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RESEARCH REPORT ON QUERIES RAISED BY THE FOURTEENTH FINANCE COMMISSION

2. ON CENTRAL CONTROL OVER SUB-NATIONAL DEBT IN INDIA

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INTRODUCTION

This Note enquires into the control exercised by the Central Government of India over the public debt of State Governments through the mechanism of Article 293 (3) of the Indian Constitution. Article 293 (3) requires State Governments that are indebted to the Central Government to seek the consent of the Central Government before raising further borrowings. In recent years, the outstanding liabilities of State Governments to the Centre have declined rapidly, and it is possible that over the horizon of the next few years, some State Governments *may* be able to repay all Central Government loans. Under Article 293 (3) consent would no longer be required by such States in order to raise fresh borrowings, raising concerns about the inability of the Central Government to control the combined fiscal deficits of the Centre and the States, with potential consequences for macroeconomic stability. In this context, two queries have been raised by the Fourteenth Finance Commission for our consideration:

1. Whether the FRBM legislations can be taken to be covered under the debt limit that the Parliament or the State Legislature is required to fix under Articles 292 and 293?
2. What are the options for the Central Government to regulate sub-national debt in case States are no longer indebted to the Union of India?

To answer these queries, in this note, we present several alternative recommendations to extend Central control over the aggregate level of State Government borrowings. Our recommendations fall into the following categories:

1. Amending Article 293 to ensure its applicability in a wider number of scenarios;
2. Ensuring that Article 293 (3) continues to apply to all borrowings by State Government even beyond the next few years; and
3. Developing statutory and non-statutory fiscal frameworks derived from Article 293.

It is to be noted that our research does not directly address the normative question as to whether Central control over sub-national debt in India is either necessary or desirable. It proceeds largely on the basis of the queries raised which assume this to be so.

Section 1 establishes the role played by Article 293 in ensuring the combined fiscal sustainability of the Central and State Governments. Section 2 provides information on the background of Article 293. Section 3 presents data on the historical and present composition of State Government liabilities. Section 4 presents recommendations for fiscal discipline going forward. Lastly, Section 5 summarises and concludes this note.

1. Fiscal sustainability and macroeconomic stability

Fiscal discipline underpins macroeconomic stability in a country. Unsustainable fiscal deficits and high debt burdens can compromise both growth and stability, leading to high inflation, reduced expenditure on development, deteriorating government services, as well as macroeconomic distress.[1] In the context of a decentralised federal economy, ensuring the sustainability of fiscal policy is further complicated by the presence of State Governments that can also make spending and borrowing decisions.[2]

State Governments can pose a specific threat to fiscal sustainability and, therefore, macroeconomic stability, because their interests are not always aligned with those of the Central Government. In particular, State Governments may rationally prioritise their interests, and those of their constituents, over national interests. This may be exacerbated by the implicit understanding that the Central Government will bail out a State Government that is in distress: this commitment problem makes it even less likely that State Governments will pursue sustainable fiscal policies.

There are several sobering examples of the close relationship between sub-national debt crises and national debt crises. Brazil suffered several sub-national debt crises in the 1980s and 1990s, with multiple provinces requiring Central Government refinancing of their debt in 1989, 1993 and 1999. Argentina's default on its sovereign debt in 1991 has been associated with sub-national debt crises in two of its provinces. Mexico's 1995 Tequila currency crisis plunged several sub-national entities into distress. Following Russia's 1998 financial crisis, more than half of its provinces defaulted on debt.[3]

In such a context, mechanisms to ensure fiscal discipline across the entire country, including State Governments, are critical to ensure growth and stability. India has long relied on a rule embedded in the Constitution to control the spending and borrowing of State Governments. Article 293 (3) of the

[1] There is a large literature on the macroeconomic effects of unsustainable fiscal policies. A very short and non-exhaustive list includes Sargent, Thomas J. & Neil Wallace, 1981."Some unpleasant monetarist arithmetic," *Quarterly Review*, Federal Reserve Bank of Minneapolis, Federal Reserve Bank of Minneapolis, issue Fall; Elmendorf, Douglas W. & N. Gregory Mankiw, 1999. "Government Debt," *Handbook of Macroeconomics*, edition 1, volume 1, chapter 25, pages 1615-1669, Elsevier; Burnside, C., M. Eichenbaum, and S. Rebelo, 2001, "Prospective Deficits and the Asian Currency Crisis," *Journal of Political Economy*, Vol. 109 (6), pp. 1155–97; Gale, W. and P. Orszag, 2003, "The Economic Effects of Long-term Fiscal Discipline," Urban-Brookings Tax Policy Center Discussion Paper No. 8 (Washington: Brookings Institution); Hemming, R., M. Kell, and A. Schimmelpfennig, 2003, Fiscal Vulnerability and Financial Crises in Emerging Market Economies, *IMF Occasional Paper No. 218*, Washington: International Monetary Fund; Kumar, Manmohan S. & Jaejoon Woo, 2010. "Public Debt and Growth," *IMF Working Papers 10/174*, International Monetary Fund; Reinhart, Carmen M. & Kenneth S. Rogoff, 2010. "Growth in a Time of Debt," *American Economic Review*, American Economic Association, vol. 100(2), pages 573-78, May.

[2] *See* Rodden, Jonathan A. and S. Gunnar Eskeland, 2003. *Fiscal Decentralization and the Challenge of Hard Budget Constraints*, vol. 1, 1 ed., The MIT Press, for a review of the literature on subnational borrowing.

[3] For a review of these cases and further references, *see* Liu, Lili, and Michael Waibel, 2008. "Subnational borrowing, insolvency, and regulation." in A. Shah, ed., *Macro Federalism and Local Finance*, chapter 6, pages 215-41, World Bank.

Constitution of India requires State Governments that are indebted to the Central Government to seek the consent of the Central Government before raising further borrowings from other sources. Since all the State Governments have been and continue to be indebted to the Central Government, the Central Government effectively controls the amount of public debt raised by State Governments. This constitutional mechanism has been used by the Central Government to ensure that State Governments do not exceed annual borrowing limits that are set at the beginning of every year. Presently, these limits are set by the Finance Commission in accordance with a formula that ensures that the fiscal deficit of no State exceeds 3% of Gross State Domestic Product ('GSDP').[4]

The indebtedness of the State Governments to the Central Government, however, is not a permanent condition; it seems increasingly likely that many State Governments may be in a position to eliminate all liabilities to the Central Government by, as early as 2020. In short, we need a new framework for fiscal sustainability. This note presents recommendations for extending Central Government's control over the total borrowings of State Governments in order to ensure federal control of the combined fiscal deficits of the Centre and the States.

2. Article 293: Present mechanism that ensures fiscal sustainability of State Governments

Chapter II of Part XII of the Constitution of India deals with borrowing by the Central Government and State Governments. It comprises two provisions— Article 292 which covers borrowing by the Central Government and Article 293, which covers borrowing by State Governments. Since the focus of the present enquiry is State debt, it is only Article 293 that will be looked into in this section.

This section is divided into two sub-sections. Sub-section 1.1 is a historical recounting of the pre-constitutional position pertaining to State borrowing and Constituent Assembly Debates in this regard. Sub-section 1.2 analyses the scheme of Article 293 and argues why it requires amendment to address present day needs.

1.1. Borrowing by Provinces- The Pre-Constitutional Position

The provisions of Article 293 are substantially derived from Article 163 of the Government of India Act, 1935 ('GOI Act').[5] In essence Article 163 allowed the Government of the Provinces to borrow any money

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[4] For the most recent borrowing limits, see para 9.85 of the Report of the Thirteenth Finance Commission.

[5] Article 163 reads,

"(1) Subject to the provisions of this section, the executive authority of a Province extends to borrowing upon the security of the revenues of the Province within such limits, if any, as may from time to time be fixed by the Act of the Provincial Legislature and to the giving of guarantees within such limits, if any, as may be so fixed.

upon the security of the revenues of the province. This was subject to any law made by the Provincial Legislature. If the borrowing was a loan from the Federal Government, then the Federal Government could impose conditions as it deemed fit. If Provinces had taken such loans and were indebted to the Federal Government, then the taking of any subsequent loans by the province from the market would be subject to the Federal Government's consent. The same condition would apply if the Province was desirous of taking a foreign loan. Consent however, it was mandated, ought to be provided by the Federal Government in ordinary circumstances. Disputes over the legality of withholding consent, if any, would be resolved by a decision of an arbitrator appointed by the Chief Justice of India (earlier this was decided by the Governor-General).

