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EXAMINING THE LEGAL BASIS FOR THE CONDITIONS THAT THE GOVERNMENT OF INDIA MAY IMPOSE ON STATES WHILE PROVIDING CONSENT UNDER ARTICLE 293(3) OF THE CONSTITUTION

Report to the Fifteenth Finance Commission

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Table of Contents

CHAPTER 1: INTRODUCTION AND CONTEXT SETTING 1

CHAPTER 2: ARTICLE 293 IN THE CONTEXT OF SUBNATIONAL BORROWING REGULATION IN INDIA 3

A. Constitutional scheme 3

1. *Historical background* 3
2. *Analysis of the present Article 293* 5

B. Larger architecture of regulation 8

1. *Finance Commission* 9
2. *Reserve Bank of India* 10
3. *Central Fiscal Responsibility Legislation* 13
4. *State Fiscal Responsibility Legislations* 14

CHAPTER 3: POLICY CONSIDERATIONS IN SUBNATIONAL BORROWING REGULATION 16

A. The Decentralisation Dilemma 16

B. Designing Fiscal Incentives for States and Prospective Creditors 19

CHAPTER 4: THE INDIAN EXPERIENCE WITH SUBNATIONAL BORROWING REGULATION 22

A. Developments in Subnational Borrowing Regulation 22

1. *Impact of Twelfth Finance Commission Recommendations on the Fiscal Health of Indian States* 23

B. Institutional Response to the Global Economic Recession of 2008 24

C. Recent Developments: Fourteenth Finance Commission Recommendations and FRBM Review Committee Report 25

D. Future Outlook for Subnational Borrowing Regulation 28

CHAPTER 5: INTERNATIONAL PRACTICE IN SUBNATIONAL BORROWING REGULATION 32

A. Ex-Ante Regulations 32

1. *Market Discipline* 32
2. *Fiscal Rules* 34

3. *Centralised Administrative Regulation* *36*
4. *Cooperative Regulation* *37*
B. Ex-Post Regulations 37
C. Conclusion and Relevance for India 39

CHAPTER 6: RECOMMENDATIONS ON THE EXERCISE OF ARTICLES 293(3) AND (4) 43

A. Review of Findings 43
B. Subsidiarity in the Regulation of State Borrowing 44
C. Proposed Regulatory Structure 45
1. *Layer 1: Market Discipline* *46*
2. *Layer 2: State-Level Mechanisms* *47*
3. *Layer 3: Centralised Regulation* *48*
4. *Significance of and Exceptions to the Proposed Regulatory Structure* *49*
D. Recommended Criteria/Conditions Under Articles 293(3) and (4) 50
E. Recommendations for when States will no longer be indebted to the Centre 54

CHAPTER 7: CONCLUSION 57

ANNEXURE 1: SURVEY OF STATE FISCAL RESPONSIBILITY LEGISLATIONS AND RULES I

A. Table 1: Fiscal Indicators and Targets i
B. Table 2: Transparency Mechanisms iv
C. Table 3: Enforcement Measures vii
D. Table 4: Supplementary Measures to ensure Fiscal Discipline x

CHAPTER 1: INTRODUCTION AND CONTEXT SETTING

Over the past two decades, there has been a trend towards greater fiscal decentralisation in India, particularly with respect to subnational borrowing. This is reflected, *inter alia*, by the substantial share of market borrowings in the overall borrowing profile of the States,[1] replacing loans from the Centre which used to be the predominant source of funding in this regard.[2] It is also reflected in the enactment of Fiscal Responsibility Legislations (FRLs) at State-level.[3] These changes have led to States not only getting more freedom, but also demanding greater responsibility in managing their debts. In view of this inherent tension associated with fiscal decentralisation, the right balance between autonomy and macroeconomic fiscal stability needs to be struck. For this purpose, it becomes necessary to review the existing constitutional, legal, and institutional architecture of subnational borrowing regulation in India to identify where gaps emerge and how they can best be filled.

Article 293 of the Constitution of India covers borrowing by State Governments. Under clauses (3) and (4) of Article 293, State Governments need to obtain the consent of the Centre for raising fresh loans in case they are indebted to the latter, and such consent may be granted subject to conditions. The Fourteenth Finance Commission (FC-XIV) in its report noted the possibility of States being no longer indebted to the Centre in the future, such that the Centre would be unable to exercise its powers regarding consent and conditions as aforesaid. However, it concluded that such a situation will by and large not arise till 2030 (except in two States where it will arise by 2025). Since these dates were outside its award period, FC-XIV did not examine this issue.[4] Therefore, for now, the mechanism established by this constitutional provision remains relevant. It is worth noting that FC-XIV did not give any guidance or recommendation regarding the power to impose conditions under Article 293(4). However, the terms of reference of the Fifteenth Finance Commission (FC-XV) require it to make recommendations on this question.[5]

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[1] The share of market borrowings by States in financing Gross Fiscal Deficit was a substantial 66.1% in 2017-18. *See* RBI, 'Annual Report' (2018) ch VII, para VII.16, available at https://www.rbi.org.in/Scripts/AnnualReportPublications.aspx?Id=1234 (last accessed 29 October 2018).

[2] C. Rangarajan and Abha Prasad, 'Managing State Debt and Ensuring Solvency: The Indian Experience' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013) at pp. 115-116.

[3] Report of the Fourteenth Finance Commission (2015-20) (December 2014), at para 4.1

[4] Report of the Fourteenth Finance Commission (2015-20) (December 2014), at para 14.103.

[5] The Gazette of India: Extraordinary, 'Notification number S.O. 3755(E)', Department of Economic Affairs, Ministry of Finance, Government of India (27 November 2017) para 6(vi), available at http://www.egazette.nic.in/WriteReadData/2017/180483.pdf (last accessed 29 October 2018).

In light of this, FC-XV has sought a report on 'Examining the legal basis for the conditions that the Government of India may impose on the States while providing consent under article 293(3) of the Constitution'. Specifically, the following queries have been raised by FC-XV for our consideration.

1. What is the status of Article 293(3) and its impact on state finances?
2. Based on a study of relevant international practices:
   a. What are the alternative arrangements, if any, which may exist in other similarly placed countries in terms of federal fiscal arrangements, and may be applicable in India?
   b. What are the potential conditions that may be imposed by the Central Government on State Governments for giving consent under Article 293(3)?

This report is broadly structured in the following manner. Chapter 2 covers Article 293 in the context of subnational borrowing regulation in India, analysing the historical background and provisions thereof, particularly the scope of conditions which may be imposed under Article 293(4) from a legal perspective. It also surveys the existing institutional and legal architecture of subnational borrowing regulation in India. Chapter 3 analyses the relevant policy considerations in this regard, focusing on the decentralisation dilemma. In light of this, the question of designing appropriate fiscal incentives for States and creditors is considered. Chapter 4 studies the peculiarities of the Indian experience with subnational borrowing regulation in order to determine the particular constraints, policy objectives, and concerns in this regard and to determine an appropriate path for reforms.

Chapter 5 surveys the international practice on this subject, covering various types of ex-ante and ex-post regulations employed across the world, as well as their relevance to the Indian context. Chapter 6, drawing from the conclusions of the previous chapters, recommends an alternative fiscal arrangement that India can employ to effectively regulate subnational borrowing, and lists out the potential criteria and conditions which may be imposed under Articles 293(3) and (4). It also provides recommendations to adequately cater to a scenario where States are no longer indebted to the Centre. Lastly, chapter 7 contains key conclusions of the report. The report is supplemented by an annexure containing 4 tables which carry out a study of the provisions contained in all State FRLs. Please note that this report is primarily a legal study and does not exhaustively deal with all macroeconomic issues arising in relation to the subject matter under study.

Chapter 2: Article 293 in the context of Subnational Borrowing Regulation in India

Subnational borrowing in India is regulated by various constitutional provisions, central and state legislations, as well as by institutions such as the Finance Commission and the Reserve Bank of India (RBI). This chapter aims to facilitate a broad and thorough understanding of the various mechanisms currently in place which regulate borrowing by States. It is divided into two parts. The first part contains a historical background and analysis of the constitutional scheme governing subnational borrowing. The second part surveys the larger architecture of subnational borrowing regulation, and to this end covers the roles played by the Finance Commission, RBI, and the Central and State FRLs.

A. Constitutional scheme

Chapter II in Part XII of the Constitution of India deals with borrowing. Article 292 covers borrowing by the Central Government, and Article 293 covers borrowing by States.[6] One of the objectives of this report is to understand the scope of constitutionally permissible conditions (under Article 293(4)) which the Central Government can place on State borrowing. Article 293 has seldom been interpreted by courts.[7] In light of this, its history and background may be traced to ascertain the intention of the drafters, and its provisions may be analysed accordingly.

