Chapter 6

Finance Commission and State’s Debt

It has been observed in the previous chapters that, in federal fiscal systems, on ground both of equity and efficiency, resources are generally assigned more to the central government, whereas states together with the local government have larger responsibilities. The resultant vertical imbalances require transfer of resources from the centre to the states. States also have different capacities and needs, and this lends to a horizontal dimension to the issue of resource sharing. ¹ Neither vertical nor horizontal imbalance is expected to be static. Some of the core provisions regarding sharing of resources are built into the constitution itself. But changes in the economic and fiscal situation warrant a review of the arrangement from time to time. The constitution has provided for both continuity and change. The finance commission is entrusted with the periodically examining the issues according to the constitutional provisions and the term of reference. In this chapter, an attempt will be made to review of the approach adopted by the Finance Commissions to analyze and minimize the problem of growing indebtedness of the states to the Union government, and in-depth study will be made on the recommendations of three immediately preceding commissions. Central loans to the states have been increasing with varying interest rates and maturing periods. It has introduced complications into the centre-state financial relations.

This dangerous trend drew the attention of the central government and

¹ N. J. Kurian, Debt Relief for States, Economic & Political Weekly, July 30, 2005
therefore finance commissions have been asked for finding solutions\(^2\). 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 form the sixth finance commission onwards. Till the Eighth finance commission, the term of reference of the finance commission required them to make an estimation of the non plan capital gap of the states and to undertake a review of the debt position with particular reference to the central loans to the states these commissions were asked to suggest debt relief measures having regard to the overall non-plan capital gap and the purpose for which loans had been utilized and the requirement of the centre. From the ninth finance commission onwards, finance commissions were mandated to review the debt position as a whole and suggest corrective measures in particular references to financial and managerial efficiency. 1The ninth Finance Commission noted with the state of indebtedness of the states which appear to be sliding into vicious cycle. Loans are advanced to specific period and rate of interest. Finance commissions subsequently recommend corrective measures, often across the board, consisting of write offs, extension of maturity periods, and lowering of interest rates, thus converting loans effectively into grants, partially or fully. Periodically repeated debt relief exercises may induce states to overstate their demand for borrowed funds. Corrective measures should therefore, be formulated in a manner as would provide an in-built incentive for prudent use of borrowed funds\(^3\). While the tenth finance commission had the mandate to suggest corrective measures keeping in view the financial requirement of the centre, the

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\(^2\) Tapun Kumun Shandilya, Central Loans to States under Five Year Plans, Deep & Deep Publications,1991, p.21

\(^3\) Report of Tenth Finance commission, Dec.,1994, p.54
Eleventh Finance Commission was required to make an assessment of the debt position of the states as on March 31, 1999 and suggest corrective measures as were deemed necessary, keeping in view the long term sustainability for both the centre and the states. It was for the first time that the phrase ‘long term sustainability of debt’ was included in the terms of reference to a Finance Commission. The EFC looked at the relative position of the states in terms of interest payments to revenue receipt which include the states’ share of central taxes and grants. The EFC felt that the scheme of general debt relief link to fiscal performance formulated by the TFC needed to be strengthened for the EFC was discontinuing the other scheme of the debt relief recommended by the TFC consider the long term sustainability of debt for both centre and states. The twelfth Finance Commission (TFC) has to contend with difficult fiscal environment in formulating its recommendations. It has to deal with challenges arising from the economic and political environment.  

The seventh Finance Commission (1978) had recommended that small savings loans outstanding against each state at the end of 1978-79 could be consolidated into one loan and treated as a loan in perpetuity. This recommendations however was not accepted by the government of India although it did not concede that the states would not be required to make any repayment during 1978-79. Apart from waiving repayment for 1984-85, the eighth Finance Commission did not recommend any further relief or change in the arrangement with respect to the small saving loans. The ninth Finance Commissions did not recommend any change in the terms and conditions relating to these loans. After examining the matter afresh, the tenth Finance Commission found that the net amounts available under small savings scheme had been falling in the recent years. From a peak of

4 S. Gurumuthi, Twelfth Finance Commission and States’ debt burden, Economic and Political Weekly, October 5, 2002
50 percent. net collections as a percentage of gross collections had fallen to about 25 percent. The amounts retained by the centre net of interest payment and administrative changes indicated that this source contributed only marginally to its funds. The Tenth Finance Commission noted that small savings schemes had to be run jointly by the centre and the states in order that he benefits of economies of scale reaped. that all states were able to participate and that investors feel protected. It followed that the liability of repayment ought to be shared. Further, if the small savings loans were to be treated as loans in perpetuity, it would mean a rising interest on states in perpetuity. For all these reasons the commission did not favor these loans being treated as loans in perpetuity.  

