CHAPTER X

UNION-STATE FINANCIAL RELATIONS: BORROWING POWER

Introduction

Among the several serious fiscal-developmental questions arising from the present system of resource transfer from the Centre to the States, the one relating to the Centre's loans to the States has been causing great concern. It has become so alarming as to threaten the very stability and autonomy of States finances. Though indebtedness of the States to the Central Government is a pre-Constitution phenomenon but it was with the inauguration of planning that the era of creditor-debtor relationship between the Union and the States, in fact, started.¹ Between 1948 and 1951, the total amount of Central loans to the States was about Rs. 50 crores. During the period of First Five Year Plan 2570 Central loans totalling Rs. 900 crores were issued to the States. The total debt burden of the States including public debt and unfunded debts rose from Rs. 449 crores in 1952 to Rs. 9568 crores in 1972, to Rs. 16263 crores by the end of March 1978 and Rs. 18785 crores as estimated for 1979.

The States continued to borrow money and with each Plan their debt liabilities went on soaring. In the year 1978-79, the States borrowed Rs. 2930.13 crores and that in 1979-80, they were debted to an amount of Rs. 2464.12 crores. The bulk of this debt burden of the States is accounted for by the loans obtained from the Central Government. In 1952, loans taken from the Central Government constituted just over 53 per cent of the total debt of the States, but by the end of 1972 these had risen to over 70 per cent.²

These figures testify the phenomenal increase in the States' debt to the Centre but there is nothing alarming about this

¹ In the past, the Central Government did not give loans to the Provinces as a general rule. See Dr. Diwan, 139.
<table>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Loans and Adv. from the Union</td>
<td>240 (53.6)</td>
<td>943 (72.7)</td>
<td>2014 (74.5)</td>
<td>4110 (75.1)</td>
<td>5584 (74.0)</td>
<td>8579 (72.6)</td>
<td>9149 (17.2)</td>
<td>9682 (70.7)</td>
<td>10481 (69.9)</td>
</tr>
<tr>
<td>B. Ways and Means Advances from the RBI</td>
<td>16 (3.4)</td>
<td>10 (0.8)</td>
<td>42 (0.5)</td>
<td>189 (3.2)</td>
<td>241 (1.6)</td>
<td>188 (1.4)</td>
<td>181 (1.2)</td>
<td>167 (1.0)</td>
<td>157 (1.0)</td>
</tr>
<tr>
<td>C. Provident Fund, etc.</td>
<td>58 (13.1)</td>
<td>86 (6.7)</td>
<td>133 (4.9)</td>
<td>231 (4.2)</td>
<td>367 (7.4)</td>
<td>857 (7.9)</td>
<td>1001 (8.5)</td>
<td>1151 (9.3)</td>
<td>1377 (19.8)</td>
</tr>
<tr>
<td>D. Loans from Banks and other Institutions</td>
<td>-</td>
<td>-</td>
<td>50 (1.8)</td>
<td>162 (2.3)</td>
<td>201 (2.7)</td>
<td>342 (2.9)</td>
<td>399 (3.2)</td>
<td>483 (3.6)</td>
<td>518 (4.0)</td>
</tr>
<tr>
<td>E. Market Loans</td>
<td>131</td>
<td>222</td>
<td>410</td>
<td>720</td>
<td>950</td>
<td>1543</td>
<td>1758</td>
<td>2031</td>
<td>2210</td>
</tr>
<tr>
<td>F. Bonds</td>
<td>3</td>
<td>35</td>
<td>90</td>
<td>107</td>
<td>97</td>
<td>82</td>
<td>78</td>
<td>77</td>
<td>81</td>
</tr>
<tr>
<td>G. % of E &amp; F</td>
<td>(29.9)</td>
<td>(19.8)</td>
<td>(18.3)</td>
<td>(15.0)</td>
<td>(14.1)</td>
<td>(14.0)</td>
<td>(14.6)</td>
<td>(15.5)</td>
<td>(15.3)</td>
</tr>
<tr>
<td>Total</td>
<td>449</td>
<td>1297</td>
<td>2739</td>
<td>5219</td>
<td>7740</td>
<td>11591</td>
<td>12566</td>
<td>13591</td>
<td>14824</td>
</tr>
</tbody>
</table>

Note: Figures in brackets indicate percentages.

(Source: RBI Bulletins and Report on Currency and Finance, 1975-76.)
manifold growth. In the words of the Sixth Finance Commission, the continuous increase in the indebtedness of the States to the Centre "only reflects the assistance provided by the Centre to the States year after year for financing not only their Plan outlays but also for meeting the non-Plan needs such as those arising from relief expenditure on natural calamities." Besides, such increase in States' indebtedness is "inherent in a developing economy." So long as money is raised or utilized towards achieving social and economic goals of national priority, the Seventh Finance Commission observes that "one need not feel unduly perturbed."4

There may be several reasons for this heavy indebtedness of the States. It may be the result not merely of the poor resources with the States but also of the poor mobilization of those resources by them. The huge resources-need for financing their Plans adds to the plight of the States. In most of the cases the resources available with the States are just sufficient to meet their non-Plan expenditure and if they employ these for the Plan purposes, these States would be left, practically with nothing for the non-Plan expenditure. Some of the States have resources which are not enough to meet their normal expenditure even and therefore, they have to depend wholly on grants and loans from the Union or other possible sources.5 Equally significant is the constitutional fact that makes the State Government's ability and power to borrow dependent on the discretion and consent of the Union Government. This aspect is discussed in detail in the following paragraphs.

Borrowing Power of the Union and the States

Article 292 and 293 of the Constitution of India relate to the borrowing powers of the Union and the States respectively.

3. Ibid.
5. Dr. Diwan, 140.
Entry 35 in the Union List of the Seventh Schedule confers exclusive power on the Union Parliament to make laws in respect of the public debt of India. Corresponding Entry 43 in the State List confers exclusive power on the State Legislatures. Foreign loans can be floated exclusively under a Union Law under Entry 37 of the Union List. Thus both the Union and the States have power to borrow money but their powers are not co-extensive. Under Article 292, the Union Government may borrow upon the security of the Consolidated Fund of India (and give guarantees) within the limits fixed by Parliament. Article 293 empowers the State Governments to borrow within India (and to give guarantees) upon the security of the Consolidated Fund of the States within limits fixed by the State Legislators. But the power of the State Governments is, in fact, controlled by the Union Government in terms of Clause (3) of Article 293 which says that "a State may not without the consent of the Government of India raise any loan, if their is still outstanding any part of the 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". While giving its consent, the Government of India may impose 'any condition which it may think fit to impose.'

Since practically all the States are indebted to the Union from the first, they have been left with no independent power to raise loans. The States were, therefore, persuaded by the Central Government to agree to a unified policy of borrowing from the market. But having not succeeded in the pursuit, the Central Government permitted the States to borrow from the market on their own and thus having power to do so, the Centre has not stood in the way of States' borrowing. However, the Central loans are so easily available that it is not often that the States have to resort to public borrowing. Besides all the States, having been indebted to the Central Government, are required to seek its consent before they can float loans in the open market. This helps in fixing an order of priority of States' borrowing.