The principle underlying Article 163 was that Provincial autonomy to borrow is secured constitutionally; however in cases where the Federal Government has a direct stake (when the Province is indebted to it, or it has given a guarantee on a market loan by a Province) and when the macroeconomic stability of the country is potentially threatened by a Province's recourse to external lenders (foreign loans), the Province would have to seek the consent of the Federal Government. Thus Article 163 sought to strike a balance between Provincial autonomy and Federal control, that its drafters believed would be appropriate to the time.

The Expert Committee on the Financial Provisions of the Union Constitution presided over by Nalini Ranjan Sarker, appointed by the Constituent Assembly, underlined the need for such balance. Provincial autonomy in raising loans from the market, the Committee felt was essential since it creates financial responsibility and is a dependable metric to assess the credit rating of a province. At the same time, co-ordination between borrowings by different provinces was felt to be equally essential not only to fix priorities between borrowings *inter se* but also to prevent unhealthy competition between Provinces and

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(2) The Federation may, subject to such conditions, if any, as it may think fit to impose, make loans to, or, so long as any limits fixed under the last preceding section are not exceeded, give guarantees in respect of loans raised by, any Province and any sums required for the purpose of making loans to a Province shall be charged on the revenues of the Federation.

(3) A Province may not without the consent of the Federation borrow outside India, nor without the like consent raise any loan if there is still outstanding any part of a loan made to the Province by the Federation or by the Governor-General in Council, or in respect of which a guarantee has been given by the Federation or by the Governor-General in Council.

A consent under this sub-section may be granted subject to such conditions, if any, as the Federation may think tit to impose.

(4) A consent required by the last preceding sub-section shall not be unreasonably withheld, nor shall the Federation refuse, if sufficient cause is shown, to make a loan to, or to give a guarantee in respect of a loan raised by, a Province, or seek to impose in respect of any of the matters aforesaid any condition which is unreasonable, and, if any dispute arises whether a refusal of consent, or a refusal to make a loan or to give a guarantee, or any condition insisted upon, is or is not justifiable, the matter shall be referred to the Governor-General and the decision of the Governor-General in his discretion shall be final."

thereby preserve the capital market.[6] A tentative suggestion was thus made that such co-ordination be done by a Ministerial Conference or Loans Council, as was the arrangement in some other countries. This suggestion however was not accepted.

Article 163 of the GOI Act was adapted as Article 269 of the Draft Constitution. When Draft Article 269 was taken up for discussion in the Constituent Assembly[7] two key concerns were its focus— the extent of legislative control over borrowing by Centre and States[8] and the need to ascertain the purpose of a State loan.[9] Draft Article 268 (dealing with Central Government borrowings) and Draft Article 269 both made borrowing an executive act. However it allowed the Parliament and State Legislatures to impose limits on borrowing by the Central Government and State Governments respectively. Further for any loans from the Centre to the States, the Central Government would have to act subject to any law made by Parliament in this regard. Taking this further, HV Kamath recommended that the purpose for which the loan was being sought should be a key factor on the basis of which parliamentary control ought to be exercised.[10] Thus profligate borrowing by States for non-urgent purposes could be effectively checked by the Parliament.

Responding to both these concerns, Ambedkar felt that borrowing should remain an act of the executive. Further, Parliament and State Legislatures were given the power to exercise control over such borrowing. Such power could even extend to 'an Annual Debt Act made by Parliament prescribing or limiting the power of the executive as to how much they can borrow within that year.'[11] These powers were significant and Ambedkar thus felt that it would be 'very difficult to imagine any future Parliament which

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[6] Report of the Expert Committee on Financial Provisions, December 5, 1947 in *The Framing of India's Constitution: Select Documents Vol. 3* (B Shiva Rao ed., New Delhi: Universal Law Publishing, 2012) 260, 282-3.

[7] Underlining the importance of the provisions, a member M. Ananthasayanam Ayyangar said,

"Though the entire borrowing both of the Centre -as well as of, the provinces and loans may be granted by the Union Government to States are put compendiously in two articles 268 and 269, they are more important and- require greater scrutiny than the powers to impose taxation, with respect to which and for the -distribution of which-the revenues of both the Union and the States-we have devoted a long Chapter."

Constituent Assembly Debates, 10th August 1949 available at
<http://parliamentofindia.nic.in/ls/debates/vol9p9a.htm> accessed on 25 September, 2014.

[8] *See* speech by KT Shah, Constituent Assembly Debates, 10th August 1949 available at
<http://parliamentofindia.nic.in/ls/debates/vol9p9a.htm> accessed on 25 September, 2014.

[9] *See* speech by HV Kamath, Constituent Assembly Debates, 10th August 1949 available at
<http://parliamentofindia.nic.in/ls/debates/vol9p9a.htm> accessed on 25 September, 2014.

[10] *Ibid*.

[11] Per BR Ambedkar, Constituent Assembly Debates, 10th August 1949 available at
<http://parliamentofindia.nic.in/ls/debates/vol9p9a.htm> accessed on 25 September, 2014.

will not pay sufficient or serious attention to this matter and enact a law.'[12] Thus, apart from formal changes in this article, making express reference to the Consolidated Fund of India, which was set up under the Constitution, and exclusion of foreign loans from the remit of the article, the basic structure of Article 163 of the GOI Act remained unchanged.

Draft Article 269 thus became Article 293 of the Constitution.

1.2. Scheme of Article 293

Article 293 is in four sub-clauses.[13] Sub-clause (1) states the general principle that the State Government is free to borrow money within the territory of India upon security of the Consolidated Fund of the States. Two safeguards are key— first, the limits on such borrowing may be fixed by the State Legislature from time to time and second, the freedom to borrow is subject to the rest of the article, i.e. the remaining sub-sections. Limits on State borrowings have been specified by fiscal responsibility legislations in States, a matter that we will turn to presently;[14] the restrictions in the article itself may be found in sub-clauses (2), (3) and (4) which is the focus of attention in this section.

Sub-clause (2) provides a restriction on the State Government's freedom to borrow in a situation when the loan in question is made by the Central Government or guaranteed by it. In such a situation the Parliament may lay down conditions for such loan or prescribe limits only within which guarantees on loans can be given. This is conceptually sound since a lender has the right to specify the terms and conditions of lending. When such a loan has been taken and the State is still indebted to the Centre on

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[12] *Ibid*.

[13] Article 293 reads,

"Borrowing by States

(1) Subject to the provisions of this article, the executive power of a State extends to borrowing within the territory of India upon the security of the Consolidated Fund of the State within such limits, if any, as may from time to time be fixed by the Legislature of such State by law and to the giving of guarantees within such limits, if any, as may be so fixed

(2) The Government of India may, subject to such conditions as may be laid down by or under any law made by Parliament, make loans to any State or, so long as any limits fixed under Article 292 are not exceeded, give guarantees in respect of loans raised by any State, and any sums required for the purpose of making such loans shall be charged on the Consolidated Fund of India

(3) A State may not without the consent of the Government of India raise any loan if there is still outstanding any part of a loan which has been made to the State by the Government of India or by its predecessor Government, or in respect of which a guarantee has been given by the Government of India or by its predecessor Government

(4) A consent under clause (3) may be granted subject to such conditions, if any, as the Government of India may think fit to impose."

[14] *Infra*.

it or any other loan, or when the Central Government is a guarantor on a loan taken by a State, in such situations, sub-clause (3) provides that the State Government must seek the consent of the Central Government before raising any loan. Sub-clause (4) allows the Central Government to prescribe conditions it deems fit. It is instructive to note that unlike Section 163 of the GOI Act there is no default rule that such consent ought to be provided. This is also logical— the Central Government, not only by virtue of being a creditor, but also being responsible for macroeconomic stability in the country, should play a determinative part in State borrowings from the market.

Thus it is clear that the autonomy of State Governments to borrow is circumscribed primarily in case of loans given or guaranteed by the Central Government (sub-clause 2). If the latter has been taken and not repaid, only in such situations would other loans raised by the State from the market also require Central Government consent (sub-clauses 3 and 4). This scheme of division was appropriate at the time the provision was drafted. This is because Central loans to States were a key component of the State's finances at the time of the drafting of the Constitution. The taking of such loans would obviously have to depend on the Central Government and any law Parliament might make in this regard. Further, though the drafters envisaged State loans from the market, since State Governments were expected to be indebted to the Central Government, it would automatically trigger the application of sub-clauses (3) and (4).

