Chapter 1

Introduction

The debt problem at the State level has been a major problem in federal financial relations and is of direct concerns to the indebted states. Union loans to the states have loomed large in the total federal financial transfers such as grants and tax shares. Union Loans involve a reverse flow of financial transfers in the form of payment of interest and repayment of principal in India. Thus, the issue of containing public debt at sustainable level has been a major concern at the level of both centre and states. While the financial crisis of the union government has so far been averted, there is little sign that the burden of debt servicing faced by many states has become less burdensome, indeed for many debtor states the situation has been deteriorating. Public authorities are no doubt realizing the economic implications of the problems created by growth of state’s indebtedness. These problems have roused the interests of the economists as is evident from some studies made on public debt of states.

Overview of literature on public debt

The spate of problems of public debt in recent years have grown stimulus to new ideas and concepts in the analysis of Public debt both in theoretical and practical aspects. Most of the analysis in economic literature of the growth and role of public debt has been conducted in terms of situation obtaining in economically developed countries of west. Hence, we begin by exploring previous literature on Public Debt relating to developed countries.
The development of this literature can be portrayed chronologically by referring to some selected works, even though many authors have contributed to the literature. Lerner \(^1\) (1948) advanced the thesis that the burden of the debt rests upon people at the time the debt is created, as illustrated by the aphorism "we owe it to ourselves".

In sharp contrast, Buchanan \(^2\) (1958) argued that public debt allowed people in the present to shift the cost of government onto people in the future. Barro\(^3\) (1974) denied the ability of public debt to transfer cost forward in time because, with inter-generational altruism, an increase in debt would be accompanied by an increase in saving to pay the future taxes required to service the debt. And in another paper\(^4\), by the same author published in 1979, discussed the "Ricardian" equivalence theorem on public debt i.e. the proposition shifts between debt and tax finance for given amount of public expenditure would have no first-order effect on the real interest rate, volume of private investment, etc. Aiyagari and McGratten\(^5\) (1998) concluded that the welfare gains or losses of variations in debt are small. This is due in large part to their choice of the utilitarian welfare criterion in combination with the specific level of transfers assumed. A study by Martin Floden\(^6\) has shown that even if changes in government debt have little impact on utilitarian welfare measure, the insurance value of increasing debt can be large.

---


\(^5\) Martin Floden, "The effectiveness of government debt and transfers as insurance", Journal of Monetary Economics, Vol. 48, No. 1 August, 2001
The implications of the paper by Jaime De Pinies\(^6\) is that if additional finance were forthcoming, imports could be larger while still keeping debt-to-export ratios on a declining trend. So long as debt-to-export ratios are on a declining trend, the debtor country is solvent and will be able to repay its debt.

A study by Paul Krugman\(^7\) has presented a highly abstract analysis of the issues involved in dealing with the developing country debt problems. He has argued that the best way to think about debt problems is as one of the debt that overhang, the inherited debt of some countries is larger than that of the present value of the resource transfer than their creditors expect them to make in the future. The paper by Alessandro Prati\(^8\) studies an episode of hyper-inflation that took place in France in the mid 1920s and suggests that a long and balanced maturity structure would increase a government’s ability to resist a run on a government debt. Guillermo A. Calvo’s study\(^9\) highlighted that expectations may play a crucial role in the determination of equilibrium when the government debt is auctioned off to the public, and there is no attempt to manage expectations or to peg interest rates. Joao Victor Issler, Luiz Renato Lima\(^10\) presents tests on the sustainability of Brazilian public debt for the post war period 1947-1992. They show that debt is sustainable only if seigniorage is included as a government revenue.

---


\(^8\) Alessandro Prati, “Stopping a run on government debt”. Journal of Monetary Economics vol. 27. No. 2 April, 1991


Given the overview of literature on public Debt, a new survey on debt analysis is needed for updating the recent development on debt analysis. The works of Avramovic\textsuperscript{11} (1964), King\textsuperscript{12} (1968) and Solomon\textsuperscript{13} (1977) can be mentioned here. Assuming a target growth rate, in conjunction with a fixed capital output ratio and fixed marginal propensity to save, Solomon shows that debt/output ratio will be bounded if target rate of growth is greater than real interest rate. Kharas\textsuperscript{14} (1984) looks at a situation in which government borrowing from abroad for infrastructural facilities where the returns go to the private sectors. If the government is constrained in its ability to raise tax rate, the expansion of tax base is required for debt servicing.