6. Clause (4), Article 293.
7. Dr. Diwan, 141.
borrowings and the timings of the loans. It also avoids competition between the Union and the State Governments in borrowing which might have caused unhealthy movements in the money market to the disadvantage of all. In this whole exercise the Government of India becomes the main borrower and the States depend upon it. It is, therefore, desirable to canalize all borrowings of Union as well as States, which is done on the security of the Government of India, through an institution akin to the Australian Loan Council. This function is discharged by Reserve Bank of India which acts as the banker and agent for the debt operations of the Central Government and does the same for the State Governments, so far as the market loans are concerned.

**Debt Liabilities of the States**

The State Governments have the following main types of debt obligations:

1. **Permanent debt**: These loans include the loans raised in the market in India and certain other categories of debt like Zamindari Abolition Bonds. They represent rupee loans issued to the public. These are the counterparts of the permanent or funded marketable loans of the Government of India. These, thus, include cash and conversion loans as well as bonds issued in compensation for the abolition of intermediary rights in lands;

2. **Floating debt**: It represents mainly the ways and means advances and overdrafts from the Reserve Bank of India and cash credits from the State Bank of India and Commercial Banks in terms of short-term loans;

3. **Loans from Centre**: This is the most important category of State loans, which are mainly, given for the Centrally-assisted schemes and Centrally-sponsored schemes. Some loans are also granted for non-Plan purposes;

4. **Unfunded debt**: It consists of State Provident Funds, Postal Insurance and Life Annuity Funds, Saving Bank Deposits, etcetera;
5. Other debts: These are raised from Life Insurance Corporation of India, National Co-operative Development Corporation and National Agricultural Credit Operations Fund (Long-term Operations) of the Reserve Bank of India.

On the recommendations of the team on Reforms in the Structure of Budget and Accounts, the above classification of States' debt obligations is modified to include only three main categories, namely, internal debt, loans and advances from the Central Government, and Provident Funds.

Reasons for the States' Indebtedness to the Central Government

It has been seen that loans from the Centre constitute the most important component of the outstanding debt of the States. The main reason for this is the high percentage of State Plans which is financed through Central loans. Another is the consequence of Article 293 which circumscribes the freedom of the States in borrowing from the public, with the result, market borrowings of all the States are practically determined by the Central Government in consultation with the Reserve Bank of India. Further that Central Government being so liberal in the matter that it is not often that the States resort to public borrowing.

It is evident from the Table X(2) that throughout the past decade, loans from the Centre have constituted no less than 77 percent of the total outstanding debt of the States. True, that this indebtedness of the States arises on account of their inability to meet their Plan and non-Plan requirements, but the present burden of outstanding Central loans is attributable mainly to the Plan loans. Although the non-Plan loans do contribute to aggravate the situation, yet these are not the primary cause of the dependence of the States on the Union.

9. Dr. Diwan, 141.
### Table X(2)

Debt Position of the States and Loans from Central Government

<table>
<thead>
<tr>
<th>End of March</th>
<th>Outstanding Total Public Debt</th>
<th>Loans from Central Government</th>
<th>(3) as % of (2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
</tr>
<tr>
<td>1961</td>
<td>2606</td>
<td>2014</td>
<td>77.3</td>
</tr>
<tr>
<td>1966</td>
<td>5281</td>
<td>4103</td>
<td>77.7</td>
</tr>
<tr>
<td>1969</td>
<td>7058</td>
<td>5569</td>
<td>78.9</td>
</tr>
<tr>
<td>1970</td>
<td>7524</td>
<td>5982</td>
<td>79.5</td>
</tr>
<tr>
<td>1971</td>
<td>8199</td>
<td>6353</td>
<td>77.5</td>
</tr>
<tr>
<td>1972(B.E.)</td>
<td>8824</td>
<td>6856</td>
<td>77.7</td>
</tr>
<tr>
<td>1973(B.E.)</td>
<td>9279</td>
<td>7269</td>
<td>78.3</td>
</tr>
</tbody>
</table>


The Study Team on Centre-State Relations gave special attention to this problem and observed that "non-Plan loans by themselves are well within the capacity of the States to liquidate by amortization (or repayment from revenue where necessary) and ... the causes for rising indebtedness must be looked for in the massive increase in Plan loans." Theoretically, the States are free not to take these loans, but they can exercise this 'legal' freedom only by foregoing to undertake the development projects for which they are given. Obviously for political reasons, no State can afford to be left behind in a competitive process of economic development and is, therefore, willy-nilly, compelled to accept the Union loans with or without strings attached to them. The process becomes unending when once the States accept the loans, which accordingly becomes an important lever for the Central Government to project its power into the region of State autonomy. "Such has become the logic of the Union-State fiscal relationship", says Dr. Diwan that "the Union can neither refuse to give loan nor can it bring a distress warrant.

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against the States. And it is in this that lies the strength of the States and it is in this there is a secure guarantee of State autonomy. In view of the ever increasing dependence of the States on the Union for financing the development projects, assisted or sponsored by the Central Government, this category of States' indebtedness is bound to grow in relative importance, for the years to come.

Equally significant has been the impact on the State's indebtedness of the non-remunerativeness of some of the assisted schemes of projects. Under the Gadgil formula regulating the flow of Plan assistance, 70 per cent of the Plan assistance is given in the form of loans. In an ideal scheme of devolution of resources, only such expenditure should be financed out of borrowed funds as creates self-liquidating assets so that the repayments of principal as well as interest payments can be made out of the revenues thus generated. However, this principle had been attached little importance by the Union Government and loans have been given and utilized for financing all kinds of projects irrespective of the financial remunerativeness of the assisted schemes. This practice is justified by the Central Government with the logic that 'all expenditure on durable or fixed, though not necessarily productive or self-liquidating assets, should be held eligible for being serviced out of loans.'

Broadly speaking, the entire capital disbursement of the States falls under categories: (a) repayment of the Central loans, (b) loans and advances to third parties, and (c) developmental outlay. During the First Plan period, the developmental outlay constituted about 65.7 per cent of the total capital disbursement. It came down to 32.4 per cent during the Annual

11. Union-States Fiscal Relations, 141.
12. See supra 'Plan Grants' Chapter IX.
13. Grewal, 177. See also Bhargava, 133-34.
Plan period and to 32.6 per cent during the Fourth Five Year Plan period. It rose to 95.6 per cent during 1977-78 and picked up further in 1979-80. The developmental outlays of the States have been in electricity generation, irrigation works, road transport undertakings, social services, construction of roads, bridges etc. The States have to provide infrastructural facilities to their own commercial undertakings as well to those of the Union. Thus the entire developmental outlays of the States can be classified in two categories: (a) expenses in providing infrastructures to the States and Union commercial undertakings and (b) expenses in commercial undertakings. The expenditure under the first category is not income-yielding. But investments in commercial undertakings are also not yielding much return. Rather some of them run into losses. These losses also make the situation further critical. 15

The amount of loans given to different States also does not relate to their capacity to bear the burden of repayments and interest. Earlier to the Fourth Plan, the patterns of assistance, different for different schemes, were uniformly applied to all the States. Under the new procedure also according to which 70 per cent of the Plan assistance constitutes loans, all States are considered uniformly. As a result, for a number of States, the burden of Central loans has become really unbearable. Finding no revenues for amortization of Central debt, these States have to resort to fresh borrowing to repay the Central loans. Thus the borrowing spree continues and the States are further sinking in the debt.