Thus while States had the formal autonomy to borrow as they wished according to Article 293(1), the spirit of the section is to ordinarily subject State borrowing *de facto* to the formal control of the Central Government. In practice, this control is exercised by the Department of Expenditure in the Ministry of Finance which is the nodal department for granting consent under Article 293(3).[15] This provides an avenue for the Central Government to both have knowledge of, as well as control State borrowings, should the need arise.

This is the practical working of the balance between State financial autonomy and the need for Central co-ordination and oversight that was drawn by the drafters of the Constitution and followed thereafter. However the data encapsulated in the next section demonstrates that this balance may have to be redrawn.

3. Composition of State liabilities: decline in Central Government loans

The composition of State Government liabilities has changed significantly in the last 25 years. The share of loans and advances from the Centre has declined from just over 57% of all State liabilities in 1991 to 6.6% in 2014 (based on budgetary estimates; see Table 1). There are several reasons for this

[15] Source: <http://www.finmin.nic.in/the_ministry/dept_expenditure/plan_finance/DEbt/permission-loans.asp> accessed on 26 September, 2014.

transformation. First, a change in the accounting procedure for small savings deposits in 1999 shifted a large share of State liabilities owed to the Central Government to a fund in the Public Account. Second, the Twelfth Finance Commission (FC-XII) has recommended that the Central Government stop intermediating in the raising of borrowings by States to finance their fiscal deficits.

3.1. National Small Savings Fund

Prior to 1999, small savings in the form of postal deposits, purchase of savings certificates and other social security schemes were deposited into the Public Account of the Central Government, while loans to State against these deposits were made out of the Consolidated Fund of India.

On the recommendations of the 'Committee on Small Savings' (chair: Mr RV Gupta), a separate fund called the National Small Savings Fund ('NSSF') was created within the Public Account into which all small savings were deposited and out of which loans to State Governments were made against these deposits.[16] As a result, the investments by the NSSF in State securities do not comprise loans from the Central Government, as presently specified in Article 293. Instead the Central Government determines the mandatory minimum share of NSSF deposits that must be shared with the States. In 2011-12, this mandatory share was reduced from 80% to 50%. Since this debt is relatively expensive, States have not borrowed beyond the mandatory minimum share from the NSSF.

Table 1: Composition of outstanding liabilities of State Governments (in billions of Rupees)[17]

Year	Market loans, power bonds and other bonds	% of total	National Small Savings Fund	% of total	Loans from Banks and FIs incl WMA	% of total	Loans and Advances from Centre	% of total	Provident Fund, Reserve Fund, Contingency Fund, Net balances	% of total	Total Outstanding Liabilities
	1		2		3		4		5		sum(1 to 5)
1991	157.1	12.3%	-	-	35.6	2.8%	735.2	57.4%	353.6	27.6%	1,281.5
1995	312.8	14.4%	-	-	46.1	2.1%	1,152.4	53.2%	653.5	30.2%	2,164.8

[16] For a review of the creation of the NSSF, *see* Report of the Committee on Comprehensive Review of National Small Savings Fund (2011). Available at <http://finmin.nic.in/reports/report_committee_comprehensive_review_nssf.pdf> accessed on 28 September, 2014.

[17] Source: *State Finances: A Study of Budgets of 2013-14*, RBI, Appendix Tables 11 and 12. Available at <http://rbi.org.in/scripts/AnnualPublications.aspx?head=State%20Finances%20:%20A%20Study%20of%20Budget> accessed on 25 September, 2014.

2000	755.0	14.8%	252.5	5.0%	244.4	4.8%	2,303.3	45.2%	1,540.1	30.2%	5,095.3
2005	2,434.4	24.0%	2,822.0	27.8%	694.2	6.8%	1,600.5	15.8%	2,589.6	25.5%	10,140.7
2010	5,346.5	32.4%	4,550.2	27.6%	839.6	5.1%	1,431.5	8.7%	4,318.7	26.2%	16,486.5
2011	6,185.9	33.8%	4,946.4	27.0%	831.3	4.5%	1,441.7	7.9%	4,884.4	26.7%	18,289.8
2012	7,527.7	37.8%	4,864.2	24.4%	836.9	4.2%	1,435.5	7.2%	5,275.1	26.5%	19,939.2
2013RE	8,833.5	40.6%	4,867.5	22.4%	855.5	3.9%	1,504.1	6.9%	5,691.9	26.2%	21,752.5
2014BE	10,966.6	45.1%	4,801.5	19.7%	900.9	3.7%	1,603.4	6.6%	6,060.3	24.9%	24,332.8

Notes: RE – revised estimates. BE – Budgetary estimates.

3.2. Recommendations by FC-XII

A more fundamental reason for the decline in Central loans to States is the recommendation by FC-XII in 2004-05 for the disintermediation of the Central Government from the raising of public debt by State Governments. This recommendation led to the elimination of the loan portion of Central plan transfers to States, as the Central Government since 2007-08 only makes grants to States under plan transfers. The remainder of the plan funds must be raised by States themselves through, for example, market borrowings. The FC-XII further recommended that the size of the plan projects and the plan grants must take into account the debt capacity of every State: to this extent, there is some indirect control imposed on the debt borrowing of States through the allocation of grants for projects (4.68, FC-XII Report). However, the share of Central Government liabilities for State Governments has declined since 2007-08.

The rationale for this recommendation by the FC-XII was that States would now rely on market borrowings to finance their expenditure and would, accordingly, be subject to the disciplinary action of markets. States that borrowed unsustainably would face higher interest rates while fiscally prudent States would be able to borrow at rates well below those offered on Central Government loans. Moreover, most developed federal economies primarily rely on market discipline to ensure fiscal sustainability at the sub-national level.

In India, however, there is the concern that market discipline in the present scenario may be ineffective in ensuring fiscal sustainability. State Government securities – States development loans (SDLs) – are presently held, in the main, by commercial banks and other financial institutions as a part of their statutory liquidity requirements (‘SLR’). While market discipline is undoubtedly a sustainable and sensible mechanism for managing fiscal prudence, it may be something of a long-term solution in the Indian context. In the interim, effective mechanisms will need to be in place to ensure that States do not imprudently borrow and endanger the economy’s macroeconomic stability.

4. Recommendations: Mechanisms to ensure management of State borrowings

4.1. Amending Article 293 to allow Central control over sub-national debt

From the description and analysis in the Sections above it is clear that the constitutional balance between financial autonomy of States and Central control over States borrowings needs to reflect a changed reality. To this end, two solutions are proposed:

4.1.1. Amend 293(2)

1. Amend Article 293 (2) to insert the words 'regulate taking of any loans by any State, or' after 'make loans to any State or,'

The amended Article 293 (2) would thus read:

> '(2) The Central Government may, subject to such conditions as may be laid down by or under any law made by Parliament, make loans to any State or, **regulate taking of any loans by any State or,** so long as any limits fixed under article 292 are not exceeded, give guarantees in respect of loans raised by any State, and any sums required for the purpose of making such loans shall be charged on the Consolidated Fund of India.'

As discussed in Section 2 of this Note, the scheme of the article is to list the chief sources of loans that the State Government can avail of subject to any conditions in Article 293 (2). This refers to loans from the Centre to the States as well as loans guaranteed by the Centre at the time of drafting of the Constitution. Since these loans were significant at the time, meaning that States were indebted to the Centre, a third category, i.e. loans from the market, would also require consent of the Central Government. This served two purposes— first, allowing the Central Government as a creditor to consent to any subsequent loans by States; second, arming the Central Government, as the authority ultimately accountable for macroeconomic stability in the country to keep track of and check the taking of all sub-national debt.

Given the reduction in loans from the Centre to the States, the former function may have limited relevance for most States. However the latter function continues to remain significant. It is thus necessary that Central Government power to check sub-national debt is secured. This can be done by enlarging the scope of Article 293 (2). Thus apart from the situation when States are indebted to the Centre or loans are guaranteed by the Centre (covered under Article 293 (3)), the taking of any loan by the State may be made subject to regulation by the Central Government as may be prescribed by a parliamentary law. The effect of this amendment is thus to ensure that there is the possibility of Central Government control over sub-national debt, irrespective of the source of such State borrowing.