In line with the above overview of literature on Public Debt and Debt analysis, it becomes more relevant to do a similar survey of literature of Public debt at state level. Although there is an extensive literature on Public debt Financing and debt analysis, there has been little research on the study at state level. Therefore, we need to have a fresh survey of literature relating to my study. We begin by exploring previous literature confining to India only. Seshan A\textsuperscript{15} (1987) was the first to draw a pointed attention to the possibility of domestic debt in India reaching an unacceptably high level in the none too distant future. Subsequently, the Report of the Controller and Auditor General (CAG) of India (1988) also warned against the alarming growth in domestic debt.

\textsuperscript{11} Avramovic D., et al. (1964) Economic Growth and External Debt Baltimore, MD: Johns Hopkins Press. 1984

\textsuperscript{12} King B., Note on the Mechanics of Growth and Debt Crisis", World bank Staff Occasional Papers no.6, 1968


\textsuperscript{14} Kharas H., Long Run Creditworthiness of Developing Countries: Theory and Practice, Quarterly Journal of Economics, 1984, p.415-39

\textsuperscript{15} Seshan, A., "The Burden of Domestic Public Debt in India", RBI, Occasional Papers (June) 8:1, 1987, p. 45-77
The initial studies, based on simple trend analysis, were criticized by Rangarajan, Basu and JadHAV\textsuperscript{16} on the grounds that they lacked analytical constructs behind the findings. This study called for a comprehensive and much deeper analysis on measurement of budget deficit and debt. In their pioneering work the authors examined the dynamic nexus between the two. Using data for the 1970s and 1980s, the authors simulated two alternative scenarios for financing the deficit: a debt financing scenario and a monetary-financing scenario.

Under the debt-financing scenario, they concluded that “the higher interest burden may invariably lead to a squeeze on budgetary capital outlays, thereby stifling economic growth”. Under the monetary-financing scenario they concluded that “resorting to monetary financing is likely to set in motion a vicious circle of large deficit, higher monetary financing, greater inflation leading again to a larger deficit”.

H. D. Pathak\textsuperscript{17} (2001) outlines econometric models for the Indian Economy to study dynamic inter-relationship between domestic public Debt management conducted by RBI and Fiscal operations of the Government. While assessing the debt sustainability for the state governments, Prasad, Goyal and Prakash\textsuperscript{18} (2003) discussed that the outstanding debt of the state governments would touch 34 percent in 2007-08 from the level of 26 percent in 2002-03.

Another work by Goyal, Jeevan and Ray\textsuperscript{18} (2004) which assesses the inter-temporal budget constraint using co-integration techniques observes that government finances are unsustainable both at the central and the state levels, though there is some signs of weak sustainability, if combined


finances are considered. Recognizing that unsustainable public debt is likely to have a major adverse impact on monetary policy objectives, financial stability and public debt management, the Reserve Bank of India (RBI) in successive Annual Reports since 1991 has been advocating fiscal prudence. The research conducted in the Department of Economic Analysis and Policy (DEAP), and published in the Report on Currency and Finance (RCF), particularly, for the years 1998-99, 2000-01 and 2001-02, has highlighted the issues relating to sustainability of public debt and deficit. The thrust of this analysis was to set out a methodology, to assess sustainability and to recommend policy for achieving fiscal prudence.

The RBI Annual Reports for 2000-01 and 2001-02 recommend durable fiscal consolidation through revenue maximization. Another recent work by Reserve Bank of India (RBI) has made a study of Debt Sustainability at state level in India (August 2005), which addressed the issue of debt sustainability in India at state-level, if at all, only at an aggregate level across all states, or at an even higher level of aggregation including the Centre. The study noted that, “Studies on debt sustainability in the Indian context have tended to be confined to the Central Government, or to state finances only at a consolidated level. State-wise analysis is conspicuous by its absence.”

