion, Rs. 556 billion, Rs. 1.4 trillion, respectively, as on March 31, 2021, which is the estimate we have depicted in Exhibit 6 above.

Additionally, there is anecdotal evidence of a further considerable extension of guarantees by some states in the current fiscal, in a bid to hasten project implementation. However, data on the same, especially whether the projects being supported will generate sufficient cash flows to ensure that guarantee servicing does not eventually devolve on the state government, is not available as of now in public domain.

Guarantees could be an actual and not contingent obligation of the state government in some instances: Theoretically, guarantees are a contingent obligation of the guarantor and the servicing of the guaranteed instrument becomes the actual obligation of the guarantor only when the contingency included in the guarantee document materialises. However, there are many instances when the state governments extend guarantees to non-revenue generating projects of entities (such as irrigation entities, entities set up for specific objective of undertaking

Inadequate monitoring mechanism for guarantees extended by states, uneven track-record of guarantee invocation by trustees/lenders, boosts risk of default

capex/developmental activities etc.). In such cases, it is clear upfront that the payment of interest and repayment of principal of the guaranteed instrument will be undertaken by the state government itself when it falls due, making it an actual and not a contingent liability. For instance, in some cases, the guarantees extended by the state government are with budgetary support, indicating that the Government will itself service that guarantee when it falls due.

It is important to discern whether the liability arising from extending a guarantee is an actual liability of the state government or a contingent liability. In the absence of complete information on this categorisation, ICRA adds the total guarantees extended to the debt stock of each state, to determine the relative leverage levels.

Regardless, the potential servicing of the guaranteed obligations by the state governments in the future could materially widen their deficits and compress the fiscal space available for other priorities at the time of the servicing, especially in the case of those states whose GRFs do not provide them an adequate cushion

Additionally, there is lack of clarity on the rigorousness and the procedure being followed by each state government with regard to monitoring guarantees extended to the state-level entities. Periodic monitoring of the cash flows of the state-level entities vis-a-vis their debt-servicing requirements by the state government, as well as timely notification and invocation of guarantees by the Trustees/Lenders could help averting defaults on guaranteed debt.



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Business Contacts

Mr. L. Shivakumar
E-mail: shivakumar@icraindia.com
+91 22 6114 3406 / +91 98210 86490

Mr. Jayanta Chatterjee
E-mail: Jayantac@icraindia.com
Tel: +91 80 4332 6401/ +91 98450 22459

Media and Public Relations

Ms. Naznin Prodhani
E-mail: Communications@icraindia.com
Tel: +91 124 4545 860

Registered Office

B-710, Statesman House 148,
Barakhamba Road
New Delhi-110001
Tel: +91 11 23357940-45

Corporate Office

Building No. 8, 2nd Floor,
Tower A, DLF Cyber City, Phase II,
Gurgaon - 122 002
Tel: +91-124-4545300

Ahmedabad

1809-1811, Shapath V,
Opp: Karnavati Club,
S.G.Highway, Ahmedabad - 380015
Tel: +91 79 4027 1500/501

Bengaluru 1

'The Millenia', Tower B Unit No. 1004,
10th Floor, 1 & 2 Murphy Road,
Bengaluru - 560 008
Tel: +91 80 4332 6400

Bengaluru 2

2nd Floor, Vayudooth Chamber
15-16, Trinity Circle, M.G. Road,
Bengaluru - 560 001
Tel: +91 80 4922 5500

Chennai

5th Floor, Karumuttu Centre
634, Anna Salai, Nandanam
Chennai - 600 035
Tel: +91 44 4596 4300

Hyderabad 1

4th Floor, 'Shoban'
6-3-927/A&B. Somajiguda
Raj Bhavan Road,
Hyderabad - 500 082
Tel: +91 40 4067 6500

Hyderabad 2

No. 7-1-58, 301, 3rd Floor, 'Concourse',
Above SBI-HPS Branch, Ameerpet,
Hyderabad - 500 016
Tel: +91 40 4920 0200

Kolkata

A-10 & 11, 3rd Floor,
FMC Fortuna 234/3A,
A.J.C. Bose Road,
Kolkata-700 020
Tel: +91 33 7150 1100/01

Mumbai

3rd Floor, Electric Mansion
Appasaheb Marathe Marg,
Prabhadevi,
Mumbai - 400 025
Tel: +91 22 6169 3300

Pune

5A, 5th Floor, Symphony, S. No. 210
CTS 3202 Range Hills Road,
Shivajinagar, Pune - 411 020
Tel: +91 20 2556 1194

Email: Info@icraindia.com

Helpdesk: 9354738909

Website: www.icra.in/ www.lcraesearch.in