Constitutionally, this proposal has two clear merits. Besides ensuring that the Central Government both knows of and needs to consent to sub-national debt by States, irrespective of its indebtedness it achieves this in a manner that is flexible and consonant with the original scheme of the article. The flexibility is a product of the fact that Parliament is now vested with the power to make an appropriate law regulating the consent-granting function of the Central Government over State borrowing. Thus, if borrowing limits are breached with potential to affect macro-economic stability then the law may provide that consent may not be given. Any exceptions to this or alternative methods of regulation can also be built into the law. In this way it factors in the key concerns that were the subject of intense scrutiny by the Constituent Assembly.[18] Thus it provides an institutional, long-term yet flexible solution to the envisaged problem of uncontrolled sub-national debt.

Secondly, the proposal provides a new modern manifestation of the balance between States' autonomy and Central control over sub-national debt. The drafters of the Constitution drafted Article 293 in a manner that reflected their perception of the balance at the time. *De facto* control of State debt by the Centre was provided for with State loans taken from the Centre being the trigger for such control. Now that such loans have reduced, it is essential not to throw the baby out with the bathwater. A notional control of State loans by the Centre must remain. Making this amendment will ensure such control remains, while allowing the Parliament to strengthen or mitigate the rigour of the provision. This not only strikes an alternative balance between State fiscal autonomy and Central control but also allows Parliament to alter the balance in the interest of macroeconomic stability in India.

It must be noted though that this amendment is not entirely without demerits. Requiring all State borrowing to be subject to Central Government regulation, whether or not States are indebted to the Centre, would come into conflict with recent efforts to increase the operational independence of States in the area of public debt. Several recent policy measures have strengthened the ability of the States to raise borrowing on their own. For example, as of 2006-07, all open-market borrowings in the form of the sale of State Development Loans – State Government securities – have taken place through a transparent auction-based system managed by the RBI, in order to enable price discovery.[19] The recommendations of the FC-XII (discussed in Section 3.2) were also intended to minimise the role of the Central Government in raising State borrowings. Amending Article 293 (2) may reverse some of these recent attempts. However on an overall assessment, the benefits of such amendment might be felt to outweigh the costs.

4.1.2. Amend 293(3)

[18] It is to be noted that the Assembly did not reject these views but merely recommended that Parliament pass a law in this regard.

[19] *See* Section VII of Gopinath, S, "Sub-national Fiscal Reforms and Debt Management - Indian Experience", Paper presented at the workshop on 'Sub-national Fiscal Reform and Debt Management', April 29, 2009, Washington, organised by the Economic Policy and Debt Department, World Bank.

2. Insert an Explanation after sub-section (3):

   'In this clause of this article "any part of a loan which has been made to the State by the Government of India or by its predecessor government" includes loans made from the public account of India as defined in Article 266(2).'

As demonstrated above, loans from the Central Government to State Governments have diminished considerably over time,[20] especially after FC-XII recommendation to this effect.[21] However, it is not as if loans to State Governments from all sources have declined concomitantly. As discussed in Section 3, one important reason for the decline in Central Government loans to States has been the setting up of the National Small Savings Fund (NSSF) in the Public Account of India.

The public account of India is constitutionally enshrined in Article 266(2). Any public money received by the Central Government that is not part of the Consolidated Fund of India shall be part of the public account of India. Explaining the distinction, the Delhi High Court in *Shri Vashist Bhargava v. ITO, Salary Circle*[22] held that moneys in the public account of India do not belong to the Central Government unlike money in the Consolidated Fund of India. The operation of both, however can be regulated by law.

The exclusion of transfers from the public account of India from the scope of Article 293 (3) is without clear justification and limits the efficacy of the aggregate borrowing limits recommended by the Finance Commission for the States and implemented by the Central Government. This is especially so since in the overall determination of state borrowings under Article 293 (3) state borrowing from NSSF funds are included. Currently, there are separate borrowing restrictions on different categories of liabilities – a limit on market borrowings by States (subject to the terms of Article 293), as well as a mandatory minimum share in NSSF funds.

Combining different sources of borrowings together and setting an overall borrowing limit will streamline the fiscal disciplining mechanism and allow States more flexibility to raise debt on the best possible terms. At the same time, the extension of the scope of Article 293 (3) will allow the Central Government to monitor overall fiscal sustainability and set appropriate limits on public borrowings by States.

The recommended Explanation conforms to this understanding of the public account. By deeming loans from this account to constitute the sum total of loans made to the State by the Central Government, it merely deems such loans, for the purpose of Article 293(3) to constitute loans from the Central

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[20] *Supra* note 16.

[21] *See* Recommendations of the Twelfth Finance Commission, available at < http://www.indiabudget.nic.in/es2004-05/chapt2005/chap25.pdf> accessed on 26 September, 2014.

[22] ILR (1975) 1 Del 634.

Government. Such deeming provisions for a limited purpose are a well-known feature of law. In *J&K Cotton Spinning and Weaving Mills Limited v. Union of India,*[23] the Supreme Court held,

> "The Legislature is quite competent to enact a deeming provision for the purpose of assuming the existence of a fact which does not really exist."[24]

Creating a legal fiction for a specific purpose is thus the rationale for a deeming provision. Explaining the linkage between a deeming provision and its purpose, the Supreme Court in *State of Uttar Pradesh v. Hari Ram*[25] held,

> "In interpreting the provision creating a legal fiction, the Court is to ascertain for what purpose the fiction is created and after ascertaining this, the Court is to assume all those facts and consequences which are incidental or inevitable corollaries to the giving effect to the fiction."[26]

It is clear that it is within the competence of Parliament to legislate a deeming provision for a specific purpose. Further, such deeming provisions exist in the Constitution. Article 169 (3) provides that when Parliament by law abolishes the Legislative Council of a State, the constitutional amendments that are necessary to give effect to such a law would not be deemed to be amendments to the Constitution.[27] Though such amendments would *in fact* be amendments to the Constitution, as commonly understood, *in law,* they would not be considered so, since that would entail an onerous procedure for amendment that the drafters felt unnecessary in this case.

At the same time, explanations of particular terms in articles are a commonly used drafting device in the Constitution. Explanations occur 34 times in the Constitution (excluding Schedules). While several Explanations are clarificatory, some define terms in a manner that entails specific inclusions or

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[23] (1987) Supp SCC 350.

[24] *Ibid*, para 40.

[25] (2013) 4 SCC 280.

[26] *Ibid*, para 17.

[27] Article 169 reads:

"(1) Notwithstanding anything in article 168, Parliament may by law provide for the abolition of the Legislative Council of a State having such a Council or for the creation of such a Council in a State having no such Council, if the Legislative Assembly of the State passes a resolution to that effect by a majority of the total membership of the Assembly and by a majority of not less than two-thirds of the members of the Assembly present and voting.

(2) Any law referred to in clause (1) shall contain such provisions for the amendment of this Constitution as may be necessary to give effect to the provisions of the law and may also contain such supplemental, incidental and consequential provisions as Parliament may deem necessary.

(3) No such law as aforesaid shall be deemed to be an amendment of this Constitution for the purposes of article 368."

exclusions. For example, Article 220 which provides restriction on practicing after holding a position as permanent judge of a High Court has an Explanation to specifically exclude High Courts in erstwhile Part B States from the ambit of this provision. This meant that this restriction did not apply to those holding office as judges in the High Courts in those States, which included Mysore, PEPSU and Madhya Bharat High Courts. In other words, these High Courts, while considered as such for ordinary purposes, would be deemed not to be High Courts for this article.

Thus it is a constitutionally accepted practice to incorporate explanations to particular articles. In these explanations, Parliament is legislatively competent to enact a deeming provision that defines a term in a certain way, including or excluding specific interpretations. It is in this vein that "any part of a loan which has been made to the State by the Government of India or by its predecessor government" is sought to be explained by including within its remit loans from the Public Account of India.

In conclusion, the extension of the scope of Article 293 (3) to cover transfers from the public account of India to State Governments is consistent with economic and legal principles. This will extend the ability of the Central Government to regulate sub-national debt while eliminating the arbitrary exclusion of certain types of borrowings from the overall fiscally prudent borrowing limit. At the same time it is important to note that both proposed constitutional amendments, according to Article 368 of the Constitution of India require passage by the requisite majority in Parliament alone, without having to seek ratification from any State Legislatures. Thus the proposal is not only sound in principle but capable of being implemented in practice.