The tenth finance commission rightly noted that the disturbing features of the debt profile of states and its management appear to be the following:

1. Diversion of borrowed funds for meeting revenue expenditure;
2. Use of loans in unproductive enterprises, or enterprises which are potentially productive but are beset by poor performance, and currently yielding low or even negative returns;
3. Non-provision for depreciation or amortization funds in respect of government owned assets, leading to repayment of fresh borrowing.

It should be noted that a bulk of the transfers made by the finance commissions or over 90 percent are unconditional. And there is nothing to state that finance commissions should not give additional or specific purpose transfers. The constitution position is that, “all plan expenditures, special purpose grants and grants etc would come within the scope of Article 275(1) itself”. As regards the FRAs, the states are required to take advantage of the benefit of debt restructuring. Similarly, the debt write-off is conditional on reducing revenue deficits. If a state thinks that these are stringent conditions, it can forego these benefits which in any case are not very large.  

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6 N. J, Kurian, Debt Relief for States. Economic and Political weekly. July 30, 2005
Surely states have the right to determine their expenditures levels by revenue from own sources. They can also determine the level of capital expenditures by creating surplus in the revenue account. But when the states want spend on wages and salaries not by raising revenues from own sources but by borrowing, the national taxpayer is asked to pay for this service. Similarly, macroeconomic considerations require control over the borrowing of the states.

The constitutions makers are aware of this fact and therefore, stipulated in article 293, when a state is indebted to the central government, it has to obtain the latter’s permission to undertake additional borrowing. But in practice there are several ways in which states could have recourse to additional borrowed resources. These include small savings, ways and means advances from the reserve bank of India, public sector enterprises. Successive Finance commissions have been recommending debt relief to the states by way of rescheduling and some write off in response to the complaints from the states that their repayment obligations to the centre are absorbing a very large part of fresh loans. Prior to the ninth finance commission, the states are allowed the full benefit of loans for externally funded projects like assistance from bilateral aid agencies or international agencies like World Bank, the states’ share being restricted to only 70 percent of the aid amount. The states were made eligible for receiving 100 percent of such assistance thanks to the recommendations of ninth Finance commission.

Besides, loans from the centre and market borrowings, the other sources of growth in liabilities in recent years have been loans from financial institutions and the public account liabilities. According to an analysis by the RBI, the overall impact of the rising debt level has reduced the flexibility of states to release funds for basic infrastructure and the social sector.

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7. N. J. Kurian, ibid

8. S. Gurumuthi [2002], opcit
Some attention was paid to this issue by the central government while drafting the terms of reference to the Tenth and Eleventh Finance commissions in 1992 and 1998 respectively. Both the commissions formulated certain schemes for debt relief to the indebted states which however, were not sufficient to deal with magnitude of the problem. It is necessary that the issue be addressed more seriously while drafting the terms of reference of Thirteenth Finance Commission.

**Debt Relief for state governments through Finance commissions**

In successive finance commissions, the issue of giving debt relief to the states has been considered, and has been extended by the following ways:\(^9\): (i) consolidation of loans on common terms and with reduction in the interest rates for the future, (ii) revision in the terms of repayment of loans given to states without a lowering of interest rates, (iii) moratorium on interest payments and repayment of principal due in certain years, (iv) write-off of loans or repayments falling due during a specified period, (v) introduction of schemes of debt relief linked to fiscal performance etc. While the Second, Seventh and Eighth Finance Commissions consolidated some of the earlier loans and rescheduled them at lower rates of interest, the Sixth Finance Commission revised the terms of repayment of outstanding loans. The Seventh Finance Commission also recommended that small savings loans outstanding at the end of 1978-79 be converted into loans in perpetuity. This recommendation was, however, not accepted by the central government. Write-off of specific loans also constituted a part of the recommendations of these commissions.