With the increase of debts, the liability to repay them also increases. Further, all loans from the Centre do not represent resources available with the States for investment as heavy borrowing in the past, creates equally heavy repayment obligations. It is evident from the Table X(3) that the substantial part of the fresh loans has been returned to the Centre by the States by way of repayment. It is therefore not surprising that the States view the quantum of the Centre's

15. Dr. Diwan, 147.
### Gross loans from the Centre and Repayments by the States

(Rupees in crores)

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross loans</th>
<th>Repayments</th>
<th>Repayments as percentage of gross loans, (3) as % of (2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
</tr>
<tr>
<td>1951-52</td>
<td>60.8</td>
<td>12.2</td>
<td>20.0</td>
</tr>
<tr>
<td>1955-56</td>
<td>249.5</td>
<td>24.0</td>
<td>9.6</td>
</tr>
<tr>
<td>1960-61</td>
<td>328.1</td>
<td>95.4</td>
<td>29.1</td>
</tr>
<tr>
<td>1961-62</td>
<td>452.4</td>
<td>133.9</td>
<td>29.6</td>
</tr>
<tr>
<td>1962-63</td>
<td>523.5</td>
<td>144.7</td>
<td>27.7</td>
</tr>
<tr>
<td>1963-64</td>
<td>624.0</td>
<td>179.4</td>
<td>28.8</td>
</tr>
<tr>
<td>1964-65</td>
<td>680.1</td>
<td>216.0</td>
<td>31.8</td>
</tr>
<tr>
<td>1965-66</td>
<td>821.4</td>
<td>276.2</td>
<td>33.6</td>
</tr>
<tr>
<td>1966-67</td>
<td>919.3</td>
<td>281.3</td>
<td>30.6</td>
</tr>
<tr>
<td>1967-68</td>
<td>877.5</td>
<td>385.0</td>
<td>43.9</td>
</tr>
<tr>
<td>1968-69</td>
<td>895.4</td>
<td>573.6</td>
<td>64.1</td>
</tr>
<tr>
<td>1969-70</td>
<td>1036.1</td>
<td>637.8</td>
<td>61.6</td>
</tr>
<tr>
<td>1970-71(RE)</td>
<td>1011.7</td>
<td>665.0</td>
<td>65.7</td>
</tr>
<tr>
<td>1971-72(RE)</td>
<td>1200.0</td>
<td>843.0</td>
<td>70.3</td>
</tr>
</tbody>
</table>

**Source:** Grewal, Table 17, p.176

Loans forthcoming for Plan financing in a given year, as what is left after meeting their commitments of repayment to the Centre out of the Centre's loan itself. Such a practice has serious implications. When the fresh loans are regularly utilized only for the repayment of the old loans, the States may grow indifferent to the financial results of the schemes financed through these loans. This tendency results in the loss of efficiency in the application of already scarce resources, which presents a serious national problem. The Study team of the Administrative Reforms Commission observed that "this has bred in the States a degree of indifference as a result of which, when receiving assistance from the Centre, they heed little whether the assistance is in the form of a loan or a grant."\(^{16}\)

The foregoing analysis brings out that it is the Central loans themselves that are mainly pushing the States down and down in the meshy marsh of indebtedness. The States have been entangled too much in the net of indebtedness that the more they try to relieve themselves, the more entangled they are. But the fact of the matter according to Dr. Diwan is that "the States do not care to disengage themselves from the net."\textsuperscript{17} So long as more loans are coming, so long the Creditor does not press them for debt services, the States are happy to be caught in the net and lie there secure. And they know that there is no end to the bounty of their Creditor.\textsuperscript{18}

The Problem of Non-Plan Gap and the Debts of the States

It has already been said that non-Plan gap of the States is one of the important factors that contribute to aggravate their debt position. We may now analyse various situations when the State incur such gaps. The non-Plan side of the budgets of the States have two components, revenue component and capital component. The gap occurs if expenditure exceeds the revenue. To meet the non-Plan current expenditure, a State has current revenues comprising tax and non-tax revenues at pre-Plan rates, tax-devolution and grants-in-aid received under the recommendations of the Finance Commission. The working of the successive Finance Commissions brings out that the Commissions have to make assumptions as to the tax and non-tax revenues of the States in order to balance the non-Plan budgets and to come to the non-Plan gaps of the States. Very often these assumptions do not materialise.\textsuperscript{19} The States assessed as surplus

\textsuperscript{17.} Union-States Fiscal Relations, 142.
\textsuperscript{18.} Ibid.
\textsuperscript{19.} Take for instance the Fourth Commission expected that the revenues of the States, at 1965-66 rates of taxation, would yield an aggregate surplus of Rs.373.73 crores over the five years ending March, 1971. However the actual surplus during the five years ending 1968-69, was only Rs.238 crores showing a shortfall of Rs.135 crores, Report, Fourth Finance Commission, 59, 1965. Report, Fourth Five Year Plan, Table 27, at 74, 1969-74.
show a deficit and thus arise the problem of providing for these gaps. Such discrepancies arise partly due to some unanticipated increase in non-Plan expenditure, such as increase in the salaries and allowances of the employees of the State Governments and partly because of the unrealistic assumptions made by the Commission. Referring to the assumptions made by the Fifth Finance Commission anticipating a surplus of Rs.1273.4 crores on the non-Plan revenue account during the five years ending March 1974, which in the estimation of the Planning Commission came down only to Rs. 48 crores with some of the States showing a deficit of Rs. 320 crores instead of a balanced budget, the latter observed that these deficits were partly attributable to the fact that the Finance Commission had not allowed devolution from the Centre for covering fully the appropriations which these States proposed to make from their current revenues towards reduction or avoidance of the debts on the basis of their existing practices. The Commission further observed: "In fact, it is also attributable to the assumptions made by the Finance Commission for its assessment of revenue deficits of States, namely, that State Electricity Boards would pay to State Governments the full interest falling due during the Fourth Plan period with the exceptions of Assam and Rajasthan Boards which would pay only half, that receipts from commercial irrigation works would cover the working expenses and interest at the rate of 2½ per cent on investment and that there would be no net loss on other departments commercial schemes and investments by State Governments. In addition the Finance Commission also assumed recovery of interest on loans and advances to third parties at a rate equivalent to the average rate of interest payable by the State Government concerned on its own borrowings while no allowance was made for interest payment on ad hoc loans from the Centre. All this implies some additional mobilisation by States, particularly by way of revision of electricity tariffs and water rates. Consequently on the basis of the devolution finally recommended by the Fifth Finance Commission, some States are faced with the problem of substantial revenue deficits at 1968-69 rates of State taxation."
On scanning States' budgets, it is seen that expenditure of the States comprise: capital expenditure on developmental programmes (both Plan and non-Plan); capital outlays on non-developmental projects (for example, State trading undertaken outside the Plan and compensation to landholders on account of abolition of Zamindari); loans and advances to third parties (both Plan and non-Plan); discharge of permanent debt (non-Plan); and repayment of Central loans and other lending institutions. These capital disbursements can be financed out of capital receipts comprising loans from public, floating debt, States' share in small savings, negotiated loans from autonomous bodies, State Provident Funds, net deposits and advances and loans, and advances repaid to the State Governments. Normally net loans from the public, States' share in small savings, State Provident Fund, negotiated loans and market borrowings of the States are treated as Plan resources. The remaining are usually called 'miscellaneous capital receipts', which are available for financing the non-Plan capital expenditure. These receipts will be positive or negative depending upon whether there is a surplus or deficit on non-Plan capital account. The overall non-Plan picture emerges when net miscellaneous capital receipts are added to the balance from current revenues (non-Plan). If both are negative or if the negative magnitude of one outweighs the positive magnitude of the other, there will be an overall non-Plan gap.