1. Historical background

[6] Article 293 reads,
"Borrowing by States
(1) Subject to the provisions of this article, the executive power of a State extends to borrowing within the territory of India upon the security of the Consolidated Fund of the State within such limits, if any, as may from time to time be fixed by the Legislature of such State by law and to the giving of guarantees within such limits, if any, as may be so fixed.
(2) The Government of India may, subject to such conditions as may be laid down by or under any law made by Parliament, make loans to any State or, so long as any limits fixed under article 292 are not exceeded, give guarantees in respect of loans raised by any State, and any sums required for the purpose of making such loans shall be charged on the Consolidated Fund of India.
(3) A State may not without the consent of the Government of India raise any loan if there is still outstanding any part of a loan which has been made to the State by the Government of India or by its predecessor Government, or in respect of which a guarantee has been given by the Government of India or by its predecessor Government.
(4) A consent under clause (3) may be granted subject to such conditions, if any, as the Government of India may think fit to impose."

[7] Nirvikar Singh, 'Fiscal Federalism' in Sujit Choudhry, Madhav Khosla, and Pratap Bhanu Mehta (eds), *The Oxford Handbook of the Indian Constitution* (Oxford University Press, 2016) at p. 536.

The origin of Article 293 can be traced to the Government of India Act, 1935 (GoI Act, 1935).[8] Specifically, clauses (1) and (2) of Article 293 substantially reproduce sub-sections (1) and (2) of Section 163 of the GoI Act, 1935, and clauses (3) and (4) of Article 293 are derived from sub-section (3) of Section 163 of the GoI Act, 1935. The mechanism under the GoI Act, 1935 enabled a considerable degree of central control over provincial autonomy.

There are two notable differences. Firstly, in the GoI Act, 1935, sub-section (3) of Section 163 allowed Provinces to raise loans from outside India with the consent of the Federation. Under Article 293, States cannot borrow from outside India, as the States' borrowing power is specifically limited to "within the territory of India".[9] Secondly, sub-section (4) of Section 163 in the GoI Act, 1935 was not incorporated in the present Article 293. It had provided, *inter alia,* that consents required to be obtained by the Provinces from the Federation under previous sub-sections could not be unreasonably withheld, and neither could the conditions imposed be unreasonable. In case of disputes over the same, the matter was to be referred to the Governor-General, whose decision would be final.

Articles 268 and 269 of the Draft Constitution, which later became Articles 292 and 293 respectively in the present Constitution, were discussed at length in the Constituent Assembly. During these discussions, Shri Ananthasayanam Ayyangar addressed the omission of sub-section (4). He explained that the establishment of a national government, which would replace the foreign power which used to

[8] Section 163 reads,
"Borrowing by Provincial Governments
(1) Subject to the provisions of this section, the executive authority of a Province extends to borrowing upon the security of the revenues of the Province within such limits, if any, as may from time to time be fixed by the Act of the Provincial Legislature and to the giving of guarantees within such limits, if any, as may be so fixed.
(2) The Federation may, subject to such conditions, if any, as it may think fit to impose, make loans to, or, so long as any limits fixed under the last preceding section are not exceeded, give guarantees in respect of loans raised by, any Province and any sums required for the purpose of making loans to a Province shall be charged on the revenues of the Federation.
(3) A Province may not without the consent of the Federation borrow outside India, nor without the like consent raise any loan if there is still outstanding any part of a loan made to the Province by the Federation or by the Governor-General in Council, or in respect of which a guarantee has been given by the Federation or by the Governor-General in Council. A consent under this subsection may be granted subject to such conditions, if any, as the Federation may think fit to impose.
(4) A consent required by the last preceding subsection shall not be unreasonably withheld, nor shall the Federation refuse, if sufficient cause is shown, to make a loan to, or to give a guarantee in respect of a loan raised by, a Province, or seek to impose in respect of any of the matters aforesaid any condition which is unreasonable, and, if any dispute arises whether a refusal of consent, or a refusal to make a loan or to give a guarantee, or any condition insisted upon, is or is not justifiable, the matter shall be referred to the Governor-General and the decision of the Governor-General in his discretion shall be final."
[9] Constitution of India, 1950, Article 293(1).

administer the country, rendered this sub-section unnecessary.[10] Even the requirement that unreasonable conditions should not be imposed was thus considered unnecessary. Evidently, the drafters were comfortable with giving more control to the Central Government over the States post-independence regarding sub-national borrowing.

Some general observations regarding these borrowing provisions were also made in the Constituent Assembly. Shri K.T. Shah and Dr. B.R. Ambedkar stated that borrowing is an executive act. Dr. Ambedkar further clarified that this executive power is not unfettered as it will be subject to law.[11] It is worth nothing that at the time when the provision regarding consents and conditions for borrowing was under consideration, seven out of the nine Provinces had outstanding loans. Yet, the Provincial Governments evidently did not believe that this put them unduly in the grip of the Central Government and did not oppose either the consent mechanism or the power to impose conditions.[12]

It may also be relevant to note that the Constituent Assembly had appointed an 'Expert Committee on the Financial Provisions of the Union Constitution'. This committee in its report had observed that the Provinces should possess freedom to borrow from the open market, as the market would provide effective credit ratings and thus bring about fiscal responsibility.[13] For the purpose of fixing an order of priority for borrowings and preventing unnecessary competition between different Provincial Governments, it considered setting up an expert machinery such as a Ministerial Conference or a Loan Council.[14] Ultimately, the committee did not recommend such an arrangement as it felt that co-ordination by the RBI was sufficient for this purpose.[15]

2. Analysis of the present Article 293

Article 293 contains four clauses. Clause (1) extends the executive power of a State to borrowing and to giving guarantees. However, both these powers are subject to any limits which the State Legislature may fix by law. Additionally, and unlike in the case of the Centre under Article 292, the borrowing power of States under this clause is applicable only "within the territory of India". Under clause

[10] *See* Constituent Assembly Debates, Vol 9, speech by Shri Ananthasayanam Ayyangar, 10th August 1949, available at http://cadindia.clpr.org.in/constitution_assembly_debates/volume/9/1949-08-10 (last accessed 20 October 2018).
[11] *See* Constituent Assembly Debates, Vol 9, speech by Dr. B.R. Ambedkar, 10th August 1949, available at http://cadindia.clpr.org.in/constitution_assembly_debates/volume/9/1949-08-10 (last accessed 20 October 2018).
[12] Granville Austin, *The Indian Constitution: Cornerstone of a Nation* (9th edn, 2005) at p. 233.
[13] For a discussion on market discipline, *see* chapter 5.
[14] For a discussion on similar mechanisms that exist in some other countries, *see* chapter 5.
[15] *See* Report of the Expert Committee on Financial Provisions, December 5, 1947, in B. Shiva Rao (ed) *The Framing of India's Constitution: Select Documents* (Universal Law Publishing 2012), Vol 3, 260, 282-3.

(2), the Centre may make loans to any State, subject to conditions which Parliament may specify by law. The Centre may also give guarantees in respect of loans raised by States, but this is also subject to limits which in this case Parliament may have fixed under Article 292.

Clauses (3) and (4) set some limitations. Under clause (3), if a loan made to the State directly by the Centre is outstanding or if the Centre has guaranteed any other outstanding loan taken by the State, no fresh loan can be raised by the State without the consent of the Centre, which by virtue of clause (4), it may grant subject to conditions. Therefore, from a plain reading of Article 293, it follows that the executive borrowing power of the State has been limited by making it subject to their legislatures, limiting it to within India, and subjecting it to the consent and conditions of the Centre when States are indebted to it.

(a) Scope of conditions which may be imposed under Article 293(4)

A relevant question for consideration is, what is the scope of the conditions which may be imposed under clause (4) of Article 293. This clause has not been interpreted by courts so far, and it appears that different interpretations may be possible.

On the one hand, it may be argued that the power to impose conditions under clause (4) is completely unfettered. A plain interpretation can hold that, since clause (4) does not explicitly limit the scope of possible conditions and allows for such condition as the Central Government may "think fit to impose", there is no textually envisaged limit to the exercise of such power.[16]

On the other hand, it may be possible to argue that the conditions under clause (4) must necessarily be directly related to the specific loan for which consent under clause (3) is given.[17] For example, if consent under clause (3) is sought for the purpose of market borrowing, then conditions under clause (4) should perhaps be imposed with respect to that specific instance of borrowing only. However, attaching conditions relating to the State's power of giving guarantees generally,

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[16] Even if the language of clause (4) itself does not limit its scope, a question can arise whether certain conditions imposed under the same could circumscribe State autonomy in conflict with other constitutional provisions. Specifically, it is worth noting that Article 162 defines the State's executive power as being co-extensive with the law-making power of its legislature, and under entry 43 of List II and Article 293(1), all States have passed FRLs. This would mean that managing the public debt of the States, including decisions over borrowing, forms part of the executive power of the State. However, Article 162 is qualified by the phrase, "Subject to the provisions of this Constitution", which indicates that Article 293(4) should have precedence over it. Hence, even when read with Article 162, Article 293(4) remains unfettered.