4.2. Ensuring Article 293 (3) continues to apply to States

Another approach to extend Central Government control over State borrowings is to ensure that States remain indebted to the Centre for as long as possible; this would effectively ensure that State Government will have to approach the Centre for consent to issue debt. The main components of Central Government loans to States are the following:

1. Loans for State plan schemes, Central plan schemes, and centrally sponsored schemes, miscellaneous loans by Central ministries, including the Ministry of Finance
2. Ways and means advances from the Central Government
3. Additional Central Assistance for Externally-Aided projects

The following sections discuss opportunities to extend Central Government loans to the State Governments under each of these categories. In general, the scope for extending Central loans is limited, however, and such a solution can only be a temporary one, at best.

4.2.1. Loans for State plan schemes, Central plan schemes, and others

Following the recommendations of the FC-XII, discussed in Section 3.2, the Central Government no longer intermediates in State borrowings, with the exception of on-lending of loans procured for externally aided projects. As per the recommendations of the FC-XII, existing Central Government loans to the States were consolidated into fresh 20-year loans, and, since 2007-08, central transfers to States have been almost entirely in the form of grants. Even those schemes that have been partially funded by loans are now being replaced by grant-only transfers. For example, police modernisation funds have included a small loan component but transfers going forward are likely to take place through grants only. Similarly, Central Government contributions to the National Disaster Response Fund ('NDRF') and the State Disaster Response Funds ('SDRFs') are presently made on a grant basis only.

Since no new loans are being issued from the Central Government to the States, one approach would be to restructure existing debt to extend the maturity for a number of years. Restructuring loans would require consolidating existing loans from the States to the Centre to longer-term loans. Following the debt consolidation recommended by the FC-XII, most loans owed to the Centre were reset for 20 years. Many are expected to terminate by 2020. These loans could be restructured to a longer time frame with corresponding interest rate relief on the earlier repayments. However, this creates several problems: an extended debt overhang, which creates pressure for State Governments struggling to reduce their debt as a proportion of GSDP. Restructuring these loans will also entail costs for the Central Government. Finally, it is possible that States will choose not to restructure loans further, particularly those States with healthy finances. A restructuring of debt must be acceptable to the debtor before it can be achieved.

Another temporary solution could be the extension of a specific loan facility to certain States. For example, the Centre makes loans to States to fund post-disaster reconstruction, as this is not covered by the NDRF and the SDRFs. Most of these transfers are on-lending of loans from external funding sources. However, were the Central Government to set aside funds for this purpose, these loans would ensure indebtedness of the States to the Centre, invoking Article 293 and ensuring control over State borrowings. However, this solution will be temporary and will only apply to those States that require access to post-disaster reconstruction funding.

Finally, it may be possible for the Finance Commission to recommend non-interest bearing loans, in addition to grants, that it makes as part of its standard allocations. By recommending loans, as opposed to grants, the Finance Commission will leave the current year Central fiscal deficit unchanged while at the same time generating a debt overhang that will postpone the problem of States no longer being indebted to the State.

In conclusion, following the recommendations of the FC-XII, the intermediation of the Centre in the public borrowing of the States has been largely eliminated. As a temporary measure, certain specific and narrow categories of loans, and even non-interest bearing loans could be reintroduced and extended to

the States in order to ensure that Article 293 continues to apply over the short term. However, we do not recommend reversing the recommendations of the FC-XII solely for the purpose of retaining Central control over State borrowings as a long-term solution to managing fiscal sustainability.

4.2.2. Ways and means advances

The ways and means advances ('WMA') are a facility offered by the Reserve Bank of India ('RBI') to the States to manage short-term liability mismatches. The terms of each State's agreement with the RBI is determined on the basis of bilaterally signed Memorandum of Understanding. Beyond the facility offered by the RBI, the Central Government also extends a WMA facility of up to Rs. 1000 crore in its annual budget (Demand 36). These advances are made automatically to States with a standing order from the Ministry of Finance to approve the loans under Article 293 (3). If some States approach a position of zero indebtedness to the Centre, transfers under the WMA facility must also be reconsidered. In particular, we recommend that the Centre consider denying States access to the WMA facility operated with Central funds if they do not conform to annual borrowing limits as determined at present. This acts both as a disincentive for States to breach their borrowing limits without prior permission from the Centre, as well as ensure that States which breach Article 293 (3) do not subsequently become indebted to the Centre through short-term advances.

Access to the WMA offered by the Central Government has previously been linked to fiscal prudence on the part of the States. In 1999-2000, eleven States signed Memorandums of Understanding ('MoUs') with the Central Government in which they committed to introducing fiscal reforms in exchange for WMA transfers on the tax and grant transfers due to them.[28] However, the use of this facility is quite limited compared to the RBI window. Since the RBI uses funds at its own disposal to make short-term loans to States under the WMA facility, these transfers do not fall within the scope of Article 293. However, the extension of any credit facility to any State should rely on the credit-worthiness of that State. In the past, the RBI has shut the WMA window for States which have breached the terms on which they borrow from the RBI (see, for example, RBI Annual Report 2001, which documents the suspension of WMA to three States) and this process of disciplining is an important part of maintaining sub-national debt sustainability.

In conclusion, we recommend that States that breach their annual borrowing limits be denied the use of WMA funds from the Central Government, which may act as a disincentive for them to over-borrow. However, the use of this facility is not substantial: most States primarily rely on the RBI for WMA funds. Linking State access to RBI WMA with debt sustainability will be an effective supplementary mechanism for enforcing fiscal prudence.

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[28] Srinivasan, T.N., 2002. "India's Fiscal Situation: Is A Crisis Ahead?" in A. Krueger, ed, *Economic Policy Reforms and the Indian Economy*. Chicago: University of Chicago Press.

4.2.3. Additional Central Assistance for Externally Aided Projects ('ACA for EAP')

An important component of Central loans to States is through on-lending of funds sourced from international institutions, multilateral agencies and other foreign financers. Most of these loans are to fund investment in infrastructure. Since States are denied direct access to foreign funding owing to 'foreign loans' being a matter within the sole legislative competence of the Central Government,[29] and consequently a matter to which executive power of the Union extends, the Central Government must take on the loan on behalf of the States and on-lend the funds to the States. Following the recommendations of the FC-XII, as of April 1, 2005, this money is loaned to the non-special category States on the same marginal terms at which the Centre receives the funding. As such, the Central Government is within its constitutional right to deny States that do not remain within their prescribed borrowing limits access to funding from external sources.

Andhra Pradesh, Bihar, Karnataka, Madhya Pradesh, and Tamil Nadu account for over 60% of all ACA for EAP. However, many other States also have outstanding liabilities to the Central Government in this category. Many of these loans tend to be of longer maturities, which ensures that Article 293 (3) will remain applicable to all attempts by such State Governments to raise funds from the market.

In conclusion, while we do not make any explicit recommendation in this regard, it is clear that Article 293 (3) will continue to apply for as long as States seek access to external funding, particularly to finance infrastructure projects. If State Governments wish to raise funds from international institutions, they will have to abide by the borrowing limits set for them at the Centre, and this will be an important incentive for them to comply with fiscal rules.

[29] Entry 37. List I, 7th Schedule to the Constitution.

Table 2 State-wise maturity profile of outstanding government assistance for States for Externally Aided Projects[30]

States	Per cent of Total Amount Oustanding				
	0-1 Year	1 to 5 Years	5 to 10 years	10-20 Years	Above 20 years
1. Andhra Pradesh	1.4	9.2	19.3	40.6	29.4
2. Bihar	0.5	5.4	18.0	52.5	23.6
3. Chhattisgarh	3.7	24.1	30.1	42.1	0.0
4. Gujarat	0.1	6.1	19.4	38.9	35.5
5. Goa	0.0	4.9	22.8	45.7	26.6
6. Haryana	0.0	14.0	20.0	40.0	26.0
7. Jharkhand	0.0	6.7	14.7	62.7	15.9
8. Karnataka	0.9	9.5	21.7	43.4	24.4
9. Kerala	1.0	6.4	23.3	47.5	21.8
10. Maharashtra	5.4	28.4	38.1	17.1	11.1
11. Madhya Pradesh	1.9	12.5	22.5	49.5	13.6
12. Odisha	0.8	10.2	21.7	38.4	28.9
13. Punjab	2.3	12.9	25.0	37.5	22.3
14. Rajasthan	0.4	3.1	11.6	47.6	37.3
15. Tamil Nadu	1.4	7.5	21.4	41.6	28.1
16. Uttar Pradesh	0.0	3.5	17.1	42.7	36.7
17. West Bengal	0.4	8.7	22.9	45.2	22.8
18. Multi-States	0.6	10.1	20.1	40.5	28.7
Total	**1.2**	**9.2**	**21.1**	**43.2**	**25.3**

4.3. Developing a Framework derived from Article 293

4.3.1. Managing debt through Fiscal Responsibility Legislation

The Central Government and all State Governments are bound by their Fiscal Responsibility and Budget Management legislations (hereinafter 'FRBM legislations'/ 'FRBM Acts'). Though specific legislations may have different titles, the rationale for all these laws is to ensure fiscal stability and prudence by reducing fiscal deficit, eliminating revenue deficit and establishing transparent processes regarding matters pertaining to public finance. Several such legislations were enacted in States pursuant to the recommendation of FC- XII, which mandated the enactment of fiscal responsibility legislation as a precondition for availing the debt relief scheme offered to States. FC-XIII too recommended certain amendments to be made to these legislations as preconditions for certain fiscal transfers.