G. Thimaiah's, Burden of Union Loans on the States (1977), is a study which tried to analyze the problems of Union loans to the states in the Indian federation within the framework of modern theory of fiscal federalism, and suggested certain short term and long term solutions to reduce the financial and economic burden of the union loans on the states. Central Loans to States under Five Year Plans (1991) by Tapan Kumar

---

19 Indira Rajaraman and others, A Study of Debt Sustainability at State level in India, RBI, 2005
Shandilya21 made a detailed exhaustive study and analysis of magnitude, direction and impact of central loans to states under five year plans specially after fourth five year plan. However, the study was made with special reference to Bihar state only.

**Need for the study of Public debt of the specific State**

It is quite relevant to quote here what T.Shandilya said, “loan financing has occupied a very important place as a method of resource mobilization to finance economic development in a modern state”.22 It is now used as a means to stimulate economic development and achieve the wider objective of economic planning.

The Eighth Finance commission took that “There is nothing basically wrong in the growth of public debt”.23 With the expanding public functions, no government particularly in a developing economy, can undertake large scale programs of development without recourse to borrowing. The Sarkaria Commission in its “Report on Centre-State Relations” has agreed with the observation of the Commission.24

The Eighth Finance commission took the stand, “The centre has to view States requirement in perspective of total needs”.25 The development of the country as a whole is a collective responsibility of the centre and state governments.

For the purpose of development, the central government territory includes all the states”. The Eighth Finance commission also views, “The growing volume of central assistance for the plan is an indication of the partnership between the union and states in the coming the hands of the governments

---

22 Tapan Kumar Shandilya, ibid, p.9
23 Report of Eighth Finance commission. 1984, p.100
25 Report of the Eighth Finance Commission, p.100
in order to pursue their economic growth-oriented policy and also to promote the social welfare of the society. This has led the states blaming the Union government’s policy providing plan assistance to the state’s plan mostly in loans and with unjustifiable terms and conditions to these loans. In a way, this problem has created a sense of dissatisfaction among the states. Even, the related problems of state’s unauthorized overdrafts from the Reserve Bank of India (RBI) were separately investigated and policy measures were suggested by the Fifth Finance commission which has minimized the seriousness of the problem indebtedness. But the consequential problem arising out of the growth of state governments’ indebtedness to the union government has not been given its due attention either the RBI or by the state governments or even by the economists. It is only the union government which drew the attention of the central government and therefore finance commissions have been asked for finding solutions. The problem was referred, for the first time to the second finance commission. But, in spite of the various suggestions of the second finance commission the fundamental problem of increasing states’ debt and debt servicing could not be solved. The burden of debt servicing charges continued to increase. Thereafter, a review of the state debt has been the term of reference from the sixth finance commission onwards. It is seen from the above discussion that, while the issue of debt sustainability is a concern across all the states, their heterogeneity in terms of size, level of income, and their financial position measured by various fiscal indicators and ability to raise resources on their own, calls for varied policy initiatives. The severity of debt problem faced by different states need state specific analytical and exhaustive study, as it will have implications on states debt sustainability as well as centre-state financial relations. The present study is an attempt to fill the gap in the study of public debt of the Manipur state specific, under the framework of federal financial problems of India.

20 ibid. p.101
Constitutional Framework of Inter-Governmental Borrowing in India

In the literature of public debt we find a fairly developed theoretical framework of public debt in general. The general theory of public debt has given considerable importance to the burden of public debt i.e. the burden of interest on loans and repayments of principal on the economy and people of present as well as future generations. Many of these generalizations have been empirically tested and certain broad guidelines for government public debt policy are recommended. However we do not have economic theory of intergovernmental public debt as yet. Though the theory of fiscal federalism has developed to a high level of sophistication, theory of intergovernmental debt remains neglected. Hence it is necessary to have a closer look into intergovernmental debt operations, based on the general theory of public debt on the one hand and theory of fiscal federalism on the other.

In order to reduce wide inter-state disparities in income, rising revenues etc. intergovernmental borrowing comes the best option available to achieve thee objectives. "Though intergovernmental debt operations can be used to promote these objectives, they are inadequate taken in isolation. However, in the context of the universal presence of vertical federal fiscal imbalance, intergovernmental debt operations become useful supporting tools when used along with other more effective federal fiscal transfers such as tax sharing and grants for achieving these multiple objectives. The first consideration which should be examined in any theory of intergovernmental debt operations is: when should the state governments borrow from the national government and for what purpose. This question invariably assumes that there is a constitutional provision for state borrowing as such. "In the Indian constitution, articles 292 and 293 pertain to borrowing by the government. Under the constitution, the

27 G. Thimia, opcit. p. 5
state government can borrow only within the territory of India. The constitution empowers the central government under article 293 to provide loans to the states. Article 293 states as:

Borrowing by states:

(1) Subject to the provisions of this article the executive powers of a state extend to borrowing within the territory of India upon the security of consolidated fund of state within such limits, if any, as made from time to time be fixed by legislature of such state by law and to the giving of guarantees within such limits, if any, as may be fixed.