[17] RBI, 'Report of the Technical Committee on State Government Guarantees' (1999), ch 3, para 3.3, available at https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=17 (last accessed 27 October 2018).

due to it being unrelated to the transaction for which consent is being sought, will, perhaps, not be possible as per this interpretation.[18]

In addition to the above, it may also be possible to read certain implied limitations in clause (4). This may be done in two ways. First, in light of purposive interpretation, it is worth noting that the requirement of obtaining consent under clause (3) is applicable only when a State is either indebted to the Centre, or when repayment of a loan taken by the State which the Centre has guaranteed remains outstanding. This suggests that a possible purpose of this provision is to protect the rights of the Centre in its capacity as a creditor. Apart from this, a broader purpose of creating a mechanism to facilitate macroeconomic stability may also be discernible, as State indebtedness negatively affects general government debt, i.e. the fiscal health of the nation as a whole. Since clause (4) enables the Central Government to impose conditions only when granting consent under clause (3), reading these two clauses together suggests that such conditions should also be limited to questions of State indebtedness and macroeconomic stability. In other words, conditions which do not pertain to State indebtedness and which have no fiscal stabilising effect would be beyond the ambit of clause (4). This would mean that a condition pertaining to the State's power of giving guarantees can be sustainable under this interpretation, as such a condition can have a fiscal stabilising effect. However, a condition that a State should, for instance, spend the amount obtained by borrowing necessarily and exclusively for the purpose of developing its police force, would not be sustainable.

Second, the principle of federalism may prove to be a relevant consideration when reading possible implied limitations into clause (4).[19] The case of *S.R. Bommai v Union of India*,[20] where it was held that the President's power to declare emergency in a State is not absolute, provides a useful illustration in this regard.[21] Article 356 confers this power in the event of failure of constitutional machinery in a State. In interpreting this Article, the Supreme Court of India held that since federalism is part of the basic structure of the Constitution,[22] any specific provision that has the effect of impinging on this federal character of the Constitution should be interpreted narrowly. Such interpretation should aim to preserve federalism and ensure that powers reserved to States are not whittled

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[18] RBI, Report of the Technical Committee on State Government Guarantees (1999), ch 3, para 3.3, available at https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=17 (last accessed 27 October 2018).

[19] Federalism is seen as a structural principle underlying and connecting various constitutional provisions, giving it coherence. *See Nagaraj v Union of India*, (2011) 6 SCC 535.

[20] *S.R. Bommai v Union of India*, (1994) 3 SCC 1.

[21] For another illustrative example, *see Government of NCT of Delhi v Union of India*, (2018) 8 SCC 501.

[22] This was also observed in *Government of NCT of Delhi v Union of India*, (2018) 8 SCC 501, and *Kuldip Nayar v Union of India*, (2006) 7 SCC 1.

down. Accordingly, the exercise of power conferred by such a provision should be strictly confined to the purposes and circumstances mentioned therein.[23]

By analogy, it may be possible to argue that conditions imposed under clause (4) of Article 293 should not impinge on the federal character of the Constitution, beyond what is strictly required for the purposes of that provision. As discussed above, a purposive reading of clauses (3) and (4) together suggests that the purpose behind the same is to protect the Central Government's rights as a creditor, and to provide a mechanism for regulation of subnational debt in the interest of maintaining macroeconomic fiscal stability. The same conclusion regarding implied limitations is therefore reached via both approaches, which is that since State borrowing is subjected to the control of the Centre only when the former is indebted to the latter, such control should be exercised strictly in light of this indebtedness, for overall fiscal health only, and not for any other purpose.

In summary, it is evident that a wide range of interpretations may be possible when considering the scope of clause (4) of Article 293. Bearing in mind that, so far, this specific issue arising under clause (4) does not appear to have been interpreted by any court, the Central Government should be particularly mindful of the possibility of a narrow, purposive interpretation of the same. In light of this, it is advisable that the Central Government adopts a conservative approach and limits the scope of any conditions it may impose on states to only such conditions which pertain to State indebtedness and macroeconomic fiscal stability.

B. Larger Architecture of Regulation

The constitutional scheme as explained in the previous part is being implemented by various means. This part will cover the manner in which this is being done, as well as the other elements which, at present, play a decisive role in subnational borrowing regulation. Recommendations made by the Finance Commission appear to be one of the factors considered by the Central Government when taking decisions regarding consent and conditions under clauses (3) and (4) respectively of Article 293. Additionally, the RBI in its capacity as banker to the State Governments and regulator of the Government securities market also plays a key role. FRLs have been passed at the Central and State levels to regulate borrowing, which indirectly and directly have an effect on subnational borrowing.[24]

[23] *S.R. Bommai v Union of India*, (1994) 3 SCC 1, Per P.B. Sawant, J. at para 106. *See also* paras 96, 158, and 276. *See also ITC Ltd. v Agricultural Produce Market Committee*, (2002) 9 SCC 23 and *International Tourist Corporation v State of Haryana*, (1981) 2 SCC 318. For a contrary argument, *see Jindal Stainless Steel Ltd. v State of Haryana*, (2017) 12 SCC 1.

[24] In addition to these, the Central Government has also taken some measures to simplify the consent mechanism from time to time. For instance, since August 2016, States need to obtain consent from the Centre under Article 293(3) for open market borrowings only thrice a year, namely in April, December, and March. In addition to this, in June 2018, the Centre decided to

1. Finance Commission

The Finance Commission is a constitutional body that makes recommendations regarding various matters such as vertical and horizontal distribution of tax proceeds, principles governing grants-in-aid, etc.[25] It is constituted every five years by a Presidential order which specifies its terms of reference. Recent Finance Commissions have focused on increasing fiscal discipline in subnational borrowing through aggregate borrowing caps and a shift from discretionary lending or on-lending by the Centre to more market-mediated borrowing by the States.[26] This has been such a consistent practice that it would be appropriate to describe it as the zeitgeist of recent federal fiscal policy.

FC-XIV also made some recommendations in this regard. For its award period of 2015-20, FC-XIV recommended that the fiscal deficit of all States should be maintained at an annual limit of 3% of their Gross State Domestic Product (GSDP). Over and above this ceiling, States can be eligible for an extra 0.25% for any given year if their debt to GSDP ratio is less than or equal to 25% in the preceding year. Additionally, another 0.25% can also be availed if interest payments are less than or equal to 10% of revenue receipts in the preceding year. Thus, a State can have a maximum fiscal deficit of 3.5% of their GSDP for any given year. The flexibility in availing the additional limits under either or both of the above two options would only be available to a State if there is no revenue deficit in the year in which borrowing limits are to be fixed, and in the immediately preceding year. In case a State does not fully utilise its 3% limit, the unutilised portion can be carried forward to the next year, provided it is within the aforesaid award period.[27]

However, it is worth noting that Finance Commission recommendations are, strictly speaking, only advisory in nature, and the Central Government is not bound

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independently process each State proposal for availing additional borrowing limits as and when such proposals were received. This was done to avoid the delays which used to occur previously, when such proposals received from different States in different intervals were bunched together into a consolidated approval. *See* Press Information Bureau, 'Central Government decides to simplify the consent mechanism for Open Market Borrowings (OMBs) under Article 293(3) of the Constitution of India for raising OMBs by the States', Ministry of Finance, Government of India (18 August 2016), available at http://pib.nic.in/newsite/PrintRelease.aspx?relid=149010 (last accessed 18 October 2018); Press Information Bureau, 'Government of India simplifies the process for permission of Additional Fiscal Deficit Limit over and above 3% of Gross State Domestic Product for the States (GSDP)' Ministry of Finance, Government of India (25 June 2018), available at http://pib.nic.in/newsite/PrintRelease.aspx?relid=180163 (last accessed 30 October 2018).

[25] *See* Constitution of India, Article 280; *See also* the Finance Commission (Miscellaneous Provisions) Act, 1951.

[26] Nirvikar Singh, 'Fiscal Federalism' in Sujit Choudhry, Madhav Khosla, and Pratap Bhanu Mehta (eds), *The Oxford Handbook of the Indian Constitution* (Oxford University Press, 2016) at p. 527.

[27] Report of the Fourteenth Finance Commission (2015-20) (December 2014), at para 14.64.

to implement them.[28] Under Article 281, the President has to lay before Parliament every recommendation made by the Commission, along with an explanatory memorandum as to the action taken thereon.[29] Thus, the Constitution confers upon Parliament the authority to oversee the implementation of these recommendations.[30] However, by convention, Finance Commission recommendations have largely been treated as binding over time.[31]

FC-XIV in its report stated that it expected the Central Government to enforce the fiscal roadmap outlined by it through the latter's powers to approve State borrowings under Article 293(3).[32] It does appear that the power conferred upon the Central Government under Article 293(3) is, indeed, being used for this purpose.[33] Therefore, it may be said that indirectly, the Finance Commission plays an integral role in regulating subnational borrowing.