The ninth Finance commission stipulated that repayment on account thereof, already made by the state government by way of principal and interest shall be adjusted against other payments due from the state government. Further, the state plan loans advanced during the five-year period of 1984-89 and outstanding as on 31st March, 1990 were

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\(^9\) Asha Prasad, Rajan Goyal et al., State’s Debt and Debt Relief, Economic & Political Weekly, June 26, 2004
recommended for consolidation and rescheduling for 15 years in the case of all states. During the first five years i.e. 1990-95, repayments were to be less than those due on the then existing basis to the extent of 10 per cent in the case of Andhra Pradesh, Karnataka, Madhya Pradesh, Maharashtra, Orissa, Tamil Nadu, Goa and special category states. 7.5 per cent in the case of Gujarat, Rajasthan and Uttar Pradesh and 5 per cent in the case of Bihar, Haryana, Kerala, Punjab and West Bengal.

The tenth Finance commission took the debt problem of fiscal stress state like Manipur and recommended that a debt relief scheme in two parts, namely, (i) a scheme for general debt relief for all states linked to fiscal performance and (ii) specific relief for states with high fiscal stress, special category states and states with debt problems warranting special attention. This was in addition to a scheme for encouraging retirement of debt from proceeds of disinvestment and equity holding of state governments. The general debt relief scheme of the Tenth Finance Commission measured improvement in fiscal performance by comparing the ratio of revenue receipts (including devolution and grants from the centre) to total revenue expenditure in a given year with the average of the corresponding ratio in the three Immediately preceding years. The performance of each state was measured against its own past performance. Twice the excess of the ratio over the average ratio of fiscal improvement during the preceding three years was recommended for relief on loans contracted during the period 1989-95 and falling due for repayment after 31st March, 1995. The relief was admissible only to the extent of ten per cent of the amount due for repayment from these loans in any year. We observe that the actual relief sanctioned to states based on the Tenth Finance Commission recommendations was Rs.212 crore during the period 1995-2000 compared to the relief of Rs. 565.51 crore (assuming increase in performance by 2.5 percentage points) estimated by the Tenth Finance Commission. A specific relief in the form of write-off of 5 per cent of repayments due in regard to fresh central loans given during
1989-95 and outstanding as on 31.3.95 was also recommended by the Tenth Finance Commission for special category states and three other states (Orissa, Bihar and Uttar Pradesh), considered to have high fiscal stress, as their average ratio of interest payments to revenue expenditure exceeded 17 per cent during 1989-90 to 1993-94. In the case of Punjab, one-third of repayment of principal on special term loans falling due during 1995-2000 was recommended to be waived. However, the quantum of relief is not significant as show in Table 6.1 below. The share of debt relief in the GDP has reduced from 2.95 percent in the sixth finance Commission to 0.17 percent in eleventh, indicating a relative commitment to central debt forgiveness over time. Nevertheless, successive finance commissions have established tradition of unconditional debt forgiveness.

**Table 6.1: Debt forgiveness by Finance Commissions**

<table>
<thead>
<tr>
<th>Finance Commissions</th>
<th>Year of report</th>
<th>Debt Relief (Rs. Crore)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sixth</td>
<td>1974</td>
<td>197</td>
</tr>
<tr>
<td>Seventh</td>
<td>1979</td>
<td>216</td>
</tr>
<tr>
<td>Eighth</td>
<td>1984</td>
<td>229</td>
</tr>
<tr>
<td>Ninth</td>
<td>1989</td>
<td>98</td>
</tr>
<tr>
<td>Tenth</td>
<td>1995</td>
<td>50</td>
</tr>
<tr>
<td>Eleventh</td>
<td>2000</td>
<td>340</td>
</tr>
</tbody>
</table>