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

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

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

Clearly, the Government of India has been providing short term loans in form of ways and means advances and some medium and long term loans from the Consolidated Fund of India to the state governments.

It is generally accepted that there is constitutional provisions to make loans to states. But it was thought that the capital needs of a state would be normally met by its own borrowing. But this assumption has now broken down because of the policy of planned development and so, also the centre-state financial relations are strained. It is sometimes complained that states have been financially assisted by means that
appears to be a doubtful use of Article 293. This Article 293 is a unique provision in our constitution which has no parallel in other federal constitutions. But from the article, it seems that only open borrowing is intended. As the article has been used to advance loans to the states on a large scale, the centre hardly keeps watch over the use of fund. The huge sums are used imprudently. No doubt, the borrowing powers of state have been unduly restricted by the constitution. The constitution does not permit states to borrow from outside India. The constitutional discrimination between the centre and states has been one of the irritants in Federal relations. Given a persistent surge in public debt, it can be nobody’s case that the Centre manages its debt better than states’ and the latter cannot be borrowing without restrictions. But the states’ indebtedness over the seventies and eighties has reached critical proportions leading to successive Finance commissions being entrusted with the task of easing states’ debt burden. Even if such constitutional does not exist, extra-constitutional arrangements can be justified for inter-governmental debt operations”. In this context there are two major theoretical views in the general theory of public debt which can be adopted for analyzing the inter-governmental debt operations. They are: (1) pay-as-you-go view, and (2) future generations view. The ‘pay-as-you-go’ view maintains that in normal circumstances capital as well as recurring expenditures should be financed from non-plan revenues. However these conditions can be relaxed in three types of situations, namely: (a) when there is an imminent need to incur abnormally high expenditures either once- and- for- all or to cover a limited period of time. (b) when the expenditure involved is likely to yield direct monetary returns to service the loan and to repay the principal. (self-liquidating Loans), and (c) when there is need for incurring huge expenditures to

28 G. Thimmaiah, ibid, p. 5
combat depression. Therefore, the proponents of this view maintain that
the government should not resort to borrowing for financing public
expenditures except in the above mentioned exceptional circumstances.
The ‘future generations’ view maintains that since the benefits from
capital expenditure which are proposed to be undertaken by the state
governments will be enjoyed mostly by the future generations. It is always
appropriate to finance such capital expenditures by borrowing from the
national government subject to reasonable terms and conditions of loans.
This implies that the capital expenditure programmes will benefit only the
future generations because of their long gestation period, and therefore,
the beneficiaries, (future generations), should be made to pay for servicing
and repayment of such loans. In recent years a third view has emerged
under the theory of cost-benefit analysis. This is basically a variant of
‘pay-as-you-go’ view but has received considerable attention in view of
the fashionable treatment the theory of cost-benefit analysis has received
in the hand of mathematical economist. There are two variants of the third
view: (a) simple cost benefit view, and (b) social cost-benefit view. The
simple cost benefit view maintains that when the public works go to
benefit only some specific sections of the people, it is only appropriate to
finance such public works by borrowing and to acquire the concerned
beneficiaries to pay for servicing and repaying debt through special tax
measures. The social cost benefit version of the third viewpoint maintains
that the orthodox notions concerning self-liquidating expenditures are too
confining and are to restrict the intervention of the government in the
national economic activity. What is necessary is that capital expenditures
which will earn a social return should be financed by borrowing whether
they earn a economic or financial return or not. Further it is maintained
that it is difficult to evaluate expenditures programmes to be financed by
loan in terms of social return, in the long-run it is possible to evaluate the
social–cost benefit analysis of certain type of expenditures such as on
education, roads and health facilities etc which are of the nature of social and economic infrastructure facilities.