As far as clause (4) of Article 293 is concerned, there does not appear to be any indication or clarity on whether and to what extent the Central Government is imposing conditions while according its consent under Article 293(3). Moreover, FC-XIV in its report did not give any guidance or recommendation regarding this clause. It may be relevant to note in this context that the terms of reference of FC-XV require it to make recommendations regarding the conditions that the Centre may impose on the States while providing consent under Article 293(3).[34]

2. Reserve Bank of India

The RBI is statutorily mandated to manage the public debt of the Central Government.[35] In case of States, the RBI may, by agreement with State

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[28] M. P. Jain, *Indian Constitutional Law* (Updated 6th edn, LexisNexis Butterworths Wadhwa 2013), Vol 1, 938.

[29] Nothing is contained in Articles 280 and 281 of the Constitution of India to indicate that the recommendations of the Finance Commission acquire the force of law after being laid before both Houses of Parliament in the manner required by Article 281. *See* Arvind P. Datar, *Commentary on the Constitution of India* (2nd edn, LexisNexis Butterworths Wadhwa 2010), Vol 1, 1581. For a contrary argument, *see P. Bhuvaneswaraiah v State of Mysore*, AIR 1965 Kant 170.

[30] M. P. Jain, *Indian Constitutional Law* (Updated 6th edn, LexisNexis 2013), Vol 1, 938.

[31] Granville Austin, *The Indian Constitution: Cornerstone of Nation*, (2015) at pp. 274-275; *See also* Nirvikar Singh, 'Fiscal Federalism' in Sujit Choudhry, Madhav Khosla, and Pratap Bhanu Mehta (eds), *The Oxford Handbook of the Indian Constitution* (Oxford University Press, 2016) at p. 536.

[32] Report of the Fourteenth Finance Commission (2015-20) (December 2014), at para 14.64.

[33] The Public Finance (States) Division in the Department of Expenditure, Ministry of Finance, specifies "the enforcement of the fiscal roadmap mandated by Finance Commissions through the powers to approve borrowings by States under Article 293(3)" as one of its functions. *See* Department of Expenditure, Ministry of Finance, Government of India, 'Public Finance (States) Division', available at https://doe.gov.in/public-finance-states-division (last accessed 15 October 2018).

[34] The Gazette of India: Extraordinary, 'Notification number S.O. 3755(E)', Department of Economic Affairs, Ministry of Finance, Government of India (27 November 2017) para 6(vi), available at http://www.egazette.nic.in/WriteReadData/2017/180483.pdf (last accessed 29 October 2018).

[35] RBI Act 1934, Section 20; Public debt management involves formulating and executing a strategy for managing government debt, in order to raise the required amount of funding within cost/risk

Governments undertake the management of their public debt.[36] It is worth noting that the RBI has entered into such agreements with all States, except Sikkim.[37] The RBI is authorised to act as an agent of the Central and State Governments for the issue and management of the latter's bonds and debentures,[38] and also to carry on and transact the lending or borrowing of their securities.[39] The Internal Debt Management Department of the RBI performs various functions in this regard, including floating State Government loans, facilitating investment of surplus cash balances of State Governments in dated securities under various funds, etc.[40] It is also authorised to make Ways and Means Advances (WMAs) to the Centre and States, and to fix the limits thereof. [41]

Apart from acting as a banker to State Governments as discussed above, the RBI also has regulatory power over the government securities market.[42] This is in addition to its power to regulate transactions in securities, derivatives and money market instruments.[43] To this end, it carries out market development activities such as introducing new instruments, developing trading platforms and clearing and settlement systems, and widening the investor base.[44] Since 2006-07, market borrowings of State Governments have been carried out entirely through auctions conducted by the RBI, through issuance of bonds by the State Governments called State Development Loans (SDLs).[45] The share of market borrowings by States in financing Gross Fiscal Deficit was a substantial 66.1% in 2017-18, and gross market borrowings had increased by 9.7%.[46] One example of the extent of RBI control in

objectives. It includes cash and liquidity management of governments and development of a liquid and deep market for government securities to facilitate cost reductions of public debt. *See* RBI, 'Manual on Financial and Banking Statistics - March 2007' (2007), ch 7, available at https://m.rbi.org.in/Scripts/PublicationsView.aspx?id=9483 (last accessed 26 October 2018).

[36] RBI Act 1934, Section 21.

[37] RBI, 'Frequently Asked Questions: RBI as Banker to Government' (2017), available at https://rbi.org.in/Scripts/FAQView.aspx?Id=61 (last accessed 22 October 2018).

[38] RBI Act 1934, Section 17(11)(f); *See also* Government Securities Act, 2006 read with Government Securities Regulations, 2007.

[39] RBI Act 1934, Section 17(12AA).

[40] RBI, 'Internal Debt Management Department' (2009), available at https://rbi.org.in/scripts/PublicationsView.aspx?id=11356 (last accessed 22 October 2018).

[41] RBI Act 1934, Section 17(5); WMAs are temporary loan facilities provided by the RBI to Governments, to help them tide over temporary mismatches in the cash flow of their receipts and payments. *See* RBI, 'Report of the Informal Advisory Committee on Ways and Means Advances to State Governments' (1999), ch 2, available at http://www.rbi.org.in/SCRIPTs/PublicationReportDetails.aspx?UrlPage=&ID=6 (last accessed 23 October 2018).

[42] The Central Government delegated its powers in this regard to the RBI in 2000, by a notification issued under Section 16 read with Section 29A of the Securities Contracts (Regulation) Act, 1956.

[43] RBI Act 1934, Section 45W.

[44] RBI, 'Internal Debt Management Department' (2009), available at https://rbi.org.in/scripts/PublicationsView.aspx?id=11356 (last accessed 22 October 2018).

[45] RBI, 'Internal Debt Management Department' (2009), available at https://rbi.org.in/scripts/PublicationsView.aspx?id=11356 (last accessed 22 October 2018).

[46] RBI, 'Annual Report' (2018) ch VII, para VII.16, available at https://www.rbi.org.in/Scripts/AnnualReportPublications.aspx?Id=1234 (last accessed 29 October 2018).

this area is that, in the past, it typically did not allow market borrowing by State Governments that were already indebted.[47]

Thus, the RBI evidently plays a very important role in the regulation of subnational debt. In this regard, it also coordinates with the Central Government. The Centre in exercise of its powers under Article 293(3) indicates the State-wise net allocation of market borrowings to the RBI at the beginning of the financial year. Accordingly, the RBI decides the timing, tenure, and notified amounts of the SDLs.[48] In making these decisions, it takes into account the market and liquidity conditions as well as the cash needs of the States.[49] For instance, in October 2017 the RBI announced that SDL auctions would now be conducted weekly, instead of fortnightly as used to be the case. This was implemented as part of a series of measures intended to move towards market-based pricing that is sensitive to an individual state's fiscal risk metrics, in order to facilitate adequate reflection of risk asymmetries across States in the SDL market.[50]

Another example of such coordination appears to be the Standing Technical Committee, constituted by the RBI in 2006 with representation from the Central and State Governments along with the RBI itself. This committee was expected to advise on wide-ranging issues relating to the borrowing programmes of the Central and State Governments, through a consensual and cooperative approach.[51] It has been making annual projections regarding the borrowing requirements of States, taking into consideration various factors such as macroeconomic and financial

[47] Nirvikar Singh, 'Fiscal Federalism' in Sujit Choudhry, Madhav Khosla, and Pratap Bhanu Mehta (eds), *The Oxford Handbook of the Indian Constitution* (Oxford University Press, 2016) fn 15 at p. 525.
[48] RBI, 'Internal Debt Management Department' (2009), available at https://rbi.org.in/scripts/PublicationsView.aspx?id=11356 (last accessed 22 October 2018); SDLs qualify for Standard Liquidity Ratio (SLR), can be used as collaterals for borrowing through market repo, and for borrowing by eligible entities from the RBI under the Liquidity Adjustment Facility. *See* RBI, 'Frequently Asked Questions: Government Securities Market in India – A Primer' (2016), para 1.7, available at https://rbi.org.in/scripts/FAQView.aspx?Id=79 (last accessed 27 October 2018).
[49] RBI, 'Internal Debt Management Department' (2009), available at https://rbi.org.in/scripts/PublicationsView.aspx?id=11356 (last accessed 22 October 2018)
[50] RBI, 'Statement on Developmental and Regulatory Policies', Press Release (4 October 2017), para 6, available at https://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/PR92499923D3773DD4C1C8B5D9ACF9B6138CE.PDF (last accessed 29 October 2018); SDLs are generally in demand as they qualify for SLR, and because certain entities like Insurance Companies and Provident Funds are required to mandatorily invest in government securities. However, due to recent cuts in the SLR requirement and discussions on reducing mandatory regulatory investment as well, the demand for SDLs can be negatively affected. *See* FRBM Review Committee Report, Volume 1 (January 2017) at p. 89.
[51] Y. V. Reddy, Governor, RBI, 'Annual Policy Statement for the Year 2006-07' (2006), para 134, available at https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=2827&Mode=0 (last accessed 28 October 2018). *See also* Shyamala Gopinath, 'Sub-national Fiscal Reforms and Debt Management - Indian Experience', RBI (2009), available at https://www.rbi.org.in/scripts/FS_Speeches.aspx?Id=426&fn=2757 (last accessed 26 October 2018).

conditions, sustainability of debt, provisions of State FRLs, and fiscal risks from issuance of guarantees.[52]

3. Central Fiscal Responsibility Legislation

The Central FRL, titled the Fiscal Responsibility and Budget Management Act, was passed in 2003 (FRBM Act 2003). It aimed to bring about prudential debt management and fiscal sustainability through limits on Central Government borrowings, debt and deficits, and greater transparency in fiscal operations of the Central Government.[53] It was amended by the Finance Act, 2018.[54] It now states that the Central Government shall endeavour to ensure that general government debt does not exceed 60% of Gross Domestic Product (GDP), of which the Central Government debt should not exceed 40%, by the end of 2024-25.[55] 'General Government debt' is defined as the sum total of the debt of the Central Government and the State Governments, excluding inter-Governmental liabilities.[56] Therefore, the Central FRL confers an executive power on the Central Government which is directly related to State Government debt.