A State Government faced with the problem of overall non-Plan gap may adopt either of the following courses. It may cut down its non-Plan expenditure on revenue or capital account. It may divert a part of the additional resource mobilisation for meeting this gap. Or, it may over-borrow from the Reserve Bank

21. Representing cash credits from the State Bank of India and other nationalised Banks.

22. Such as Life Insurance Corporation, National Co-operative Development Corporation.

23. For example, deposits of depreciation reserves of public commercial concerns; sinking funds and reserve funds.

of India and subsequently request for ad hoc loans from the Centre to clear the overdrafts. But the past experience shows that the last course has been adopted for various reasons, though the other two courses have been applied but very rarely. A cut in the non-Plan expenditure by the State is somewhat difficult for obvious political reasons apart from other considerations. Non-Plan accounts, in most of the cases, are of a contractual nature which are required to be honoured. Expenditure on debt-servicing and expenditure on salaries and allowances of the Government employees are also not subjected to reduction. A cut in the transfers to local Governments by the State Governments (which are very small) if imposed would have only insignificant effect. There is also not much scope for economy which can be affected in committed expenditure incurred on the maintenance and upkeep of the assets created during the previous plans. Diversion of additional resource mobilisation for meeting this non-Plan gap is discouraged and is not approved by the Planning Commission as it is bound to upset the estimates of the Commission about the availability of the resources for the Plan-purposes. It was so realised by the Planning Commission at the beginning of the Fourth Plan. The Commission estimated that after taking credit for the recommendations of the Fifth Finance Commission, several States would show overall non-Plan gaps. If these States were allowed to divert their additional resource mobilisation for meeting these gaps, the Commission observed, "then the States' own resources for the Plan would be correspondingly reduced, in fact, some of the States would have nothing left for their Plans." This would not only upset the Plan of the concerned State but also the entire national Plan. The other course considered by the Planning Commission was that those States, with non-Plan gaps, would have to be given much larger Plan assistance than had been intimated to them at the beginning of the Plan. This could not be done, since 1969-70 Plan assistance to the States was allocated

25. It is so evident from the existing standards of maintenance of their services even in richer States like Haryana and Punjab. See Report, Fifth Finance Commission, 50, 1969.
according to the formula adopted by the National Development Council. These were the reasons which led the Planning Commission to persuade the Union Ministry of Finance to sanction 'Special Accommodation Loans' to States with overall non-Plan gaps. All this brings out that the non-Plan gaps do contribute to the plight of the States.

The Problem of Unauthorised Overdrafts

All the State Governments²⁷ have agreements with the Reserve Bank of India under Section 21-A of the Reserve Bank of India Act 1934, to enable the Bank to handle their monetary transactions. It requires the State Governments, to keep certain minimum cash balances with the Bank. Under Section 17(5) of the Act, the Bank makes advances to the State Governments against their balances, which are repayable within three months from the date of advances. However, the limits of advances for each State are specified in the Letters of Exchange, executed in pursuance of the agreements. In addition to these normal advances the Bank also gives special advances to the States against their holdings of the Central Government's securities. The Bank also sanctions, for some States, additional ad hoc limits for secured advances. All these are known as ways and means advances. Unauthorised overdrafts arise either because the agreed limits of advance are exceeded by the State Governments or because the time limit of three months for the repayment of loans is not observed. The loan transactions of the State Governments with the Bank can be classified into three forms: (a) ways and means advances; (b) special ways and means accommodation; and (c) extraordinary form of borrowings by the States known as unauthorised overdrafts.

Regarding 'ways and means advances', each State can draw up to thrice the level of the minimum balance that the State is required to hold with the Bank. That lending is almost automatic once a request comes from the State Government concerned.

and does not involve any complicated procedure. The State Governments are required to execute a promissory note for the entire limit of advances and a letter of continuity (renewal) if necessary, is obtained on 1st July every year.28

Special ways and means accommodation is granted against hypothecation of Central Government securities and the theoretical limit of this type of advance is Rs. 2 crores. In practice however, this theoretical maximum is not always adhered to and the outer limit being allowed to vary with the size of Central Government securities the States are in a position to pledge. The loans are normally repayable within three months but can be renewed after the expiry of the usual period. The amounts borrowed are cleared either by authorising the RBI to sell the securities pledged or making good the amount out of normal budgetary receipts.29 The special advances are sanctioned upto thrice the level of normal ways and means advances.

The extraordinary pattern of borrowing, commonly called as 'unauthorised overdrafts', so considered unauthorised in the sense that no prior arrangements exist between the borrowing State and the Bank.

Before the advent of Plans, the States could normally finance their transactions without having recourse to over-drafts, although the limits of advances, as already mentioned above, were very small. These were just equal to the minimum cash balance that a State was required to keep with the Bank. But with the beginning of the First Plan, the monetary transactions of the State Governments with the Bank increased, with the result that some of the States resorted to overdrawing from the Bank. In view of the changed circumstances, the Bank increased in 1953, the limits for 'normal' or unsecured ways and means advances

28. Under the revised procedure introduced from September 19, 1965, the promissory notes are renewed once in two years. See Report, Study Team on Financial Administration, ARC, 376, 1967.

from a total of Rs. 1.85 crore to Rs. 7.88 crore. As the problem continued, the Bank, from time to time, increased the limits of 'normal' and 'special' advances to the States. In 1967, the States could draw a total amount of Rs. 18.75 crore as 'normal' advances and Rs. 37.50 crore as 'special' advances as against their minimum balances with the Bank at only Rs. 6.25 crore.

In spite of the high limits of 'authorised' overdraft, some of the State Governments could not help resorting to 'unauthorised' overdrafts. The outstanding overdrafts amounted to Rs. 120.0 crore at the end of the Third Plan (March 1966) and they rose sharply to Rs. 538 crore on April 14, 1978.  

It is the peculiar nature of the financial transactions of the State Governments that both the RBI and the concerned States come to know of the unauthorised overdrafts only after these have actually arisen. What happens is this: the monetary transactions of the State Governments are carried on simultaneously at more than 2000 treasuries, sub-treasuries and banks. These transactions are allowed to proceed without any reference to the actual position of a State Government's cash balance in the Reserve Bank, the accounts of which are maintained only at the Central Accounts Section of the Reserve Bank of India. When daily accounts are compiled, it is discovered that the debt against a State Government exceeds its limits of ways and means advances and an unauthorised overdraft is noticed.