All the above mentioned views cannot be exclusively taken as guideline for inter-governmental borrowings. Because, the relation between the Union government and the state governments in a federation is not commercial or mainly guided by profit/loss or simple cost benefit considerations. They are partners of a common endeavor to promote social welfare. This however should not be used as an excuse for wasting financial resources obtained through borrowing. Keeping all these considerations in view, we can say that the state governments can borrow from national government for the three exceptional purposes justified by 'pay-as-you-go' view and those justified under the cost-benefit analysis.

The states receive central assistance in three forms: shares in taxes and duties, grants and loans; and there are three institutional processes through which states are receiving funds from the centre, namely (1) on the basis of recommendations of the Finance commission, (2) on the basis of suggestions of Planning Commission, and (3) at the discretion of the Union ministers. It is the plan as well as discretionary transfer by which central loans are given to state governments.

The plan assistance comprises of both conditional grants and non-conditional grants. It is significant to note that grants-loan proportion of the plan assistance was not uniform before 1969 and also the loan component varied from program to program and from state to state. 30

Even internally the borrowing is subject to limitations as may be imposed by the state legislature under Article 293(1) and if the Union Government has guaranteed an outstanding loan of the state without the consent of the union Government as per Article 293(3). It is argued that restrictions do not obtain in a federation like U.S.A.

30 Tapan Kumar Shandilya, opcit, p. 15
It is felt that in a planned economy like India there is need for some restrictions. It should apply only to long-term and medium term borrowing from open market and not to borrowing from financial institutions or to short terms loans for less than one year. In this context, it is quite relevant to quote what the Sarkaria Commission feels "a solution lies in making a distinction between short-term loans under one year and medium and long term loans"\(^3\).

According to the commission, "The union should give it freely to states for borrowing from banks and financial institutions for periods less than one year under clause (4) of Article 293. Since most of these are now nationalized, no irremediable risk could be involved.

What emerges from the ongoing discussion is that, the Indian Constitution sets the basic rules of the country’s sub-national borrowing regime. Section 293 forbids state Government from borrowing abroad and requires them, as long as they are in debt to the union government, to obtain central approval for domestic borrowing. The following sources of domestic borrowing are open to the states: Government of India (central plan) loans. These are loans linked with grants in a fixed proportion, as "block plan assistance" to finance the state plan. Block plan loans and grants under the supervision of the planning Commission consists of two parts: (a) an unconditional part, called "normal central assistance", whose aggregate size is at the discretion of the central ministry of finance; and (b) a conditional part, called additional central assistance, consisting largely of the onward transmission of donor resources through the centre to the states under various externally aided projects.

After earmarking 30 percent of the normal central assistance for the special category states according to planning Commission formula. (The revised Gadjil formula (1991) gives 60 percent weight to population. 25

\(^3\) The Sarkaria Commission, “Report on Centre-State Relations”, Government of India, New Delhi, p.309
percent an inverse measure of per capita income. 2.5 percent to tax effort. 2.5 percent to Fiscal management. 2.5 percent to national objective and 7.5 percent to special problems. The block plan assistance to each state, including both normal and additional components, takes place as a standard mix of loan and grant-70/30 for the special category states.

The Constitution of India, article 293, allows state governments to raise loans upon the security of their respective consolidated funds subject to some conditions. Though overseas borrowing by state governments is banned there are no aggregate limits on domestic borrowing. In case the central governments has advanced a loan to a state which is outstanding then that particular state is barred from taking any fresh loans without the consent of the central government. In addition, the central government is empowered by article 360 to declare a financial emergency if financial stability of a state is seen to be threatened. There is no constitutional definition of what constitutes financial stability and this term is open to a variety of interpretations.32

By declaring a financial emergency the central government is empowered to take over and completely control the taxation and budgetary revenue processes of a state government. To date this provision of the constitution has never been used and there is a large amount of ambiguity about the course of action if a state government actually defaults on its loans. The fact that many state governments have debt levels that may be unsustainable implies that the central government has not exercised effective control over state government borrowing. Thus it is clearly seen that, while it is the states that determine the demand for debt, it is the centre that controls the supply. As actual borrowing has been historically driven by the supply constraint (i.e. states typically borrow whatever is available), how the central government plays its role as the controller or

32 Rajendra R. Vaidya, Borrowing, Debt Management and Contingent Liabilities: A Study of Indian State Governments, This report was prepared by consultants for the Asian Development Bank (2005), p.7
regulator of state debt has a important bearing on fiscal sustainability at the state level\textsuperscript{33}. States have six sources of deficit Financing. These are subject to differing degrees of central control.