The Central Government will thus have to endeavour to ensure that State Government debt does not exceed 20% of GDP. Under Articles 256 and 257(1), the Centre can give directions to a State if the latter is not exercising its executive power to ensure compliance with central laws, or if it is exercising it in a way that impedes or prejudices the exercise of the Centre's executive power.[57] It may be possible to argue that if State Government debt exceeds its allotted share, then it is acting in non-compliance with the Central FRL, and also impeding the Centre's executive power, as the latter is tasked with maintaining the general government debt.

However, since the wording of the relevant provision suggests that it is not strictly binding, due to the use of the words 'shall endeavour',[58] it is unlikely that Articles 256 and 257(1) will be attracted. It is also worth noting that all States have passed

[52] C. Rangarajan and Abha Prasad, 'Managing State Debt and Ensuring Solvency: The Indian Experience' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013) fn 12 at p. 139.
[53] FRBM Act 2003, Preamble.
[54] *See* Finance Act 2018, Sections 211 and 213.
[55] FRBM Act 2003, Section 4(1)(b).
[56] FRBM Act 2003, Section 2(bb).
[57] It is obligatory for State Governments to comply with directions issued by the Central Government under Articles 256 and 257(1). *See Katya Co-op. Building Society Ltd. v State of Andhra Pradesh*, AIR 1985 AP 242; *Jay Engineering Works v State of West Bengal*, AIR 1968 Cal 407; *State of Rajasthan v Union of India*, (1977) 3 SCC 592.
[58] *See* FRBM Act 2003, Section 4(1)(b).

their own FRLs along the same lines as the Central FRL.[59] Therefore, it may be argued that perhaps the only means available to the Centre to give effect to its general government debt obligation is by regulating subnational debt via Articles 293(3) and (4). It may be relevant to note, however, that this general government debt obligation has been inserted into the Central FRL by a very recent amendment, and as such, it has not yet been interpreted by any court.

4. State Fiscal Responsibility Legislations

As aforesaid, Article 293(1) provides that State legislatures have the power to limit, by law, the State's executive powers of borrowing and giving guarantees. It is worth noting that the Kerala High Court in *Mathew v Union of India*[60] held that Article 293 is an enabling provision authorising State borrowing as well as laws regulating the same, but such limits on borrowing are not embodied in the Article itself. Clearly, by virtue of this constitutional provision, the States are empowered to pass their own FRLs.[61] It can also be argued that a breach of the limits imposed by such an FRL would not only be illegal under the said Act, but may also be unconstitutional.

The Twelfth Finance Commission (FC-XII) had recommended that each state should enact FRLs prescribing specific annual targets with a view to eliminating the revenue deficit by 2008-09 and reducing fiscal deficits to 3% of GSDP based on a path for reduction of borrowings and guarantees.[62] The enactment of such FRLs was to be a precondition for availing the Debt Consolidation and Relief Facility (DCRF) as outlined by FC-XII.[63] Accordingly, by 2010-11, all States had passed FRLs.[64]

Tables 1, 2, 3, and 4 in Annexure 1 contain a study of all State FRLs and rules made thereunder, particularly covering the various fiscal indicators and targets, transparency mechanisms, enforcement measures, and supplementary measures

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[59] Report of the Fourteenth Finance Commission (2015-20) (December 2014), at para 4.1. *See also* Constitution of India, 1950, Article 293(1). *See also* Constitution of India, Seventh Schedule, List II, Entry 47.

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

[61] Moreover, 'Public debt of the State' is an entry in the State List. *See* Constitution of India, Seventh Schedule, List II, Entry 43.

[62] *See* Report of the Twelfth Finance Commission (2005-2010) (December 2004), at paras 4.79 and 12.61.

[63] *See* Report of the Twelfth Finance Commission (2005-2010) (December 2004), Chapter 12.

[64] Report of the Fourteenth Finance Commission (2015-20) (December 2014), at para 4.1; By exercising its powers under Articles 293(3) and (4), it may be possible for the Central Government to enforce fiscal deficit targets and other provisions of State FRLs. *See* Arghya Sengupta, Anisha Sharma, and Ritwika Sharma, 'Research Report on Queries raised by the Fourteenth Finance Commission: On Central Control over Sub-National Debt in India', Finance Commission of India (2014), available at https://fincomindia.nic.in/writereaddata/html_en_files/oldcommission_html/fincom14/others/42.pdf (last accessed 10 October 2018) at p. 25.

for ensuring fiscal discipline contained therein.[65] The various provisions contained in these FRLs may be a relevant consideration when formulating conditions under clause (4) of Article 293, as discussed further in chapter 6.

[65] Information set out in these tables is based on readily available public sources.

Chapter 3: Policy Considerations in Subnational Borrowing Regulation

From the above discussion, it is evident that before deciding how to operationalise consents under Article 293(3) and conditions under Article 293(4), the constitutional limitations and existing mechanisms for the regulation of subnational debt should be accounted for. In this chapter, the analysis moves from the existing legal and institutional framework to examine the relevant policy considerations in public finance and subnational fiscal management. These provide appropriate guidance in choosing the mechanisms to be employed.

Economic literature on subnational fiscal policy discusses a broad tension between two different objectives relevant to the subject.[66] On the one hand, the decentralisation of public spending necessitates greater autonomy for subnational governments in borrowing as well. Such decentralisation is thought to allow for substantial efficiency and equity benefits, promoting development in subnational territories. On the other hand, there are considerable pitfalls in allowing States greater freedom. Both States and lenders have incentives to make irresponsible fiscal decisions as long as the Central Government appears to provide a safety net. As a result, the macroeconomic stability of the country as a whole is put at risk. What follows is an account of the policy issues that emerge as a result of this tension.

A. The Decentralisation Dilemma

Theoretical literature on the economic logic for federalism forms a useful account especially for the purposes of fiscal policy.[67] This account attempts to explain which functions should be assigned to which levels of government in a multi-level polity. The provision of a public good that benefits all the subnational communities in a nation (like immigration control or national defence) should be assigned to a national government while a public good with only localised spillovers (like police protection) should be assigned to a local government. Decisions about investments that arise out of a majority rule voting system involving the entire population of the country tend to meet the views of the median voter of the country. For localised problems, such allocation of resources would not be appropriate as the median voter of the subnational territory may have a different view from the

[66] Catriona Purfield, 'The Decentralization Dilemma in India', IMF Working Paper WP/04/32 (2004); Otaviano Canuto and Lili Liu, 'An Overview' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013), at pp. 1-2.

[67] Dennis C. Mueller, *Public Choice III* (Cambridge University Press, 2003), at pp. 209-10.

median voter of the nation.[68] Ensuring more appropriate allocation requires that government structures be altered to make them more accountable and responsive, incentivising public officials to improve public services.[69]

The drive towards shifting infrastructure investment decisions to subnational governments has been an increasing trend across the world. This has been driven in part by rapid urbanisation in developing countries and the increasing demand upon local governments to put in place the conditions under which influxes of rural populations into cities can best be absorbed.[70] Infrastructure investments are particularly of relevance because of the way in which they benefit individuals across generations and allow for the matching of debt servicing capabilities with the economic life of the infrastructural asset created.[71]

While empirical evidence does not strictly corroborate the theory,[72] it may be noted that studies with the highest quality data and techniques show that decentralisation has more positive effects on the delivery of public services.[73] The outcomes that emerge from decentralisation strategies may actually depend on how well these strategies are applied in the path-dependent context of a country. Thus, some researchers point out that the effects of decentralisation on macroeconomic stability depend on the level of economic development of the country; the fact that it can increase instability in developing countries while creating stable outcomes in developed ones highlights the importance of institutions in capturing the benefits.[74] Community-based governance at subnational levels is especially worth pursuing if information flow, fraud detection and independent audit checks are in place to prevent embezzlement, misdirection and manipulation by influential groups in unequal societies.[75] Some research indicates that there is a need to allow subnational governments to have their own sources of revenue such that they do not depend excessively on intergovernmental

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[68] Dennis C. Mueller, *Public Choice III* (Cambridge University Press, 2003), at pp. 209-10.