Source. Economic and Political Weekly, June 26, 2004

Up to the eighth Finance commission, the state wise allocation of relief was linked to the proportion of the indebtedness of the respective states, relative to the size of their economies. However the tenth finance commission introduced the performance liked debt relief scheme, which was continued by Eleventh Finance commission and twelfth Finance commission with certain modifications. The tenth finance commission had recommended a scheme of debt relief for all states liked to fiscal performance. Improvement of fiscal management was measured by comparing the ratio of revenue receipts (including devolution and grants
from the centre) to total revenue expenditure in a given year with the average of corresponding ratios in three immediately proceeding years. The performance of each state was measured against its own past performance. Under another scheme proposed by TFC viz. the scheme for encouraging retirement of debt from the proceeds of the disinvestment of equity holdings of state governments not much headway could be made during 1995-00 as only Tamil Nadu could avail of relief of about Rs. 10 crore under this scheme. The EFC discontinued the schemes of debt relief based on disinvestment of fiscal stress and focused only on debt relief linked to improvement in the revenue balance by increasing the extent of potential relief in the fiscal performance liked scheme. The EFC did not consider any special debt relief for the fiscally stressed states, but continued the general debt relief scheme of the Tenth Finance Commission with the following modifications: (i) instead of a factor of 2, a factor of 5 was applied on the ratio of fiscal improvement in terms of revenue receipts to total revenue expenditure (ii) the ceiling of stipulated relief was set at 25 per cent of repayment due in any one year instead of 10 per cent and (iii) in the calculation of revenue receipts, the revenue deficit grants recommended by the EFC under article 275 were to be excluded. This relief was to be available in respect of fresh loans granted during 1995-2000 and outstanding on March, 2000. Although the estimated debt relief was Rs.600 to Rs.700 crore, we have been informed by the Ministry of Finance that till September, 2004, the states qualified for a relief of Rs.131.77 crore only. The states which have benefited under the scheme are Andhra Pradesh (Rs.77.52 crore), Arunachal Pradesh (Rs.1.72 crore), Manipur (Rs.2.47 crore), Tamil Nadu (Rs.7.89 crore) and Punjab (Rs. 42.11 crore)\textsuperscript{10}. While formulating its views on debt relief the Twelfth Finance Commission took into account the existing levels of state’s debt, their fiscal situation and, the TFC recommended debt relief to

\textsuperscript{10} Twelfth Finance Commission Report, Chapter two, p. 219
states in two parts. general debt relief through consolidation of outstanding central loans and debt write off linked to revenue reduction. General debt relief and debt write off recommended by TFC constitute 9.3 percent and 25.0 percent respectively of outstanding balances of central loans granted up to March 31, 2004 and outstanding as on March 31, 2005 for availing the facility of general debt relief, all that states are required to do is o enact fiscal responsibility legislations. Debt relief consists of rescheduled and lowering of interest rate to 7.5 percent. These benefits will be available from the year state enact fiscal responsibility legislations.

General Debt relief: The TFC recommended consolidations of central loans to states contracted till march 31,2004 and outstanding on 31 march 2005 and their reschedulement for afresh term of 20 year at an interest rate of 7.5 percent. The debt swap scheme for states introduced in 2002-03 in substitution high cost central government loans by market borrowing and loans from National saving funds (NSSF). As a result of the debt swap scheme, the amount of outstanding loans from the central government (excluding Delhi) has come down even in absolute terms to Rs.2,30,735 crore at the end of 2002-03 to Rs.205253 at the end of 2004-05. Thus, the debt swap scheme has minimized the benefit of debt consolidation to states. Outstanding debt is the highest for the middle income states, followed by the aggregate benefit as a result of consolidation of loans estimated at rs11, 929crore in terms of deferred repayment over the award period of the TFC. Debt relief as a percentage of total consolidated outstanding debt, special category states, income middle and high-income states, in that order. However, the benefit of consolidation depends on the maturity pattern of outstanding loans by external lending and the share of loans in the centre in the total outstanding debt.

With the TFC recommendations, allowing states to directly access the market for financing the loan component, and allow the states to approach market directly. If, however, some fiscally weak states are unable to rise
from the market. The centre would borrow for the purpose of on-lending to such states, but interest rate should be transferred to states on the same terms and conditions as attached to such assistance.

The external assistance pass through states should be managed by a separate fund in the public account fund. All states should set up sinking fund for amortization of all loans including loans from bank, liabilities account of NSSF. The fund should be maintained outside the consolidated fund of the states public account the public account and should not be used for other purpose, except for redemption of loans.¹¹

Debt write off: The TFC recommended write off repayment of repayment of central loans from 2005-10, after consolidation and resettlement. The write off is linked to revenue deficit reduction and subject to a state fulfilling a number of conditionalities: under the scheme, the repayments due from 2005-06 to 2009-10 on central loans contracted up to 31.03.2004 and recommended to be consolidated will be eligible for write off. The quantum of write off of repayment will be linked to the absolute amount by which the revenue deficit is reduced in each successive year during our award period. In effect, if the revenue deficit is brought down to zero, the entire repayments during the period will be written-off.¹²