The Indian Constitution sets the basic rules of the country’s sub-national borrowing regime. Section 293 forbids state Government from borrowing abroad and requires them, as long as they are in debt to the union government, to obtain central approval for domestic borrowing. The following sources of domestic borrowing are open to the states:

(i) Government of India (Central Plan) Loans

These are loans linked with grants in a fixed proportion, as ‘block plan assistance’ to finance the state plan. Block plan loans and grants under the supervision of the planning Commission consists of two parts:(a) an unconditional part, called ‘normal central assistance’, whose aggregate size is at the discretion of the central ministry of finance; and (b) a conditional part, called additional central assistance, consisting largely of the onward transmission of donor resources through the centre o the states under various externally aided projects. After earmarking 30 percent of the normal central assistance for the special category states according to planning Commission formula. (The revised Gadgil formula(1991)gives 60 percent weight to population, 25 percent an inverse measure of per capita income,2.5 percent to tax effort,2.5 percent to Fiscal management 2.5 percent to national objective and 7.5 percent to special problems.). The block Plan assistance to each state, including both normal and additional components, takes place as a standard mix of loan and grant-70/30 for the special category states.

(ii) State Bonds

State bonds are issued to banks and financial institutions through a process managed by the RBI. Bonds from different states are sold at the same time and at the same price. RBI also manages debt servicing for

\textsuperscript{33} A. World bank Report. State Fiscal Reforms in India, Progress and Prospects, Macmillan, First Publication. (2005), p,66
their bonds, and allocates for the purpose funds transferred from the central government, all of which pass through central bank. Thus the Bonds are supported by an implicit escrow arrangement, though not by central guarantee. The amount of borrowing per state is determined by Government of India (GoI) at the start of the year, largely based on precedent, though adhoc adjustment are frequently made in courses of the year to allow for 'additional market borrowing', with room for lobbying.

(iii) Negotiated Loans
These are from public insurance companies and other GOI-Owned financial institutions. The target of such borrowing is set at the time for annual plan finalization.

(iv) Small Savings
Net public Deposits from the central Post office savings schemes with administered interest rates that have been maintained above market rates, along with income tax incentives extended by the centre, are available to be states in which they accrue partially for general deficit financing purposes and partially to swap with old and more expensive small saving debt under a scheme introduced by GOI loans, but are now accounted for separately.

(v) Provident Funds
Flows into provident and insurance funds are involuntary savings of state government employees at administered interest rates- the net inflow being the difference between deposits of the premium by each account holder, on the one hand and the sum of net loans extended and final payment of maturity (at the time of retirement), on the other.

(vi) Other Public Accounts
In addition to the five sources listed above, states also finance a portion of their accounted fiscal deficits through the public accounts. Besides the provident fund accounts considered in item (v) Public account flows are
best understood as accounting transfers, whereby expenditure are booked under a deposit account but actually incurred.

The increase in the balance of public account is then defined as having financed the booked expenditure shows that in fact they may not be incurred in subsequent years as well. The outstanding balance in other public accounts is excluded from debt stock calculations, reflecting that they are largely non-debt creating.\textsuperscript{34}

State governments in India raise debt from various other sources also: Ways and Means Advances (WMA): These are short-term (typically for three months) loans provided by the Reserve Bank of India (RBI) to enable states to bridge gaps that could arise for short periods between expenditures and receipts. RBI makes these loans while fulfilling its role as banker to the state governments. The aim is to prevent short-term expenditure and revenue mismatches from causing a disruption in the activities of state governments. Generally speaking these are not considered to be a part of the debt of states as these advances have a life of less than a year. It has been pointed out that many states continuously maintain an overdraft position so such over drafts should in certain cases be considered a part of state debt. From time to time the RBI has been revising the rules and procedures to be followed with respect to these advances. In what follows we continue with the convention of not considering these advances to be a part of states’ debt.

**Loans from the Central Government**

This accounts for the largest proportion of the total loans of states (and their total liabilities). Large part of these loans arise in the process of inter Governmental fiscal transfers through the planning commission. These are loans that are combined with grants that are given to state governments to finance state plans. These loans are largely formula based and thus may have very little to do with a states borrowing capability.