[69] Tom Hart & Bryn Welham, 'Fiscal decentralisation: A public financial management introductory guide' *Overseas Development Institute* (November 2016), at p. 8, available at https://www.odi.org/sites/odi.org.uk/files/resource-documents/11063.pdf (last accessed 15 October 2018).

[70] Otaviano Canuto and Lili Liu, 'An Overview' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013), at p. 1.

[71] Otaviano Canuto and Lili Liu, 'An Overview' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013), at pp. 1-2.

[72] Jean-Paul Faguet and Caroline Pöschl (eds), *Is Decentralization Good for Development? Perspectives from Academics and Policy Makers* (Oxford University Press, 2015).

[73] Anila Channa and Jean-Paul Faguet, 'Decentralization of Health and Education in Developing Countries: A Quality-Adjusted Review of the Empirical Literature' 31(2) *The World Bank Research Observer* 199 (2016)

[74] Jorge Martinez-Vazquez & Violeta Vulovic, 'How Well Do Subnational Borrowing Regulations Work?' ADBI Working Paper Series No. 563 (2016), at p. 5.

[75] Ehtisham Ahmad et al, 'Subnational Public Financial Management: Institutions and Macroeconomic Considerations' IMF Working Paper WP/05/108 (2005), at pp. 4-5.

fiscal transfers and develop a sense of responsibility regarding their expenditure choices.[76]

The immediate issue of relevance to this report is how decentralisation of fiscal decisions increases the risks to macroeconomic stability. While some jurisdictions can devolve responsibility over revenue sources to subnational governments, significant dependency on intergovernmental transfers may be unavoidable except for the richest states and cities. As long as central governments continue to be responsible for fiscal transfers to subnational governments, this can undermine the effectiveness of hard budget constraints and disincentivise lower level governments from controlling their deficits.[77] The ability of subnational governments to offload the risks of excessive spending to higher levels is referred to as a "moral hazard" and constitutes a prime issue in fiscal federalism.[78] Populist fiscal tactics by lower levels of government can come to be systematically rewarded and the Central Government's own finances can come under risk. Situations such as these discourage responsible behaviour at the subnational level by allowing misbehaving subnational governments to free ride on common pool resources that are important for other more responsible subnational governments. There is evidence that past deterioration in the finances of Indian States is linked to exactly such institutional shortcomings.[79]

A broad aim of subnational debt regulation thus becomes ensuring debt sustainability, in recognition of the fact that borrowing is necessary but that it must be done prudently. Governmental fiscal sustainability requires that the present value of future primary balances be greater than or equal to the public debt stock so as to be able to service that debt; in debt sustainability analysis, there is thus a resultant focus on the projected behaviour of debt-to-GDP ratios.[80] A set of fiscal policies can be considered sustainable if the borrower is able to continue servicing its debt without an unrealistically large future correction to its income and expenditure. There must thus be realism in assessing assumptions

[76] Richard M. Bird, 'Subnational taxation in developing countries: a review of the literature' 2(1) *Journal of International Commerce, Economics and Policy* 139 (2011).
[77] Catriona Purfield, 'The Decentralization Dilemma in India' IMF Working Paper WP/04/32 (2004), at p. 3.
[78] A moral hazard exists when one party in a transaction can take actions that either affect the other party's valuation of the transaction, or that cannot be monitored or enforced by the other party. *See* D.M. Kreps, *A Course in Microeconomic Theory* (Princeton University Press, 1990), at p. 577; In the context of subnational fiscal policy, a subnational government takes various actions and decisions that affect the macroeconomic stability of the nation given that the Central Government may have to bail it out.
[79] Catriona Purfield, 'The Decentralization Dilemma in India' IMF Working Paper WP/04/32 (2004).
[80] International Monetary Fund, Staff Guidance Note on the Application of the Joint Fund-Bank Debt Sustainability Framework for Low-Income Countries (November 5th, 2013), available at https://www.imf.org/external/np/pp/eng/2013/110513.pdf (last accessed 23 October, 2018).

underlying the debt-to-GDP ratio projections, including in assessments regarding growth and interest rates.[81]

B. Designing Fiscal Incentives for States and Prospective Creditors

The moral hazard problem outlined above would not exist if central governments could credibly commit that they would not change the allocation of transfers ex-post, i.e. if they could credibly commit to a no-bailout policy. However, there are considerable difficulties in making such a commitment given the political context in which federalism functions.[82] The issues described above have resulted in the innovation of various tools of subnational borrowing regulation across various jurisdictions. These tools, described further in chapter 5, are aimed at ensuring that subnational fiscal behaviour is responsible and does not result in suboptimal outcomes potentially giving rising to situations of extreme instability.

Various emerging economies faced subnational debt crises in the past as they underwent the process of decentralisation. Argentina's debt default in 2001 has been linked to burgeoning provincial debt in Mendoza and Buenos Aires. There were three subnational debt crises in Brazil in the 80s and 90s. Mexico's 1994-95 Tequila Crisis made subnational debt in the country unsustainable. Subnational entities in the United States of America have also had a history of insolvency (eight States and the Territory of Florida defaulted in 1842, and 4770 local governments defaulted during the Great Depression), but such instances have declined as markets matured and regulatory frameworks were put into place.[83]

While financial markets can create discipline by imposing strictures on the behaviour of debtors and creditors, sole reliance on such market discipline is misguided given the difficulty of removing moral hazard and free rider market failures even through market-enhancing mechanisms.[84] Rule-based and centralised administrative control mechanisms are thus important approaches to alleviate risks. In coordinating fiscal behaviour through regulation, the incentive structures

[81] International Monetary Fund, 'Modernizing the Framework for Fiscal Policy and Public Debt Sustainability Analysis' (August 5th, 2011), available at https://www.imf.org/external/np/pp/eng/2011/080511.pdf (last accessed 23 October 2018).
[82] Jorge Martinez-Vazquez & Violeta Vulovic, 'How Well Do Subnational Borrowing Regulations Work?' ADBI Working Paper Series No. 563 (2016), at p. 5.
[83] Otaviano Canuto and Lili Liu, 'An Overview' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013), at pp. 2-3, 145.
[84] Teresa Ter-Minassian & Jon Craig, 'Control of Subnational Government Borrowing' in Teresa Ter-Minassian (ed), *Fiscal Federalism in Theory and Practice* (International Monetary Fund, 1997); Teresa Ter-Minassian, 'Decentralization and Macroeconomic Management' IMF Working Paper WP/97/155 (1997), at p. 9 ("Free rider" or "common pool" problems are caused due to common access and usage of a good or resource; this kind of access and use results in each economic agent having incentives to use the resource sub-optimally due to a perception that they can "free ride" or pass off costs for their usage onto others using the same "pool").

of all players must come to be aligned so that each player is cognisant of the common interests involved. To achieve this requirement, appropriate measures can run back to a number of basic considerations. Functions must be clearly defined and assigned, not least so that voters know which level of government to hold accountable for failures in service delivery. Partial decentralisation should be avoided, so that an assigned function is accompanied by powers regarding salary, operating, and capital budgets. Local traditional authorities should be taken into confidence in designing decentralisation and creating accountability.[85] To be able to benefit from borrowing decentralisation at all, the above foundational concerns may be viewed as a pre-requisite. For sound fiscal relations to emerge, they may have to be built on well-designed federal relations.

In determining how to align the incentives, it is appropriate to consider how elected public officials at the subnational level are afforded shorter terms in office than the life spans of most citizens. The short time horizons for their decisions may sometimes mean that they are constrained in their fiscal decisions to privilege more short-term objectives.[86] Meanwhile, the mobility of citizens and businesses across local jurisdictions can result in fluctuations in debt servicing capacity given changes in the debt-to-resident ratio.[87] Combined with the moral hazard and common pool problems, these issues indicate that a special role often exists for the Central Government of a country in protecting common interests, including through a Central Bank. Particularly, if powers are already strictly centralised at a constitutional level, coordination functions may appear less problematic.

However, different incentives function at the central level which could also result in suboptimal decisions. These incentives can be skewed by electoral cycles and favourable treatment towards subnational entities run by the same party as the Central Government.[88] Thus, in the context of these issues, the importance of independent specialised institutions coordinating fiscal discipline across time becomes apparent, especially where fiscal decentralisation is setting in and central control over markets is reducing.[89]

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[85] Tom Hart & Bryn Welham, 'Fiscal decentralisation: A public financial management introductory guide' *Overseas Development Institute* (November 2016), at p. 10, available at https://www.odi.org/sites/odi.org.uk/files/resource-documents/11063.pdf (last accessed 15 October 2018).
[86] Otaviano Canuto & Lili Liu, 'An Overview' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013), at p. 3.
[87] Otaviano Canuto & Lili Liu, 'An Overview' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013), at p. 3.
[88] *See* David Endicott, 'Fiscal federalism and distributive politics in India', presented at Ostrom Workshop: Indiana University Bloomington (preliminary draft) (2015), available at https://ostromworkshop.indiana.edu/pdf/seriespapers/2015f_r/endicottpaper.pdf (last accessed 10 November 2018).
[89] Otaviano Canuto & Lili Liu, 'An Overview' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013), at p. 4.