The practice of the Reserve Bank has been that when an unauthorised overdraft arises in respect of a State, it issues a notice to the concerned State Government requiring it to clear the overdraft within three weeks, failing which the Bank would be free to dishonour any further cheques of that Government. However, neither the State Government clears the overdraft nor the Bank dishonours the cheques of the Government. This is followed usually by reminders and discussions with the Finance Secretaries.

of the State Government's concerned and the issue of a notice. The Central Government is also kept informed of the position. It is only at the end of June each year\textsuperscript{32} that the States clear their overdrafts. For this purpose, the State Governments make a request to the Central Government for the sanction of \textit{ad hoc} loans so as to enable them to clear the overdrafts. All sorts of political considerations supervene and eventually it is the Central Government 'which is left to hold this unwanted baby'. Thus the State Government's debt undergoes a metamorphosis and results in being a liability of the Central Government, which treats them as a special loan to the concerned State.\textsuperscript{33} Thus what is initially a loan by the Reserve Bank to the State Government becomes a loan from the Central Government to the State Government. And the process continues. During the Second Five Year Plan, the Central Government disbursed, to seven States, such \textit{ad hoc} loans aggregating to Rs. 128 crores. During the Third Plan, it sanctioned to eleven States, \textit{ad hoc} loans amount to Rs. 286 crores. During 1972-73, \textit{ad hoc} loans disbursed by the Central Government amounted to Rs. 511 crores. The States, taking advantage of this position, continued to resort to over-drafting. At the end of January 1978, the outstanding overdrafts of the State Governments stood at Rs. 122 crores, which rose to Rs. 538 crore on April 14, 1978. The States overdrafts stood at Rs. 505 crores on June 27, 1978 which were cleared by the Central Government at the end of June, 1978 by advance release of the Union assistance and share in Central taxes to the State Governments.\textsuperscript{34}

The Fifth Finance Commission reviewed the question in some details and observed that "There is a serious danger that the example of having recourse to such unauthorised

\begin{itemize}
  \item \textsuperscript{32} The Finance Year of the Reserve Bank closes on June 30.
  \item \textsuperscript{33} Report, Study Team on Financial Administration, 376, 1967.
  \item \textsuperscript{34} RBI Bulletin, 616-17, 1978.
\end{itemize}
overdrafts by certain States, followed by their almost routine clearance by the Centre, may prove infectious. For, all those States which persistently resorted to this practice of overdrafts for financing their expenditures were not necessarily those with lowest per capita income. The practice has been viewed to be a matter of very serious concern. Apart from the contravention of Article 293(3) of the Constitution and the agreements entered into under Section 21A of the Reserve Bank of India Act, the occurrence of such overdrafts and their practically automatic clearance by the Centre through ad hoc loans, amounts to deficit financing resorted to by some of the States. It violates the fundamental principle of sound monetary management according to which it is the sole responsibility of Central Government in a federation, to take decisions regarding the need for and the extent of deficit financing in the context of overall economic considerations. Besides, this manner of financing expenditure puts fiscal prudence at a discount. When the benefits of such practices go to only a few States which resort to such overdrafts, the consequential burdens of financial mismanagement are borne by other States also. Another serious implication which results from such practice is that the authority of the Finance Commission is greatly undermined. Knowing well that the Central Government will ultimately come to their rescue, unwilling State Governments may always afford to disregard the fiscal discipline expected of them by the Finance Commission.

The idea behind State Governments taking ways and means advances from the Reserve Bank is to cover the temporary shortfalls in their revenues so that their commitments to budget expenditures should not be adversely affected. Taking into account the past trends of the State Governments' revenues and expenditures, the benefits of such practices go to only a few States which resort to such overdrafts, the consequential burdens of financial mismanagement are borne by other States also. Another serious implication which results from such practice is that the authority of the Finance Commission is greatly undermined. Knowing well that the Central Government will ultimately come to their rescue, unwilling State Governments may always afford to disregard the fiscal discipline expected of them by the Finance Commission.

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38. Ibid.
39. Ibid.
a realistic measure for fixing borrowing limits can easily be located. And, as the procedure and practice stand, the regulation of 'normal' and 'special' advances by the Reserve Bank does not pose any significant problem. But the difficulty arises, as to the manner in which the Bank may be in a position to prevent the State Governments from overdrawing their accounts.

Causes for Unauthorised Overdrafts

Before a solution to the problem is sought, it would be worthwhile to find out the causes which lead to such overdrafts. The Reserve Bank reported in 1971 that the specific reasons for the emergence and persistence of unauthorised overdrafts are now known. The problem was also taken up in detail by the Fifth Finance Commission. In their memoranda to the Commission, the State Governments pointed out that, even though they had to incur unauthorised overdrafts due to the temporary difficulties resulting from the uneven flow of receipts and expenditures (and the inadequacy of limit for ways and means advances), the main reason was the chronic imbalance between their resources and functions, inadequate devolution and absence of suitable mechanism to deal with unforeseen difficulties. Recent technical and economic developments leading to the integration of the national economy have resulted in an effective centralization of a number of highly productive taxes resulting in the growing imbalance between the States' resources and their commitments. The State Governments also pointed out that while the size of State Plans and Central Plan assistance were reviewed and revised from year to year, the recommendations of the Finance Commission remained in force for longer periods without any such review.

If due to any change in circumstances, the State Governments have to incur substantially larger non-Plan expenditure, there is no machinery, as at present, to provide increased devolution of resources to the States. Besides the volume of repayments of Central loans has in recent years, caused a considerable strain on the capital budget of the States. This has resulted in substantial amount of non-Plan capital deficits which have largely been responsible for unauthorised overdrafts by several State Governments.

42. Id. at 243.
State Governments.

Keeping in view the temporary difficulties in respect of ways and means advances, the Reserve Bank in 1972, increased the limits for unsecured advances. However, such a measure does not in any way solve the problem, but it only conceals the magnitude of unauthorised overdrafts and what were earlier called 'unauthorised' would now be called 'authorised', and the overdraft phenomenon continued.

In order to obviate this menace, the Central Government took two measures in August 1978. It extended special loans to the States having overdrafts to enable them to clear the deficit by December 1978 and an amount of Rs. 751 crore was given by way of special loans. On February 28, 1979, the Union Finance Minister announced that the Union Government would grant loans to the States to enable them to start with a clean slate and avoid overdrafts in future. For the purpose a sum of Rs. 300,000 lakhs was provided in the budget of 1979-80 and a similar amount was provided in the budget of 1980-81. The second measure was the introduction of a scheme to regulate the States' overdrafts with effect from October 1, 1978. The scheme provided: "(a) The year-end deficit will not be carried forward wholly or partly to the current financial year. A balance would be maintained between the resources and expenditure, so that there is no occasion for resorting to overdrafts. (b) If a State is indebted to the Reserve Bank for over 45 days, even within the limits of the ways and means advances, the position will be discussed with concerned State Government, to devise such corrective measures as may be called for. (c) As soon as any State Government has availed itself of 75 per cent of the authorised ways and means limit, the Reserve Bank will caution the State Government, and if, despite such caution, the State Government's account is overdrawn for more than seven working days, the Bank will automatically suspend

43. In May 1972, the limits were increased to four times their previous levels. This was in addition to what the States could get through secured advances. Annual Report, Reserve Bank of India, 10, 1971-72.
44. In addition to this an amount of Rs. 4 crore was sanctioned for the State of Jammu and Kashmir which does not maintain any account with the Reserve Bank.
payment of the State Government which will not be resumed until after the overdraft has been cleared. The existing limits of normal (unsecured) ways and means advances have also been doubled with effect from October 1, 1978."  