\textsuperscript{34} A. World bank Report. ibid. p.61
In 1969 it was decided by the National Development Council that each state would receive 30 percent of total central assistance provided on account of the state plans every year, as a grant and the rest 70 percent as a loan. For the special category states (these are all states other than the 14 major states) since the Fifth Plan the pattern of assistance was 90 percent grant and 10 percent loan. Such a system has lead to an accumulation of debt as a consequence of the planning process. Apart from this there are ad hoc loans provided to states under special circumstances. A large part of these loans arise through the process of transfers of resources to state governments from the center and not from a commercial relationship. The principal difficulty arises because plan size (which determines the size of loans from center) has never been linked to sustainable levels of state debt. No state government can or does refuse to take these loans because it does not see itself in a position to repay the loans nor does the central government refuse to give loans to state governments whose financial position is weak.

Gupta35 has aptly summarized the situation as follows and we quote: “Legally the states are under no obligation to ask for or accept loans from the Union Government. But factually the states are not in a position to exercise their legal freedom to decline Union loans. They can, dare not, forego to undertake the development projects in the states, and are, therefore, willingly compelled to accept the Union loans with or without strings attached to them. And once they accept the loan the process becomes unending. This makes states dependent on the union and, in a sense; it amounts to infraction of state autonomy But such has become the logic of Union-State fiscal relationship that the Union can neither refuse to give loan nor can it bring a distress warrant against the States.” These loans have at least to be partly serviced (interest and principal) from the funds received by states in terms of grants in aid or tax shares from the

centre (i.e. transfers arising from Finance Commission recommendations). The centre is thus taking back as interest and debt service, funds that are being transferred to the states. Both the creation of the debt is partly formula based and transfer of resources to states is also partly formula based. If these formulae are creating debt for states with no consideration of their repayment ability then the emergence of a fiscal crisis for some states on this count may be unavoidable. This would be especially true in a situation where the dispersion of states' ability to repay loans is increasing due to an increase in the dispersion of growth rates of state domestic products.

There are also other borrowing mechanisms that exist outside the formal framework. First, to circumvent central controls on market borrowing, some states raise fund through special purpose vehicles: the debt off the budget, but debt servicing is through the budget. Such practice became very popular during the course of the 1990s, especially on the part of the better off states. Various order have been issued by GOI and RBI, which would, if implemented, bring off-budget borrowing to an end. Second, states run up arrears. The most striking case of this was in the power sector, where budget constraints were truly soft as states could buy power from central utilities, sell it at loss, and not have to pay for it. Recent changes in the mechanism for paying central power utilities have, to a large extent, closed off this loophole. Without analyzing the weakness of the borrowing framework, the study will not be complete and it will be useful for analyzing the problems and prospects of Public debt management in subsequent chapters.

Too much state-level borrowing, especially for the poorer states: This is the most fundamental problem, and is partly a result of the other problem listed below. India's states were already heavily leveraged before the crisis of the late 1990s; since then, then the state-level debt burden has

\[ A. \text{ World bank Report, opcit.,p.62} \]
skyrocketed and states now have the highest debt/revenue ratio of any sub-national entities world wide. The poorer states are particularly indeed, with higher deficit and debt ratios than other states. In the last two year, GoI has wisely controlled the use of small savings for deficit financing by earmarking a significant and increasing portion to retire old high-cost debt to the centre. However, this can only be a temporary solution.

**Complex system with elements of discretion and arbitrariness**

The borrowing regime is complex with multiple borrowing channels, each with its own rules. There are elements of description and arbitrariness, especially relating to open market borrowings, the allocation of which between states follows no pattern except history.

**A New Borrowing Regime for States**

In order to avoid the above mentioned problems and, following the Twelfth Finance Commission’s (TFC) recommendations that the centre should not act as an intermediary for future lending and allow the state Governments to approach the market directly, a new borrowing regime for the States was put in place. Accordingly, in the Union Budget 2005-06, there was no provision made for Central loans for State Plan Schemes. The Union Budget indicated an amount of Rs.29,003 crore which was to be raised by the States and Union Territories with Legislature directly from the market. Furthermore, as per the TFC’s recommendations (also accepted by the Government of India), external assistance would be transferred to the States on the same terms and conditions as attached to such conditions by external funding agencies (making Centre a financial intermediary - without any gain or loss). The States would get the same maturity, moratorium and amortization schedule as the Centre gets from the external lender.