[30] Source: *State Finances: A Study of Budgets of 2013-14*, RBI, Table V.8. Available at <http://rbi.org.in/scripts/AnnualPublications.aspx?head=State%20Finances%20:%20A%20Study%20of%20Budget> accessed on 25 September, 2014.

Each of these legislations in States contains the maximum acceptable fiscal deficit as a percentage of GSDP, which, in turn, yields the annual borrowing limit of each State Government.[31] Presently, the borrowing limits are set by the Finance Commission and enforced through the requirement of the consent for any borrowings by State Governments of the Central Government under Article 293(3).[32] The key question is to assess the methods of enforcement of Fiscal Responsibility Legislation in the event that Article 293 (3) consent is no longer required by State Governments in order to raise market borrowings, and if found deficient, suggest reforms in order to ensure that sub-national debt does not breach the limits established by law. To this end, this section is divided into two sub-sections: sub-section 1 explores whether FRBM legislations constitute legislations prescribing limits on borrowing for the purpose of Article 293 (1). If so, it looks into the consequences of this interpretation. Sub-section 2 consequently looks at strengthening enforcement mechanisms under these legislations. Thus holistically, this section looks to address regulation of sub-national debt without amending Article 293 of the Constitution.

4.3.2. The Legal Basis for FRBM Legislations

As discussed in Section 2 above, Article 293 (1) allows the executive of a State to borrow upon the security of the Consolidated Fund of the State, within India, subject to any law the legislature may make fixing limits on such borrowing. The FRBM legislations, as per FC-XII recommendations, all contain a provision that sets targets for fiscal deficit reduction. These targets may be revised from time to time by the State Government. Thus given that such laws lay down limits on borrowing and are passed by the State Government, they quite self-evidently qualify as law for the purpose of Article 293 (1).

This implies that the breach of such limits will not only be illegal, since it would be contrary to the relevant statutory provision, but it would also be unconstitutional. This is because of the fact that Article 293 (1) itself prescribes that the executive power of every State to borrow shall be restricted to the limit prescribed by the State Legislature by law. If such limits laid down in FRBM legislations are not followed, the failure of the States to do so would be unconstitutional.

A consequence of such interpretation is the possibility of legal challenge if a State flouts its borrowing limits. In *Matthew v. Union of India,*[33] a case before the enactment of fiscal responsibility legislations, it was contended by way of a public interest litigation that the borrowing of money by the Kerala Government at a time when the State was already facing heavy deficits was contrary to Article 14 as well as Article 293 of the Constitution. *Locus standi* was sought as a taxpayer; a violation of Article 14 was claimed because borrowing by the Government was considered to be profligate and thereby arbitrary; a

[31] At the Centre, the maximum acceptable fiscal deficit and consequently borrowing limit are to be prescribed by rules under the Act. This is not relevant for our purposes.

[32] For the most recent borrowing limits, see para 9.85 of the Report of the Thirteenth Finance Commission.

[33] *Mathew v. Union of India (UOI)*, ILR 2003 (1) Kerala 559.

violation of Article 293 was contended based on the view that the State was borrowing money in excess of what was to its credit in its Consolidated Fund. Though the petition was admitted, the petitioner being a taxpayer whose interest was affected by State borrowing, it was dismissed on merits. The dismissal was based on one factual and one legal ground. Factually, no arbitrariness in the State's actions was made out; legally it was held that Article 293 did not prescribe any borrowing limit on the State.

It must be noted that this case was adjudicated before the enactment of the Kerala Fiscal Responsibility Act, 2003. However, given that FRBM legislation now, not only in Kerala, but also in other States, unlike Article 293 itself, does prescribe borrowing limits, it might be possible to file a public interest litigation challenging the breaching of such limits as unconstitutional. How courts will rule on these matters is debatable given the contrarian pulls of the matter being a question of economic policy, which courts have seldom intervened in, with the overarching need for courts to uphold the rule of law. Irrespective of which way the Court goes, it is necessary to assess and if necessary reform the enforcement mechanisms of this Act. This provides the surest protection that courts will refuse to entertain such petitions since alternative remedies are prescribed by the Acts.[34]

4.3.3. Scheme of Enforcement

Under the scheme of the Acts, enforcement of its provisions is sought through a variety of methods. While there are 13 types of enforcement measures that can be culled out of the State FRBM legislations, they can be classified into 4 broad categories. A table with a detailed breakdown of the type of enforcement mechanism and whether a particular State FRBM legislation contains it or not may be found in the Appendix at the end of this note. A brief survey of such methods may be appropriate here before looking at mechanisms to strengthen them.

The four categories of enforcement measures are:

I. Measure(s) to be undertaken by the Minister of Finance;
II. Measures to be mandatorily undertaken by the State Government;
III. Measures which the State Government may undertake; and
IV. Prohibitions on the State Government.

I. MEASURE(S) TO BE UNDERTAKEN BY THE MINISTER OF FINANCE

1. Review Report by the Minister of Finance

Review of the trends in receipts and expenditures in relation to budget estimates is a measure that is followed by nearly all states. The frequency of the review may vary among quarterly, half-yearly or

[34] It is a standard principle governing admissibility of writ petitions that alternate remedies be exhausted before a writ court is approached. *See Thansingh Nathmal v. Superintendent of Taxes*, (1964) 6 SCR 654.

yearly. The outcome of this review is a 'Review Report' is to be placed before the House(s) of the concerned State Legislature.

2. **Statement of the Finance Minister explaining deviations**

State Governments cannot deviate from the obligations cast on them under their respective FRBM Acts. However, due to any unforeseen circumstances, if any deviations are made, the Finance Minister shall make a statement in the House(s) of the Legislature explaining

(i) the said deviation;
(ii) whether such deviation is substantial and relates to the actual or the potential budgetary outcomes; and
(iii) the remedial measures that the State Government proposes to take.

While there is no requirement for the Finance Minister to submit a Review Report in a few states (see Appendix), the Finance Minister's obligation to make a statement explaining deviations is a measure undertaken by most States in India.

II. MEASURES TO BE MANDATORILY UNDERTAKEN BY THE STATE GOVERNMENT

1. **Measures for increasing revenue and/or reducing expenditure**

In the event of either shortfall in revenue or excess of expenditure over the intra-year targets mentioned in the Fiscal Policy Strategy Statement mandated under the FRBM Acts or the rules made under the Acts, the State Government is mandated to take appropriate measures for increasing revenue and/or for reducing the expenditure. One of these measures, as mentioned in the FRBM Acts, is the curtailment of the sums authorised to be paid and applied from out of the Consolidated Fund of the State. The FRBM Acts of Odisha, Uttar Pradesh and Uttarakhand mention that the concerned State Governments may take interim measures for revenue augmentation, or curtail the sums authorised to be paid out of the Consolidated Fund of the State, or take up a combination of both these measures.

It is instructive to note that the States of Karnataka, Uttar Pradesh and Uttarakhand have inserted a proviso to this particular provision which says that while adhering to the fiscal targets, the State Government will give priority to protecting certain expenditure declared in the Medium Term Fiscal Plan as "high priority development expenditure" (including, *inter alia*, elementary education, basic health and rural water supply) from curtailment or may impose a reduced or partial curtailment. Also, the Meghalaya FRBM Act, 2005 only mentions "appropriate measures" measures to be taken by the State Government in case of shortfall or excess, but nothing about curtailment of sums from the Consolidated Fund of the State.

2. **Statement of remedial measures in case of possible measures which may lead to revenue deficit**

In case any measure is proposed by the State Government in the course of the financial year, which may lead to an increase in revenue deficit, either through increased expenditure or loss of revenue, it shall be accompanied by a statement of proposed remedial measures. These remedial measures should strive to neutralise such increase or loss and such statement shall be placed before the House(s) of Legislature.