Nonetheless, it may be relevant to note that borrowing regulations cannot fill in for the overall system of intergovernmental fiscal relations. Fiscal and revenue autonomy may be necessary conditions for responsible borrowing; routine gap-filling through intergovernmental transfers can have the effect of disincentivising balanced budgets. Further, in the broader analysis, it may also be essential to tie revenue decisions to borrowing decisions so that debt issuance can be tied to tax increases or revenue sources.[90]

The above considerations have been further examined in the next chapter to understand the rationale and choices underlying subnational debt regulation policies specific to the Indian context.

[90] Otaviano Canuto & Lili Liu, 'An Overview' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013), at pp. 27-28.

Chapter 4: The Indian Experience with Subnational Borrowing Regulation

In determining the particular constraints, objectives, and concerns in the regulation of subnational borrowing in India, it is essential to maintain a close watch on the peculiarities of the Indian context. The fiscal position, projected outlook and available resources of the States in the current period must be considered in arriving at parameters of relevance. However, it is equally important to consider how the institutional mechanisms at play are evolving (the present position of these institutions has been discussed in chapter 2) so as to design a path for reform initiatives where necessary. These factors are considered below.

A. Developments in Subnational Borrowing Regulation

Subnational borrowing regulations by necessity must work with certain fiscal indicators in mind. Fiscal indicators are aimed at giving a picture of the financial health of the entity in question and are the basis for various forms of regulatory tools including fiscal rules, provisions regarding transparency etc., apart from determining the terms on which direct central control, credit rating, market mechanisms and the coordination mechanisms operate. In considering these indicators, it is useful to map certain phases in the evolution of the fiscal health of Indian States while considering the institutional responses that have emerged in the face of various developments.

In the period prior to 1998, States largely had low revenue balances[91] and fiscal deficits[92] while debt levels were moderate.[93] However, the period from the late 1990s to early 2000s saw significant deterioration in all indicators. Escalating fiscal stress and debt repayment pressures were experienced by many states in this period.[94]

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[91] The revenue balance or current balance is the balance of revenue/current expenditure and total revenue receipts. A deficit on this account, called a revenue deficit, is indicative of the need to borrow to finance regular consumption expenditure, as opposed to financing for (supposedly) more productive capital expenditure.

[92] A fiscal deficit is conventionally an indicator of governmental resource use that remains to be financed at the end of a fiscal year after the government has offset its income against its outlays i.e. the balance of total governmental expenditures (revenue and capital) and revenue receipts. *See* Mario I. Blejer & Adrienne Cheasty, 'Measuring the Fiscal Deficit: Overview of the Issues', in Blejer & Cheasty (eds) *How to Measure the Fiscal Deficit* (International Monetary Fund, 1993), at p. 5; C. Rangarajan et al, 'Dynamics of Interaction between Government Deficit and Domestic Debt in India' in *Select Essays on Indian Economy*, Vol 2 (Academic Foundation, 2004), at p. 16.

[93] While fiscal deficit is a year-on-year flow measure, the debt-to-GDP ratio is used as an indicator of the stock of debt through accumulation over time.

[94] C. Rangarajan & Abha Prasad, 'Managing State Debt and Ensuring Solvency: The Indian Experience' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013), at p. 109.

1. Impact of Twelfth Finance Commission Recommendations on the Fiscal Health of Indian States

While the Central Government had put in place a debt-swap scheme in 2002-03, the intervention of FC-XII in 2004 coordinated the sharpest ever sub-national fiscal consolidation in India. FC-XII recommended the institution of the Debt Consolidation and Relief Facility (DCRF), which allowed for the restructuring of Central loans to States on the condition that the latter enact an FRL.[95] The Central Government was no more to lend to the States as it earlier did and the latter were to be permitted to approach markets directly. Reduction in the growth of current expenditures, structural reform of the taxation system, guarantee redemption funds (GRFs) for the discharge of guarantee obligations, and sinking funds for the amortisation of loans were also suggested.[96]

While some states had already taken action prior to this, the above intervention was followed by action on the part of various entities. By 2009, 26 states (with the exception of West Bengal and Sikkim) had enacted an FRL and all had done so by 2010-11.[97] It may be noted that between 2004-05 and 2007-08, the general government fiscal deficit (Central as well as all State Governments) fell from 7.2% of GDP to 4% while the combined fiscal deficit of all States fell from 3.3% to 1.4%. The consolidated debt-to-GDP ratio also fell dramatically and the States on a whole achieved a revenue surplus position from as early as 2006-07.[98]

It must be noted that the reform efforts that at least partially resulted in the above corrections were ideated and carried out by various governmental agencies, including the Finance Commissions, the Ministry of Finance, State Governments, the Planning Commission and the RBI. [99] Though the newly enacted FRLs cannot entirely be credited for this turnaround, there were a number of other factors at play, including the impact of debt-swap schemes and the DCRF, increased revenue collections due to the introduction of value-added tax (VAT), rapid economic growth,[100] increased tax devolution to States (stemming from buoyant central

[95] In this legislation, the State was required to prescribe specific annual deficit targets so as to achieve the elimination of revenue deficit and the reduction of fiscal deficit to 3% of GSDP by 2008-09. *See* Report of the Twelfth Finance Commission (2005-10) (November 2004), at p. 87.
[96] Report of the Twelfth Finance Commission (2005-10) (November 2004), Chapters 4 & 12.
[97] Report of the Thirteenth Finance Commission (2010-15) (December 2009), at para 4.1; Report of the Fourteenth Finance Commission (2015-20) (December 2014), at para 4.1.
[98] Report of the Fourteenth Finance Commission (2015-20) (December 2014), at paras 14.8 – 14.11 and 14.16.
[99] C. Rangarajan & Abha Prasad, 'Managing State Debt and Ensuring Solvency: The Indian Experience' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013), at pp. 110-11.
[100] *See*, especially for the close links between growth and fiscal policy, Milan Brahmbhatt & Otaviano Canuto, 'Fiscal policy for Growth and Development' 91 *Economic Premise* (October 2012),

taxes), and reduced interest rates resulting in lower revenue expenditure.[101] Moreover, expenditure rationalisation measures in relation to retirement age, voluntary retirement schemes, restrictions on new recruitments etc. also deserve mention.[102] These may be relevant in structuring debt regulation tools that are effective in the Indian context, especially in meeting exigencies.

B. Institutional Response to the Global Economic Recession of 2008

Following these initial corrections, the global recession presented a setback that had to be dealt with by the Thirteenth Finance Commission (FC-XIII). The consolidated fiscal deficit reached a peak of 9.4% of GDP in 2009-10.[103] FC-XIII recommended a revised fiscal consolidation roadmap involving the rescheduling of targets for 2014-15: revenue deficits were to be eliminated, fiscal deficits were to be brought down to 3% of GSDP and a combined debt-to-GDP ratio of 68% was to be achieved. Resetting of interest rates for loans from the National Small Savings Fund (NSSF) and conditional write-offs for Central loans to States were also recommended.[104]

It is relevant to mention that the recommendations of both FC-XII and FC-XIII, whether for DCRF restructuring benefits, loan write-offs or interest rate resets, were aimed at ensuring that such relief measures did not raise new moral hazards. Thus, these benefits were all linked with broader institutional reform, largely in terms of enacting or amending the State FRLs.[105]

So far as the Central Government's role was concerned, in raising borrowing limits and making concessions on the fiscal deficit targets for States, it sought to make sure that countercyclical measures were taken as a response to recessionary trends. The prior countercyclical actions of the States, during what was a period of booming growth, included prudent reductions in revenue expenditure even as receipts grew.[106] Further, the RBI, in its capacity as the Central Bank, approached the matter with a close eye on market dynamics. Setting statutory requirements for banks to hold State debt bolstered the acceptability that these securities would

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available at https://openknowledge.worldbank.org/bitstream/handle/10986/17076/730410BRI0Econ0C0disclosed010030120.pdf;sequence=1 (last accessed 20 October 2018).

[101] Report of the Fourteenth Finance Commission (2015-20) (December 2014), at para 4.4; FRBM Review Committee Report, Volume 1 (January 2017), at p. 85.

[102] FRBM Review Committee Report, Volume 1 (January 2017), at p. 86.

[103] Report of the Fourteenth Finance Commission (2015-20) (December 2014), at para 14.8.

[104] Report of the Thirteenth Finance Commission (2010-15) (December 2009), Chapter 9.

[105] C. Rangarajan & Abha Prasad, 'Managing State Debt and Ensuring Solvency: The Indian Experience' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013), at pp. 127-29; Report of the Thirteenth Finance Commission (2010-15) (December 2009), at paras 9.115 and 9.116.