The most important reform of the borrowing regime would be to introduce an aggregate borrowing cap and allow for greater flexibility over the
choice of borrowing instruments within the cap. There is thus a strong case, in the short to medium term, for the Government of India to impose an aggregate cap on each state, i.e. place an upper bound on the state’s annual net borrowing. Within the cap, however, states could be provided with maximum facility for arranging their own borrowing, and be exposed as much as possible to market discipline. Adoption of such an approach would have a disciplining impact on both states and the centre. It would close avenues for bargaining by the states for additional loans, and for the centre to use its discretion to approve additional loans. GoI has in fact already begun to move in this direction. Various steps could be taken to move this reform further forward. The Ministry of Finance has started to use the borrowing levels specified in the medium-term Fiscal restructuring Plans of the various states as caps on aggregate borrowing.

It has also started to allow greater flexibility with regard to some sources provided it stays within the overall cap. The 2004/05 Union Budget gave states the option to borrow from the market instead of from the central government. Nevertheless, there is clearly a long way to go. There is no formula for defining the caps, and no mechanisms for ensuing enforcement. Following are the some of the steps that could be taken to move further in the reform journey on which GoI has already embarked. The first step would be to shift to a formula based approach for defining the aggregate gap for each state. The cap should be based on observables, and not subject to negotiation. It could be defined in terms of debt servicing or debt stock or annual net borrowing as a percentage of GSDP or total revenue receipts in an earlier year. Given the states are now adopting fiscal responsibility acts, the central government could simply adopt and enforce the borrowing targets already legislated by the states. The targets however derived, would need to be below current levels of borrowing for most states, which would force one to define a time period within which borrowing would need to be brought under the cap, and a transitional path.
Once the cap has been decided on, enforcement mechanism are needed, ex ante and ex post. Ex ante, all resources allocation discussions between the centre and the state would have to be consistent with borrowing being at or below cap.

What emerges from the foregoing discussion is that, Federations around the world show a great deal of variety in their sub-national borrowings regimes. The borrowing by the states of India has grown to unsustainable levels even though it is formally under the control of the centre shows that the actual effective control over sub-national borrowing is far below what the constitution of India allows for. Of the borrowing sources outlined above, only two-loans from Gol (Government of India), itself and market borrowing are clearly under the effective annual control of Gol interest rates independent of credit worthiness. By and large, states all pay the same interest rates for their debt, and have the access to capital market. States typically approach the market together, and it is said that the RBI pushes creditors to buy a mix of state bonds, in particular leaning on them to purchase bonds from states perceived as being less creditworthy: thus the better managed states cross-subsidies the worst managed ones. Such practices enormously weaken the incentives for prudent fiscal behaviour. In 1999, the RBI did allow states to sell bonds on their own specific auctions, up to 35 percent of their total market borrowing allocation; more recently some states have even raised up to 50 percent of their allocation in this way. But this remains only an option, not a requirement, and in fact reliance on state-specific auctions is declining, not increasing. It is also clear that the sub-national borrowing regime needs to be rationalized and simplified. At one extreme, one cold advocate forcing all states to go the market for borrowing, and relying on the markets to discipline the states and punish imprudent policies with worse credit ratings and higher interest rates. However, given the past experience, financially weak state like, Manipur reveals that the weaknesses in their finances invited adverse reaction from the financial
markets as manifested in the widening spread on State Government securities and under-subscription to market loans. The under-subscription to the State market loans also brings to the fore various factors that impact State Governments liquidity. Here it is quite relevant to note some of the factors given by World Bank Report\textsuperscript{17} factors include: (i) the fiscal health of the State Governments, (ii) the credibility of their prospective policy actions and, (iii) transparency of their budgets. Considering these adverse impacts and the lack of role for a credit markets in the current federal fiscal system, it would be inappropriate and risky to rely solely on this approach such a system. Thus, the consensus in the literatures is for ‘market-based’ discipline supplemented by rules-based controls.

\textsuperscript{17} A. World bank Report, ibid, p. 64