Debt Relief: A Measure

There is no way in which the State Governments can repay their loans to the Central Government and these Central loans are now a dead weight debt. The indebtedness of the States has reached such proportions and the problem has become so acute and endemic that there is no alternative but to provide them with debt-relief if the States are to be saved from insolvency. The successive Finance Commissions considered the problem in all seriousness. The Third Finance Commission realised the gravity of the problem and recommended the analysis and the review of the whole question. But the Commission left the problem without making an serious attempt at tackling it. The Fourth Commission merely observed that in matters of granting of loans, all States should not be treated uniformly rather a discriminatory approach should be made in regard to maturity periods, rates of interest, terms of payment etc. of the loans. The Fifth Finance Commission did give serious thought to the problem and made several recommendations. They observed that "in the context of overall shortage of financial resources available to the Central and State Governments and rising demands for expenditure in a Welfare State, it is inevitable that the State Governments, even after receiving all possible devolution of tax shares and grants as well as Plan assistance from the Centre, will not find themselves in a position to meet their needs in full." The Commission recommended: "(a) The loans which did not yield direct returns should be kept within..."
reasonable proportion of the States' own resources. (b) Those States, which in the estimates of the Planning Commission were facing an inescapable resource gap in the Fourth Plan should be given special loans. (c) The rates of interest should be reduced and the maximum rate of interest should be 5 per cent within a rebate of 1/4 for prompt repayment. (d) The recoveries of the loans should be made in equal annual instalments consisting of due interest and the principal amount.

The Sixth Finance Commission was enjoined by their terms of reference, to make an assessment of the non-Plan capital gap of the States on a uniform and comparable basis for the five years ending with 1978-79. They were to undertake a general review of the States' debt-position with particular reference to the Central loans advanced to the States and likely to be outstanding as at the end of 1973-74. The Commission was required to suggest changes in the existing terms of repayment having regard inter alia to the overall non-Plan gap of the States, their relative position and the purpose for which the loans have been utilized, and the requirements of the Centre. The Commission estimated that under the existing terms of loan repayments to the Centre, non-Plan capital deficits of the States would add up to nearly Rs. 1995 crores. It would lead the States either to unauthorised overdrafts from the Reserve Bank or to large scale diversion of Plan resources for meeting non-Plan obligations. The Commission, while taking into account the existing trends, estimated that at the end of March, 1974, the outstanding accommodation loans would stand at Rs. 89,194 lakhs. The Plan loans being also in staggering figures. Taking all these facts into consideration the Sixth Commission recommended the rescheduling of loan repayments by the State Governments to the Centre. It was done with the objective to ease the burden of

50. The recommendations was given effect to by the Union Government w.e.f. 1969-70.
51. This recommendation was also adopted w.e.f. April 1, 1969.
repayments on the States and thus to avoid non-Plan capital deficits over the Fifth Plan period. The Commission recommended:

"(a) Instead of giving large loans to the States for relief against natural calamities, they should be given large aid for the development of draught and flood prone areas. (b) The practice of giving special loans to States for covering their non-Plan gap be discontinued. (c) The existing outstanding loans should be consolidated into specific categories and terms of their repayment should be liberalized." With the objective of providing discriminatory debt relief, the Sixth Commission classified the States into three groups. Group A comprised States in whose case repayments to the Centre absorbed less than 10 per cent of their respective domestic products. Group B included States for which similar ratios fall between 10 to 20 per cent. Group C consisted all States with ratios exceeding 20 per cent. The periods of repayment recommended were longest for States in Group C and shortest in case of States in Group A.

In respect of the State's debts, the terms of reference of the Seventh Finance Commission were practically the same as those of the Sixth Commission. The Seventh Commission made far-reaching recommendations. They recommended Rs. 100.55 crores for all the States for meeting their revenue expenditure on natural calamities. After taking into account the non-Plan capital gap of the States on a uniform and comparable basis for the five years ending 1983-84, the Commission recommended the debt relief to the States.

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54. This recommendation was adopted and the Union budget for 1974-75 did not make any provision under the head and it resulted in the reduction of the gross loan to the States from Rs. 1576 crores as in 1973-74 to Rs.1075 crores in 1974-75. See Dr. Diwan, 151.
55. This recommendation was also adopted and the payment of block loans for State Plans, special accommodation loans, loans for relief against natural calamities and loans for clearing overdrafts, was rescheduled. See ibid.
to the tune of Rs. 2155.30 crores. The Table below shows the figures of the debt relief State-wise. At the end of 1978-79, the States’ debt amounted to Rs. 13463 crores. Of this, Rs. 943 crores were to be written off according to the Commission’s recommendations. Rs. 2693 crores were rescheduled to be payable over 15 years and another Rs. 7614 crores have been scheduled to be payable over 30 years.57

Table X(4)
Seventh Finance Commission’s Recommendations as to Debt Relief

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>States</th>
<th>Non-Plan capital gap as assessed by the Commission</th>
<th>Estimated debt relief suggested by the Commission</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Andhra Pradesh</td>
<td>271.96</td>
<td>135.63</td>
</tr>
<tr>
<td>2</td>
<td>Assam</td>
<td>150.61</td>
<td>112.20</td>
</tr>
<tr>
<td>3</td>
<td>Bihar</td>
<td>326.90</td>
<td>182.65</td>
</tr>
<tr>
<td>4</td>
<td>Gujarat</td>
<td>141.83</td>
<td>106.02</td>
</tr>
<tr>
<td>5</td>
<td>Haryana</td>
<td>87.31</td>
<td>38.29</td>
</tr>
<tr>
<td>6</td>
<td>Himachal Pradesh</td>
<td>35.10</td>
<td>30.37</td>
</tr>
<tr>
<td>7</td>
<td>Jammu and Kashmir</td>
<td>181.62</td>
<td>133.79</td>
</tr>
<tr>
<td>8</td>
<td>Karnataka</td>
<td>144.05</td>
<td>39.53</td>
</tr>
<tr>
<td>9</td>
<td>Kerala</td>
<td>157.14</td>
<td>115.09</td>
</tr>
<tr>
<td>10</td>
<td>Madhya Pradesh</td>
<td>245.15</td>
<td>147.34</td>
</tr>
<tr>
<td>11</td>
<td>Maharashtra</td>
<td>163.14</td>
<td>160.78</td>
</tr>
<tr>
<td>12</td>
<td>Manipur</td>
<td>14.72</td>
<td>11.85</td>
</tr>
<tr>
<td>13</td>
<td>Meghalaya</td>
<td>7.01</td>
<td>5.94</td>
</tr>
<tr>
<td>14</td>
<td>Nagaland</td>
<td>15.99</td>
<td>18.59</td>
</tr>
<tr>
<td>15</td>
<td>Orissa</td>
<td>175.47</td>
<td>36.48</td>
</tr>
<tr>
<td>16</td>
<td>Punjab</td>
<td>138.25</td>
<td>60.75</td>
</tr>
<tr>
<td>17</td>
<td>Rajasthan</td>
<td>280.00</td>
<td>137.98</td>
</tr>
<tr>
<td>18</td>
<td>Sikkim</td>
<td>0.78</td>
<td>0.66</td>
</tr>
<tr>
<td>19</td>
<td>Tamil Nadu</td>
<td>146.13</td>
<td>47.93</td>
</tr>
<tr>
<td>20</td>
<td>Tripura</td>
<td>9.19</td>
<td>10.55</td>
</tr>
<tr>
<td>21</td>
<td>Uttar Pradesh</td>
<td>593.53</td>
<td>367.63</td>
</tr>
<tr>
<td>22</td>
<td>West Bengal</td>
<td>227.30</td>
<td>191.93</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>3512.18</td>
<td>2155.30</td>
</tr>
</tbody>
</table>