However, the actual write off will be worked out by applying the ratio of repayment due in 2005-10 to the base revenue deficit, with the actual revenue reduction. The scale of debt write off will be generally be lower for fiscally stressed states, because of their higher base year revenue deficit. Therefore fiscally stressed states like Manipur need to effect much higher reduction in their revenue deficits in less fiscally stressed states. The total amount of write off in a year is restricted to the repayments due in that year, after loan consolidation and rescheduling. For a state to


¹² G.R. Reddy, ibid, 3517
become eligible loan write off in a year. cumulative reduction in revenue
deficit relative to base year figure should be at least equal or higher than
cumulative interest relief obtained by the state as a result of loan
consolidation and interest rate reduction. The write off is subject to the
further stipulation of a state containing its fiscal deficit at the level of
2004-05.If in any year the fiscal deficit exceeds 2004-05 level, the
benefits of write off would not be available, even when all the
requirements are met. A zero revenue deficit by 2008-09 will entitle the
state to a full write-off all repayments due from 2005-06 on central loans
contracted up to march 31, 2004 and consolidated by the TFC.
The condition that reduction in revenue deficit should be at least equal to
reduction in interest liability on account of debt reschedullement is
inequitable to those states whose interest saving is higher than revenue
deficit. These states need to eliminate revenue deficit to be able to derive
the benefit of debt relief. In this category fall states like Bihar, Jharkhand
Arunachal Pradesh, Meghalaya an Tripura and Manipur is under this
category. For states like Andhra Pradesh, Chastisgarh and Karnataka
interest savings are quite substantial in relation to the base year revenue
deficit. Past experience shows that actual performance by states was much
below the assessment made by the Finance commissions. Assuming that
post-tax devolution non plan revenue deficit states would do all that was
expected of them by finance commission, these states would at best
succeed in eliminating deficit on their non plan revenue accounts. These
states cannot be expected to eliminate their entire revenue accounts
deficits unless the revenue component of their plan is fully met by the
plan grants. In this scenario, fiscally stressed states would be denied the
benefit of debt write offs. On the whole, the package of general debt relief
and debt write-off does not address the problems of severely indebted
states like Manipur.
In the case of the few special category states which still have revenue
surplus the conditionality to be satisfied is that they should maintain in the
base year level of revenue surplus in each year during the award period to benefit the write off scheme. If in any year the revenue surplus is less than that of the base year, they will not get the benefit of a writ off that year. Since almost all the revenue surplus states are highly dependent on the central transfers for their revenues, the maintenance of revenue surplus to enable them to get the benefit of write off will critically depend on such transfers. The benefit of debt write off is not easy to come by. The quantum of debt write off would be linked to the absolute amount by which the revenue deficit.\textsuperscript{13}

On the issue of whether the incentive liked to the debt write off scheme will be effective, it depends on how important this relief to each state. Altogether, the write off constitutes just about 43 percent of the total estimated transfer recommended by the 12 finance commission for the five year period and given this a small portion, it is not clear whether the states will respond to the incentive. Of course, an individual state’s response to the incentive depends on the magnitude of the adjustment it has take and the volume of gain by responding to the incentive. However, Manipur to get the benefit of debt write off Rs.188.54 crores from 2005-10, the write off as percentage of transfers is 2.74% only if it is able to eliminate its revenue deficit by 2008-09. Debt servicing of the state in future, thus is likely to become much easier as a large proportion of existing debt burden may be written off.\textsuperscript{14}

Single-minded pursuit of fiscal correction to get the benefit of debt relief can have disastrous implications for those states where social and infrastructure investments have been insufficient in the past. Some of the states will have to impose heavy cuts in the development expenditures. Both revenue and capital expenditure need to adhere to the tight schedule to bring down revenue deficits to zero by 2008-09. A more rational

\textsuperscript{13} N. J. Kurian, op. cit

\textsuperscript{14} M. Govinda Rao, Pratap R. Jena, Balancing Stability, Equity and Efficiency. Economic and Political Weekly, July 30, 2005
approach may be to allow them to have more realistic adjustment path over a longer period. Otherwise they are unlikely to draw the benefits of debt write off on the basis of stipulated yearly reduction in revenue deficits.  