3. **Consistency with the objectives of the Five Year Fiscal Plan**

Another measure which is imposed by several States is that principally, the Annual Budget and the policies announced at the time of presentation of the budget shall be consistent with the objectives and target set in the Five Year Fiscal Plan, the Medium-term Fiscal Policy Plan and the Fiscal Management Targets of the State Government.

4. **Proposals for Supplementary or Additional Demands and Statements for curtailment of expenditure**

Several States have measures relating to supplementary or additional statements of expenditure. The provision relating to this measure mandates that not more than one supplementary statement of expenditure shall be presented in a financial year. Whenever such supplementary estimates are presented in Assembly the State Government shall also present an accompanying statement indicating the corresponding curtailment of expenditure to fully offset the fiscal impact of the supplementary estimates in relation to the budget targets of the current year and the Medium Term Fiscal Plan objectives.

5. **Increase in revenue deficit and fiscal deficit in case of unforeseen demands**

In case the revenue deficit and fiscal deficit increase in the case of unforeseen demands on the finances of the Government, the Government shall identify the net fiscal cost arising due to natural calamity and such cost would provide ceiling for extent of non-compliance to the specified limits.

6. **Triggers and Corrective Actions**

The measure relating to triggers is also prevalent in only a few States. It says that triggers as well as corrective actions that shall be initiated upon activation of triggers shall also be the integral part of the budget.

7. **Guidelines to be issued by the State Government for timely spending of budget**

This is a measure followed by only one State, Odisha, under the Odisha FRBM Act, 2005. This enforcement measure mandates that State Government of Odisha shall issue appropriate guidelines from time to time, for timely spending of budgetary grants.

III. MEASURES WHICH THE STATE GOVERNMENT MAY UNDERTAKE

1. **Establishment of an independent agency**

This is a provision that finds mention in various State FRBM Acts. It says that the State Government may set up an agency independent of the State Government to review periodically the compliance of the provisions of this Act and table such reviews in the House(s) of the State Legislature.

Though 15 States have such a provision in their Acts, only the States of Odisha, Goa and Haryana have taken measures to implement this provision and got each of their independent reviews conducted through the assistance of the National Institute of Public Finance and Policy ('NIPFP').[35] The States of Karnataka, Himachal Pradesh and Madhya Pradesh appear to have considered implementing the above-mentioned provision, however there is no evidence to indicate that each of their independent reviews have in fact been conducted by any entity.[36]

IV. Prohibitions on the State Government

1. No guarantees to be given after a certain limit

This is a measure that is observed by a few States (See Appendix). It mandates that whenever outstanding risk weighted guarantees exceed the limits specified in the Act, no fresh guarantee shall be given. The Punjab FRBM Act, 2003 specifically says that no fresh guarantee shall be given except for the purpose of replacing high cost debt with low cost debt in such a way that there is no net increase in outstanding guarantees after such debt swap.

2. No liability to be given outside the budgetary provision, personal liability of the officers responsible

A more onerous measure for enforcing compliance is prevalent in Jharkhand and Odisha. It says that no liability shall be created outside the budget provision in a financial year without the approval of the Government in the Finance Department. Creation of any such unauthorised liability shall be treated as gross negligence and the officer(s) responsible for creation of such liability shall be personally liable for such additional liability created.

3. No unpaid liabilities beyond a certain period of time

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[35] According to a variety of sources, since the provision regarding the setting up of such independent agencies is relatively new, several States are yet to operationalise such agencies within the purview of their FRBM Acts. *See* Report on Centre-State Financial Relations and Planning, Vol. III, Commission on Centre State Relations (March, 2010) para 5.12.06.

[36] *See* Second Report of the Expenditure Reforms Commission, Government of Karnataka (February, 2011). Available at < http://www.finance.kar.nic.in/erc-web/secondrep-full-e-final.pdf> accessed on 30 September 2014; Document seeking Expression of Interest for Appointment of Long-Term Consultants for strengthening Public Financial Management in Madhya Pradesh (2012). Available at <http://www.dif.mp.gov.in/Tenders/EOI_PFM_final.pdf> accessed on 30 September, 2014; Rakesh Lohumi, "New GSDP series to raise loan cap", *The Tribune India* (April 18, 2011).

This is a measure that is present only under the Punjab FRBM Act, 2003. It says that no department of the State Government shall allow any liabilities,

(i) which have become due, to remain unpaid for a period of more than three months; or

(ii) to incur fresh liabilities, if previously incurred liabilities, have remained unpaid for a period of more than three months.

4.3.4. Analysis

There are two inferences which can be derived from the breadth of enforcement mechanisms under FRBM Acts. First, the Acts are directed primarily at preventing revenue and fiscal deficit targets from being breached. A range of measures— measures for increasing revenue and reducing expenditure, statement on remedial measures and a few prohibitions to prevent widening of revenue and fiscal deficits— are thus provided for. Second, in the event such targets are missed, the Acts do not prescribe significant punitive action to ensure enforcement but instead opts for a soft accountability measure— a Review Report by the Finance Minister to the State Legislature and a statement explaining deviations. A further provision— to make such review independent by setting up an agency for this task— has only been established by a few State Governments. In any event, accountability in case of deviations is sought to be enforced through a reporting obligation, rather than any more stringent consequences.

There is a reason why this is so. FRBM legislations are supplements to the constitutional framework regulating State debt. Article 293 (3) and (4), key elements in this framework, provide for Central Government consent with the power to impose conditions on any State loan when the State is indebted to the Centre or the loan is guaranteed by the Centre. Since all States are indebted to the Centre, this has functioned as a *de facto* mechanism to enforce borrowing limits, such that States do not breach their deficit reduction targets. Further, if they do, stringent conditions can be imposed by this clause, which lays down no limitations on the nature and scope of conditions which can be imposed. This allows FRBM Acts to simply prescribe softer preventive measures and avoid more stringent consequences for borrowing limits breaches altogether, a concern addressed by the operation of Article 293 (3) itself.

However with some States being in a position to repay Central debt making Article 293 (3) inapplicable in their case, there is a vacuum in the law for regulating sub-national debt. Further, independent reviewing agencies that were meant to be set up under FRBM Acts, have in a majority of States not been established, or when they have, lack any real enforcement powers. It is thus necessary to bolster the architecture of the FRBM Acts to replace the enforcement function performed by Article 293 (3) of the Constitution.

4.3.5. Recommendation

It is recommended that a Joint Fiscal Responsibility and Budget Management Council (hereinafter 'Council') be established by the Central Government. The purpose of such a Council will be to act as an expert, independent body to co-ordinate fiscal strategies between the Centre and States and oversee compliance with FRBM legislations. One of its key functions will be to advise both Central and State Governments on borrowings and if felt necessary approving borrowings by State Governments if and when Article 293 (3) does not apply.

The recommendation for such a body is not a new one. A Loans Council to oversee borrowings was considered by the Expert Committee on Financial Provisions set up by the Constituent Assembly.[37] Such a body has been recommended in academic literature on the Indian fiscal system.[38] It was also mentioned in the previous two Finance Commission Reports.[39] Finally, several foreign jurisdictions also have analogous bodies.[40] However, given the widely felt need for co-ordination between Centre and States on fiscal strategy coupled with the real possibility of unregulated sub-national debt militating against such need, the time for such a Council has now come. Three key facets of this Council— its composition, functions, the legal process necessary to bring it into existence and constitutionality thereof are discussed presently.

4.3.5.1. Composition and Functions

The principle underlying the composition of the Council should be a combination of effectiveness and participation. Consequently the Council must not be too large, as that would impede effectiveness; at the same time it must be participatory with representation from the Centre and States. It is thus proposed that the Council be a five-member body. The power of appointment of the Chairperson and Members of the Council should be vested in the reformed Inter-State Council, as suggested in the following Note

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[37] *Supra* note 5.