The rescheduling of payments goes only half-way in solving the problem of the States' unmanageable indebtedness to the Centre, and provides merely a short-term solution. The real solution requires not only the rescheduling of the outstanding loans but also the rationalisation of the future loan provisions for which the responsibility falls on the Planning Commission and the National Development Council. The loan component of the Plan assistance is to be determined with regard to the remunerativeness of the assisted programmes. The ability of the State to repay its loans must also not be lost sight of. However the real and lasting solution lies in the herculean efforts on the part of the States, to boost the rate of growth and to economise in the expenditure and to stop all wasteful expenditure.

States Unauthorised Overdrafts and Special Accommodation Loans

It was at the beginning of Fourth Five Year Plan (1969-74), that the Planning Commission persuaded the Union Ministry of Finance to sanction 'Special Accommodation Loans' to States with overall non-Plan gaps. The Ministry having acceded to this request, initiated a scheme in April 1970, of 'Special Accommodation Loans' to meet the overall non-Plan gaps of some States. For this purpose, the Central Government provided Rs. 279 crores in 1969-70 and Rs. 195 crores in the budget of 1970-71. In the budget of 1971-72 Rs. 120 crores were sanctioned under this scheme. These loans, today, constitute the most significant single item of non-Plan assistance which is given outside the purview of the Finance Commission and the Planning Commission.

The need for initiation of the 'special accommodation loans' arose to enable the States to use the entire proceeds of their additional resource mobilisation for expenditure on development schemes. These loans, if taken to be available with the States to meet their non-Plan gaps, would appear to be additional non-Plan assistance provided to some States outside the recommendations of the Finance Commission. If it is assumed that the States should balance their overall non-Plan gaps from their own resources,

58. Dr. Diwan, 153.
including additional mobilisation, these loans appear as an additional Plan assistance given to some States outside the criteria approved by the National Development Council. In both cases, these loans add to the overall resources of the States receiving these and they may utilize these loans for meeting Plan or non-Plan expenditure. The scheme was protested to by some States (with no non-Plan gaps) in National Development Council meeting held in March 1970, as "a kind of bonus to improvident States". These States represented that "they were being made to suffer for having managed their finances better." 61

These special loans were given so as to solve the problem of unauthorised overdrafts. Yet, the problem persists and a number of States continued to incur overdrafts as discussed earlier.

Earlier to 1970, the Central Government used to give ad hoc loans to some States to enable them to clear their unauthorised overdrafts with the Reserve Bank. The new special loans serve the same purpose but with a difference that ad hoc loans were given to clear the already outstanding overdrafts whereas special accommodation loans seek to avoid overdrafts by anticipating them. The need for either arises out of the unsolved problem of unauthorised overdrafts.

Revenue-Yielding Capacity of the States' Debts and their Repayment

It has been observed that the underlying objective of resource transfers from the Centre to States as recommended by the Finance Commissions or the Planning Commission from time to time, has been to achieve equalization or reduction of regional disparities and to promote the levels of infrastructure development and services in different States. While so doing, the emphasis ought to be not just on raising the weaker States to the average level but on continuous process whereby the Units of varying spectrum keep continuously progressing, with disparities in the

60. Grewal, 169.
levels of development and financial strength among them getting progressively narrowed and eliminated. Loans from the Centre to States should also be given along with the normal devolution of taxes and grants with a view to achieve this national equilibrium. This requires that the States which have attained a higher level of development and are financially stronger, should receive Central assistance more in the form of loans, while other poorer States should receive the assistance more in the form of grants. If it is so done, the poor States can be saved from being crushed under the burden of interest and repayment of loans in their zeal to achieve the set standards of development. Unfortunately, under the present scheme of assistance from the Centre, the opposite is being done. The total Plan-assistance is distributed in the form of grants and loans in the ratio of 30:70 uniformly among all the States with exception of the State of Jammu and Kashmir in whose case the corresponding proportion is 90:10. It appears that the special treatment to Jammu and Kashmir is considered in view of the lower level of development and the financial weakness of the State. Thus in order, that the fundamental objective of equalisation is achieved, it is essential that the grant-loan ratio in the Central assistance must be allowed to vary according to the state of development in the receiving States.

Apart from rescheduling of repayments, the Central loans should be classified according to their remunerative capacity. From this standpoint, unremunerative or unproductive loans which will neither bring direct returns nor will have any direct income generating effect in future, should be treated as grants. This aspect of the matter was appreciated by the Second Finance Commission. The Fifth Finance Commission also observed: "It is no doubt desirable that such capital outlay as has been incurred on non-revenue-yielding assets should be written off to revenue over

63. These include for example, expenditure on meeting emergencies like floods, famine and draught conditions.
a suitable period of years..." But the Commission was not in a position to assess the extent to which the capital outlay should be treated as wholly unproductive. The Commission recommended that this examination should be entrusted to an expert Committee. The Sixth Finance Commission did deal with the question but observed that to write off old loans on the ground that they had been utilised for unproductive purposes would reduce the pool of resources available with the Centre. The conversion of the whole or part of the outstanding debt into grant on the basis of a distinction between productive and unproductive debt did not appear to the Commission a practicable proposition, for "on a closer look at the working results of the so called 'productive and unproductive schemes, the proposed classification between productive and unproductive debt would seem to have almost a touch of irony about it." However the Sixth Commission expressed their wish to seek to formulate any scheme of debt relief on the basis of a distinction between productive and unproductive debt. The Seventh Finance Commission analysed the problem in details and categorised the Central loans as productive, semi-productive and non-productive. The Commission agreed with the approach of the Sixth Commission that writing off of the States' debt burden to the Centre, as a general measure, might not be desirable except on a carefully selective basis as "it could well discourage conscious efforts on the part of the State Governments for mobilising tax and other resources sufficient to meet their requirements." But the Commission observed: "It appears logical that the Central loans applied to unproductive purposes should not be expected to be repaid, for the State Governments cannot get any return which would enable them to meet their interest liabilities, let alone repayment of the capital." The Commission, after

66. Ibid.
68. Id. at 85.
69. Ibid.
71. Ibid.
analyzing the position of the States for the last 12 years (i.e. from 1967-68 to 1978-79; from the year following the re-organization of the erstwhile State of Punjab) as regards the Central loans to the States, found that out of the total outstanding loans as stood at the end of the year 1978-79 (amounting to Rs. 13,462.84 crores), Rs. 9,426.82 crores involved expenditure on unproductive purpose. The Commission recommended for writing off of this amount of Central loans.\textsuperscript{72} It appears to be a significant development. It would be in the interest of sound debt management that all unproductive debts be taken out from the capital budget and the only way of getting rid of it is by writing off the loans advanced by the Centre for such purposes. For meeting such expenditure on unproductive uses, it would be desirable that Central assistance is given in the nature of grants than in the form of loans.