Table 6.2: Debt redemption scheme

<table>
<thead>
<tr>
<th>States (NE)</th>
<th>Debt relief</th>
<th>Repayments Due during 2005-10</th>
<th>Annual Repayments due 2005-10</th>
<th>Average revenue Surplus/deficit (2001-02 to 2003-04)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Repayment</td>
<td>Interest</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Arunachal</td>
<td>19.98</td>
<td>71.73</td>
<td>97.39</td>
<td>19.48</td>
</tr>
<tr>
<td>Pradesh</td>
<td>507.62</td>
<td>153.87</td>
<td>524.95</td>
<td>104.99</td>
</tr>
<tr>
<td>Assam</td>
<td>292.14</td>
<td>27.26</td>
<td>188.54</td>
<td>37.71</td>
</tr>
<tr>
<td>Manipur</td>
<td>14.81</td>
<td>56.49</td>
<td>80.27</td>
<td>16.05</td>
</tr>
<tr>
<td>Maghalya</td>
<td>7.31</td>
<td>50.54</td>
<td>67.85</td>
<td>13.57</td>
</tr>
<tr>
<td>Mizoram</td>
<td>21.35</td>
<td>56.06</td>
<td>80.15</td>
<td>16.03</td>
</tr>
<tr>
<td>Nagaland</td>
<td>24.76</td>
<td>123.97</td>
<td>117.53</td>
<td>23.51</td>
</tr>
<tr>
<td>Tripura</td>
<td>887.97</td>
<td>539.92</td>
<td>1156.68</td>
<td>231.34</td>
</tr>
</tbody>
</table>

Source: Twelfth Finance Commission

A major shortcoming of the debt relief plan of the TFC is that it is confined to only a small part of the outstanding debt of the states viz. loan liabilities to the centre, which constitute only about one sixth of the total’s loans which account for 30 percent of the state’s borrowing are left out. While lending by the centre has ceased, the states are now required to depend heavily on funds accruing from small savings by borrowing from the NSSF, clearly a cost source. The institutional change envisaged by

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TFC for state s’ borrowing will come to nought unless the states are freed from NSSF and accretions to NSSF are treated as part of the funds in the financial market.

It is necessary to review the planning process and do away with the plan/non-plan dichotomy as the TFC urged. The integrity of the constitutional scheme of transfers would require all revenue transfers to be mediated by FC. This would imply the plethora of centrally sponsored schemes would end and the plan grants also should come within the purview of the FC with the PC asked to look after only the capital requirement of the state which are deficient in infrastructures.

Regarding the Borrowings by states, the TFC made two important recommendations with regard to the future loan contracting by states. The first one that the centre should restrict its assistance for state plans to only grants and allow freedom to access markets for the loan components of the plan.

In the present dispensation, where plan size determines the borrowings of states, debt has become explosive. Plan size is determined more by development consolidation than by ability of a state to service the debt. The TFC recommended a body like the Australian Loan Council to fix the borrowing limits for states. In Indian context, constitution of loan council will be a paradigm shift, the way plan size is determined. A Plan size doesn’t bear any relationship with the capacity of state to service debts.16

The commission has argued that the important institutional changes are required to tackle some of the structural problems in managing government finances. On central change relates to the regime of government borrowing. It has recommended that states, like the centre, must decide their annual borrowing programme within the framework of their respective fiscal responsibility legislation. In fact the state

16 C. Rangarajan, Approach and Recommendations Twelfth Finance Commission, Economic and Political Weekly, July 30, 2005
government move on a path of fiscal correction, the market borrowing programme of the states will be sustainable and they should not face difficulties in terms of eliciting the necessary prescription. There is also need to let the states access the market directly for their borrowing requirements. Such a practice will bring in the needed fiscal discipline. The overall limit to their annual borrowing from all sources should be supervised by an independent body like loan council. Looking overall, the recommendations of the TFC relating total debt relief to states are far more significant than those made by other previous commissions. The quantum is of relief substantial and the conditional ties are not unreasonable. The critical precondition is passage of fiscal responsibility legislation and the critical fiscal correction expected to be carried out by the states is to bring down the revenue deficits.