[38] For a review of the arguments for fiscal councils internationally, *see* Ter-Minassian, Teresa, and Jon Craig. 1997. "Control of subnational government borrowing." *Fiscal Federalism in theory and practice*: 156-72; and section 2.5.5 in Eichengreen, Barry, Robert Feldman, Jeffrey Liebman, Jurgen von Hagen, and Charles Wyplosz, 2011. *Public debts: nuts, bolts and worries*. Vol. 13. CEPR. For references to the Indian context, *see* Chelliah, RF, 1983. "The Economic and Equity Aspects of the Distribution of Financial Resources Between the Centre and the States in India", paper presented at the Seminar on Centre-State Relations at Bangalore, August 1983, published by Government of Karnataka (Bangalore, 1983); Anand, Mukesh, Amaresh Bagchi and Tapas K. Sen, 2001, "Fiscal Discipline at the State Level: Perverse Incentives and Paths to Reform", NIPFP Fiscal Conference paper; Singh, Nirvikar, and T.N. Srinivasan (2005), "Indian Federalism, Globalization and Economic Reform," in T.N. Srinivasan and Jessica Wallack, eds., *Federalism and Economic Reform: International Perspectives*, Cambridge, UK: Cambridge University Press; and Singh, Nirvikar, and T.N. Srinivasan, (2006), Federalism and Economic Development in India: An Assessment, Conference Paper, Stanford Center for International Development Conference on Challenges of Economic Policy Reform in Asia, May 31–June 3 2006, Revised, October.

[39] Twelfth Finance Commission Report (2004), para 15.7, 4.1.11; Thirteenth Finance Commission Report (2009), para 9.65, 9.66.

[40] *See* IMF Policy Paper, "Budget Institutions in G-20 Countries – Country Evaluations". 2014. Washington: International Monetary Fund for details on Loan Councils in federal G-20 countries. Available at <http://www.imf.org/external/np/pp/eng/2014/040714d.pdf> accessed on 25 September 2014.

(Note 3). It should be provided that no decision of the Inter-State Council to appoint the Chairperson or Member shall be taken without the concurrence of the Prime Minister. The Chairperson and Members should be persons with significant experience in public finance, economics, public administration or law and must satisfy other eligibility criteria as the Central Government may deem fit. They should have a five-year term and their independence in functioning must be statutorily secured.

The most important function of the Council will be to determine borrowing limits for Centre and the States in consultation with all parties. The second function will be to monitor and oversee the implementation of the decisions taken by it. In particular, the Council can increase the transparency of budgetary and fiscal policy by commenting publicly on the budgets passed by the Central and the State Governments, particularly on the models used to forecast growth, revenue and expenditure estimates. The Council would also comment on the outcomes achieved by the States, measured against targets. Another aspect of the role of the Council could be to rank States according to fiscal prudence, which will further sharpen incentives to ensure fiscal sustainability. Several countries have fiscal councils that provide this role, such as Belgium, Netherlands, Slovenia and Sweden.

It should be mandatory that borrowings by Central and State Governments should only be after seeking advice from the Council. Further, any amendment to the limits themselves should also be on its advice. Given the expert nature of the body, it is expected that a healthy convention would develop by which the advice of the Council would ordinarily be accepted. Necessary exceptions in cases of national emergencies may be provided. Such an advisory role will serve two functions: *first,* the Council will become the Central repository of information pertaining to borrowings by all Governments in India, a key component of determining India's fiscal strategy. *Second,* it will provide the foundation for the Council to play a more assertive role in approving State borrowings at a time when Article 293 (3) does not apply.

4.3.5.2. Legal Process

The Council must be set up by a parliamentary legislation. The legislative competence to do so is derived from Article 246(2) of the Constitution read with Entry 20 of List III which deals with 'Economic and Social Planning'. Since the purpose of the Council is to ensure overall fiscal co-ordination and strategy including oversight of union and State borrowings, its functions are squarely covered by this legislative entry. In any event, Entry 97 of List I is a residuary entry which gives the Central Government competence to legislate on matters which are not specifically provided for. Since there is no entry more specific to this matter than Entry 20 of List III, the matter could also be covered by Entry 97 of List I. Thus passing such a law would be entirely within the competence of Parliament.

Once the legislation is passed and the Council is established, States must be mandated to amend their respective FRBM Acts. The amendment should detail the actions which the State Government may only take on the basis of advice from the Council. A suitable incentive to enact these amendments should be

provided by the Finance Commission along the lines of FC-XII and FC-XIII Reports, which tied the enactment and amendment to FRBM legislation to financial packages and relief for State Governments.

Today when Article 293 (3) continues to have relevance to all States since all States are indebted to the Centre, an *advisory* role for such a body is most appropriate. This is because making it mandatory for States to seek permission from the Council would unduly delay the process of borrowing, being an additional step, apart from seeking Central Government consent under Article 293 (3). At a time when it becomes necessary, if and when the relevance of Article 293 (3) is diminished, a future Finance Commission may recommend, if it feels in its wisdom, that the Council be given a consent-granting function over State borrowings. This would be perfectly consonant with the overarching need for macroeconomic stability while at the same time respecting fiscal autonomy for States.

5. Conclusion

Unsustainable levels of sub-national debt pose a threat to macroeconomic stability. National concerns about macroeconomic risk are not internalised by individual States. If no control is imposed on individual States, then each State will have an incentive to "over-borrow", relative to the norms that would ensure that macroeconomic stability is maintained. To this end, the Centre ought to be able to exert some control over individual States with a view to maintaining systemic stability. Legitimate concerns that Central control of the fiscal capacity of States is a violation of the principles of political and economic federalism must be balanced against the systemic risk posed to the economy from the imprudent fiscal management of a handful of States. With this in mind, we make the following alternate recommendations to extend Central Government control over State borrowing.

1. Amend Article 293
   a. Amend Article 293(2) to vest the Government of India with the power to regulate States' borrowing from the market subject to Parliamentary law;
   b. Amending Article 293(3) to include loans from the public account of India as loans from the Centre to State Governments thereby ensuring its continued applicability.

2. Ensure that Article 293 (3) continues to apply
   a. Deny WMA to States that exceed their borrowing limits;
   b. Deny States access to external funding via the Centre if borrowing limits are exceeded.

3. Developing a framework derived from Article 293
   a. Establish an independent Joint Fiscal Responsibility and Budget Management Council to oversee the implementation of State FRBMs and ensure adherence to borrowing limits therein.

APPENDIX - Enforcement Measures and States which follow the said measures

S. No.	Measure to Enforce Compliance	Followed by
1.	Review Report by the Finance Minister	Andhra Pradesh, Arunachal Pradesh, Assam, Bihar, Chhattisgarh, Goa, Gujarat, Haryana, Himachal Pradesh, Jammu and Kashmir, Jharkhand, Karnataka, Madhya Pradesh, Maharashtra, Manipur, Meghalaya, Mizoram, Nagaland, Odisha, Punjab, Rajasthan, Sikkim, Tamil Nadu, Tripura, Uttar Pradesh, Uttarakhand
2.	Statement of the Finance Minister explaining deviations	All States
3.	Measures for increasing revenue and/or reducing expenditure	Andhra Pradesh, Bihar, Chhattisgarh, Haryana, Himachal Pradesh, Jammu and Kashmir, Jharkhand, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Manipur, Meghalaya, Nagaland, Odisha, Punjab, Tripura, Uttar Pradesh, Uttarakhand, West Bengal
4.	Statement of remedial measures in case of possible measures which may lead to revenue deficit	Andhra Pradesh, Bihar, Goa, Haryana, Jammu and Kashmir, Manipur, Meghalaya, Nagaland, Punjab, Sikkim, Tamil Nadu, Tripura
5.	Consistency with the objectives of the Five Year Fiscal Plan	Assam, Goa, Gujarat, Jharkhand, Karnataka, Mizoram, Odisha, Rajasthan, Sikkim, Tamil Nadu, Uttar Pradesh, Uttarakhand
6.	Establishment of an independent agency	Andhra Pradesh, Bihar, Goa, Haryana, Jammu and Kashmir, Madhya Pradesh, Manipur, Meghalaya, Nagaland, Odisha, Punjab, Sikkim, Tamil Nadu, Tripura, Uttar Pradesh

7.	Proposals for Supplementary or Additional Demands and Statements for curtailment of expenditure	Arunachal Pradesh, Assam, Goa, Jharkhand, Karnataka, Odisha, Sikkim, Uttar Pradesh, Uttarakhand
8.	Increase in revenue and fiscal deficit in case of unforeseen demands	Arunachal Pradesh, Goa, Jharkhand, Odisha, Sikkim
9.	No guarantees to be given after a certain limit	Goa, Punjab, Tamil Nadu
10.	Triggers and Corrective Actions	Gujarat, Kerala, West Bengal
11.	No liability to be given outside the budgetary provision, personal liability of the officers responsible	Jharkhand, Odisha
12.	No unpaid liabilities beyond a certain period of time	Punjab
13.	Guidelines to be issued by the State Government for timely spending of budget	Odisha