Indirect and partially remunerative debt relates to loans which are utilized for financing schemes which though raise the productive power and taxable capacity in a State but only in the long run, for example, schemes like agricultural improvements and research, industrial development, educational and health programmes, community development and national extension services. Such schemes cannot be called as completely non-productive but also not included in the category of self-liquidating projects. Investments on such projects are considered remunerative in the sense that these increase the taxable income in the future. In these cases, the debt can be repaid without an increase or with a smaller increase in the tax rates. These schemes are intended to increase the productive capacity in the States and thus should form part of the bigger National Plan and the Centre's assistance for them should come more in the form of grants than loans. However, a part of such assistance can be given by way of loans, but that too should carry concessional rate of interest.\textsuperscript{73}

\textsuperscript{72} Id. at 88.
\textsuperscript{73} Nanjundappa, 126.
The third category includes the self-liquidating debt relating to remunerative and productive schemes. Under this category projects like the multipurpose river valley schemes, irrigation and navigation schemes, electricity schemes, road transport schemes and housing schemes may be included. Such projects include the schemes which materialise and produce results within a short span of time and those which take possibly a longer time. This, therefore, is a case for some concessions being given for the long gestation period. By and large it is reasonable to expect payment of interest and repayment of loans falling under this category according to a set schedule.74

Conclusion

The problem of States indebtedness to the Centre has been noticed above. The various causes for the sorry state of the States' finances have been analysed. The disturbing aspect of the issue is that the States find themselves in an unenviable situation where they are not able to service and repay their debt without incurring additional debt. Such a situation has been causing great concern.

It has been noticed that it is the Central loans that are mainly responsible for the existing problem which in turn is an expression of the gap inherent between the States' resources and expenditure. As the States do not have any revenue for amortization of Central loans, loan repayments are financed almost exclusively from fresh borrowings. This extension of more loans or special accommodation loans to the States is no solution. On the contrary, by further increasing their indebtedness to the Centre, those loans may ultimately aggravate the problem they are intended to solve.

The inadequacy of amount and faulty composition of the Central transfers to the States increase the liability of the State Governments on debt servicing and repayments. As a general rule, the Finance Commission does not take into consideration the plan schemes while recommending grants-in-aid. With increasing plan activities, transfers through the recommendations of the Planning Commission have increased and form a much bigger proportion of

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74. Ibid.
the total. Plan assistance is extended to the States in terms of block grants and loans in the ratio of 30 to 70. These proportions are adhered to irrespective of the purpose for which plan assistance may be needed. The Finance Commissions have avoided recommending grants big enough to provide a cushion to the State budgets for meeting increase in expenses due to rising prices, higher emoluments of the employees and for meeting natural calamities which occur so frequently in different parts of the country. The required additional assistance flows mainly in the form of loans. Unfortunately, even assistance for relief against natural calamities is often in the form of Central loans though these loans are not self-liquidating in any sense.

The approach of the Finance Commission appears to be the one in which no deliberate effort is made to create revenue surpluses for the States through tax-sharing. In this exercise, the States are looked at as agencies with inherent financial imprudence who are prone to squander away any additional resources which might come their way. With this end in view their budgetary forecasts are scrutinized with utmost care and many legitimate parts of projections are scored out. The net result is that in the calculations of the Finance Commissions, many States appear to have surplus on non-Plan revenue account for the projected period, while in reality they may realize deficits. Furthermore, the Finance Commission while recommending tax-sharing as between the States inter se, brings in the need factor. This approach redistributes the States' share in favour of the poorer States but not to their advantage. Reason being that grants-in-aid are recommended to fill in the non-Plan revenue gap only and they get reduced in the case of poorer States getting a larger share out of tax proceeds. Since the revenue surplus States do not qualify for grants-in-aid on account of such surplus, they lose through reduced tax devolution.

Besides, in the past, the non-Plan capital requirements of the States have not been covered by either the Finance Commission
or the Planning Commission. The first three Finance Commissions took into account both plan and non-plan revenue requirements of the States, while the next three Finance Commissions restricted by their terms of reference to only the non-plan revenue requirements. Only the Seventh Finance Commission, being specifically asked, took into consideration the non-Plan capital requirements also. The Planning Commission, naturally, covers only the plan requirements. This leaves the non-Plan capital requirements of the States as no body's responsibility.

The States are additionally contributing to the process through their unauthorised overdrafts. They do not see any serious danger in having recourse to such measure for these overdrafts are being cleared by the Centre as a matter of routine. This practice has inculcated a spirit of indifference to fiscal prudence in the States. They are no longer keen to improve the financial working of their electricity boards or make the irrigation projects and other investments paying enough, nor do they show any inclination towards taxing the agricultural sector.

All told, however, a kind of vicious circle has developed in which the problem of mounting State indebtedness to the Centre is feeding upon itself. The complexity of the problem and the need for solving it has been voiced from time to time. The Sixth Finance Commission recommended that loans given to the States should be properly classified into specific categories, particularly between productive and non-productive and terms of repayment should be liberalized. The Seventh Finance Commission also found it logical that the Central loans applied to unproductive purpose should not be expected to be repaid, for the State Government cannot get any return which would enable them to meet their interest liabilities, let alone repayment of the capital. The Commission, therefore, recommended to write off a sum of Rs. 943 crores out of the total outstanding debt of Rs. 13463 crores and Rs. 2693 crores have been rescheduled to be payable over 15 years and another Rs. 7614 crores over 30 years.
This does provide a short-term relief. But there does not seem to be any real and lasting solution to this permanent problem of State indebtedness. The proper solution, it is suggested, lies in rescheduling the existing debt of the States and rationalising the policy of making new loans to them. As a large part of these loans goes to finance the development expenditure, these loans should be given on sound principles.

The Planning Commission, in the past, has given assistance through grants and loans on rather arbitrary principles. It recommended discretionary assistance to the States without making known the principles on which such assistance was based. It is suggested that the Planning Commission should approve plan schemes on capital account and classify them into remunerative and non-remunerative, the former to be financed through loans, while the latter should qualify for grants. All the more, it requires change of approach of all the concerned parties, the Finance Commission, the Central Government and the State Governments.