From the foregoing discussions, it is clear that the burden of fiscal correction needed by different states vary accordingly. As far as major states are concerned the achievement of milestone laid down but the FRBM Act will depend on their success in improving revenue buoyancy and compressing non-productive revenue expenditures, especially untargeted subsidies. In respect of the smaller states also there is considerable scope for reducing wasteful revenue expenditure, but their revenue will be by and large. be governed by the central transfers which in turn depend on the tax buoyancy of the centre.

The benefits to states arising from consolidation, reschedulement and interest reduction of central Loans as recommended by TFC are considerable. As against the pre-consolidation repayment liability of Rs.44,128 crore, the post-consolidation repayment liability is of the order of Rs.32,200 crore to the states indicating a saving of about Rs.12000 crore. The only pre-condition for receiving the benefits of this scheme is passage of fiscal responsibility legislation. By the time the Finance
Commission submitted its report, five states viz. Karnataka, Kerala, Punjab, Tamil Nadu and Uttar Pradesh had passed the legislation.\(^{17}\)

If the basic policies had been sound such corrective measures and relief suggested by the Finance commissions would have been resorted to equilibrium on the longer term basis. Since the basic manner of extending loans to the states and allocating capital resources was not in consonance with the principles of capital finance, high indebtedness with the attendant high interest liabilities, out of proportion to the basic capacity to service debt would result, particularly because the debt relief schemes can be expected to be replaced. And, as we know, they have become an endemic feature of state finance. Increasing government deficits and a steady accumulated debt have been an adverse impact on the interest rates which caused significant increase in their borrowing costs.\(^{18}\) Therefore, one solution to the states indebtedness may be giving state government's Financial Autonomy. G Thimmaiah and Hemlata Rao\(^{19}\) rightly said that the finance commission should recommend to the central Government not to interfere periodically with the financial powers of the state governments. This suggestion may look awkward and embarrassing. But it has got a justification. The finance commission is going to assess the non-plan revenue gap in the current budgets of the state Governments. While so doing so it has to take into account the revenue potential of the state governments. Many state governments in their scope to raise additional revenue has come down partly because of the in-roads made by central governments into their taxing power and particularly in the field of sale tax. Since the Finance Commission is provided under the constitution to protect the financial interests of the state governments, the finance commission should caution the Central government against tampering with the financial powers of the state Governments. Here it is quite

\(^{17}\) N. J. Kurian, Debt relief for States, economic and political weekly, July 30, 2005

\(^{18}\) N. J. Kurian, ibid


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relevant to note the opportunity that the thirteenth finance commissions will have the opportunity to assess the requirements of the states in a holistic manner without making a distinction between the plan and non-plan sides. In particular, it is opportune to take the comprehensive requirements of the social sectors such as basic education and health care to ensure comparable standards of services in these services across the country. The requirement to spend more on public education and healthcare in poorer states is all the more important due to the small presence of the private sector particularly in rural areas in these states.\textsuperscript{20} It will be very difficult to change the share of the states drastically in its recommendations. However, it can make a paradigm shift to change the structure of incentives and accountability as an inherent part of the transfer system. Thus, rather than continuing with the ‘gap-filling’ approach, the commission can fully equalize expenditures on at least basic healthcare and education. It is possible to design the transfer system to build in incentives even to states that have a better record of providing education and health to improve their services further from quantity to quality. If necessary, the tax devolution percentage can be appropriately adjusted to ensure equalization of social services.

The thirteenth finance commission may also have to think of certain drastic measures in order to arrest the rising levels of debt and debt servicing liabilities of the states. It may be necessary for the commission to estimate the interest liabilities of the states for the year 2011-2016 and arrive at optimum level of interest payments as a percentage of their revenue receipts as well as reduction in revenue deficits. There are at least two measures which could help reduce the burden of the states. First, the thirteenth finance commission, in consultation with the planning commission could recommend that in future the Planning Commission would not give approval for a state plan which is formulated in excess of

its estimated resources. As regards market borrowings for financing the plan, the current system needs some modification. The planning commission after a careful assessment of the states’ fiscal position could fix an overall ceiling for market borrowings and a sub-ceiling only up to which approval for market borrowings through the Reserve Bank Of India would be given and for the balance amount of states may have to fend for themselves from the market. Keeping in view the high percentage of the revenue components of the states’ plans, the finance commission in consultation with the planning commission could recommend that the grant element of the central plan assistance as per financial needs of the backward states.