[106] FRBM Review Committee Report, Volume 1 (January 2017), at p. 87.

have in the markets. Moreover, tightening the norms for State use of overdraft facilities meant the introduction of a level of prudence in the use of short-term financing of what could be structural deficits. Ex-post disclosures of such facility usage created further market information, resulting in further discipline.[107]

C. Recent Developments: Fourteenth Finance Commission Recommendations and FRBM Review Committee Report

FC-XIV followed up on the previous measures with certain further adjustments.[108] While it found State borrowing within prescribed targets and was much more critical of the Central Government, FC-XIV laid considerable stress on the need to reformulate debt measurements so as to capture "extended debt", accounting additionally for State Government guarantees (especially to high risk public sector companies).[109] The fiscal deficit threshold for States outlined by FC-XIII was maintained until 2019-20.[110] FC-XIV also noted that the focus on deficit targets had resulted in the under-utilisation of borrowing headroom by States and concomitant constraints on capital expenditure. It recommended the creation of statutory ceilings on the sanction of new capital works to ensure that the benefits of existing projects were captured.[111] In addition, disengagement of States from mandatory NSSF borrowings, stronger accountability measures for fiscal consolidation and new institutional mechanisms for cooperative federalism were also recommended.[112]

Further, the FRBM Review Committee, chaired by Shri N.K. Singh, was constituted in May, 2016 (FRBM Review Committee) to review the working of the Central FRL.[113] The FRBM Review Committee found that States had, on the whole, been considerably prudent in their approach to fiscal policy and while they were aided

[107] C. Rangarajan & Abha Prasad, 'Managing State Debt and Ensuring Solvency: The Indian Experience' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013), at pp. 130-31.
[108] As mentioned in chapter 2, FC-XIV did not place any conditionality for operationalisation of the fiscal roadmap by States, instead expecting the Centre to enforce borrowing limits determined under a prescribed formula through its power under Article 293(3). Eschewing rigid application of uniform fiscal targets, the Finance Commission also allowed States a certain degree of operational flexibility in meeting fiscal deficit targets if they met certain debt-GSDP ratio and interest payment-to-revenue receipt ratio criteria in each preceding year. States were also permitted to carry forward unutilised borrowing headroom into the following year. *See* Report of the Fourteenth Finance Commission (2015-20) (December 2014), at paras 14.61, 14.64, 14.66 and 14.67.
[109] Report of the Fourteenth Finance Commission (2015-20) (December 2014), at paras 14.20 – 14.24.
[110] Report of the Fourteenth Finance Commission (2015-20) (December 2014), at para 14.60.
[111] Report of the Fourteenth Finance Commission (2015-20) (December 2014), at paras 14.51 and 14.52.
[112] Report of the Fourteenth Finance Commission (2015-20) (December 2014), at paras 14.81, 14.91 and Chapter 12.
[113] As part of its study of fiscal responsibility rules at the Central level, the FRBM Review Committee also went into a study of the State FRLs given the breadth of its terms of reference and the known linkages between sub-national and national macro-fiscal management.

by a rise in revenues, Central transfers had only played a limited role in the consolidations of the past.[114] Though expenditure rationalisations resulted in significant reductions in revenue expenditures, capital expenditures were not cut down. The FRBM Review Committee attributed this behaviour to specific rules in the FRLs.[115]

Furthermore, in the course of its examination, the FRBM Review Committee highlighted the significant impact that would emerge from States taking over the liabilities of Distribution Companies (DISCOMs) under the Ujwal DISCOM Assurance Yojana (UDAY) Scheme.[116] These liabilities were not to be counted as part of each State's fiscal deficit limits for 2015-16 and 2016-17.[117] While the scheme was voluntary for States to join, it appears that obtaining consent from the Centre under Article 293(3) was still required before borrowings could be done to take over DISCOM debt.[118] The circumstances that necessitated this scheme must be considered in light of related pressing issues around off-budget borrowings, which involve borrowings by entities like public sector undertakings while the repayments happen out of State budgets. Noting the warnings of FC-XIV, resultant accounting anomalies, and the likely illegality of such transactions (in light of Article 293(3)'s consent requirement), the FRBM Review Committee made clear that there needed to be better transparency and disclosure norms to track such fiscal behaviour.[119]

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[114] FRBM Review Committee Report, Volume 1 (January 2017), at p. 87.

[115] Specifically, reference was made to the 'golden rule'. Such expenditure related rules shall be further discussed in the section below; Further, in an assessment of the relevant indicators, the FRBM Review Committee found that revenue and primary deficit-to-GSDP ratios were on the rise even while they continued to be within FRL ceilings. State prudence led the FRBM Review Committee to advise that while primary deficit levels needed to be checked, the debt-to-GSDP ratio was satisfactory. *See* FRBM Review Committee Report, Volume 1 (January 2017), at pp. 87, 93-95 and 97. Please note that here, the FRBM Review Committee has noted the significance of the lower initial levels of debt of the State and its relation with higher primary deficits as compared to the Centre.

[116] FRBM Review Committee Report, Volume 1 (January 2017), at p. 88; for a study of the impact of these liabilities on the sustainability of State debt, *see* Balbir Kaur et al, 'Debt Sustainability of States in India: An Assessment' Munich Personal RePEc Archive Paper No.81929 (13 October 2017), available at https://mpra.ub.uni-muenchen.de/81929/ (last accessed 30 October 2018).

[117] Para 7.5, Office Memorandum No.06/02/2015-NEF/FRP, Ministry of Power, Government of India (20th November, 2015), available at https://powermin.nic.in/pdf/Uday_Ujjawal_Scheme_for_Operational_and_financial_Turnaround_of_power_distribution_companies.pdf (last accessed 20 October 2018).

[118] *See*, for instance, Clause 1.2 (e) of the Tripartite Memorandum of Understanding Amongst Ministry of Power, Government of India and Government of Andhra Pradesh and Andhra Pradesh State Power Distribution Companies (24th June, 2016), available at https://www.uday.gov.in/MOU/AP_UDAY_MOU(signed).pdf (last accessed 30 October 2018). Further, such debt has been referred to as being a de facto State borrowing without being treated as a de jure borrowing. *See* 'UDAY (Ujwal DISCOM Assurance Yojana) for financial turnaround of Power Distribution Companies', Press Release dated 5th November 2015, Press Information Bureau, Cabinet, Government of India, available at http://pib.nic.in/newsite/PrintRelease.aspx?relid=130261 (last accessed 30 October 2018).

[119] FRBM Review Committee Report, Volume 1 (January 2017), at pp. 90-91 (On the question of the illegality of such borrowings, the Comptroller and Auditor General had submitted to the Committee that they were prohibited under Article 293(3). This may perhaps be understood as meaning that such borrowings are being made without the consent of the Centre under Article 293(3)).

Apart from this, the surplus unutilised cash balances of States were also examined and certain causes were outlined, including the cyclicality of usage of such balances over the course of a financial year and the need for buffers due to late release of funds by the Centre for centrally sponsored schemes.[120] Recently, the RBI indicated that States should be urged towards need-based borrowing, especially keeping in mind the cash surpluses that otherwise go unutilised. Better cash management practices and mobilisation of internal resources can be incentivised if existing cash balances are required to be utilised before fresh borrowings are undertaken.[121]

An important structural change in State borrowings in the post-FRL period has been the movement away from Central loans, first towards NSSF loans and finally to open market borrowings, with markets themselves treating State loan instruments with increasing importance.[122] The FRBM Review Committee looked into the market dynamics for State debt and found that a projected reduction in demand and increase in supply would likely increase the stress on finances from increased yield rates. It also noted that though SDL rates were supposed to be market-determined, there was a very limited spread between the rates of borrowing for different States as differences in borrowing risks were not being captured by the market (indeed, the relevant instruments were assigned zero risk weights).[123] It is worth noting that the likely explanation for such lack of differentiation might be inadequate exposure of States to market risks and a likely effect might be cross-subsidisation of some States by more responsible and fiscally stable States.[124]

It is equally significant to note that inter-State heterogeneity (in relation to per-capita income, size of State Government and share of own revenue) was not found to be a matter of pressing concern due to a lack of statistical correlation[125] and consequently, the FRBM Review Committee only examined State fiscal behaviour as a collective, leaving questions regarding inter-se debt levels and state-specific resource needs to the FC-XV.[126] Further, in relation with the broader issue of market exposure, the FRBM Review Committee did not find evidence of bailout expectations on the part of Indian States.[127] As per the committee, state-specific shocks are "socialised across the general government" through arrangements put in

[120] FRBM Review Committee Report, Volume 1 (January 2017), at p. 89.
[121] RBI Annual Report (August 2018), at Box VII.1.
[122] FRBM Review Committee Report, Volume 1 (January 2017), at p. 89.
[123] FRBM Review Committee Report, Volume 1 (January 2017), at pp. 89-90.
[124] FRBM Review Committee Report, Volume 1 (January 2017), at pp. 89-90.
[125] FRBM Review Committee Report, Volume 1 (January 2017), at pp. 92-93 (this finding also brought to light that the FRL rule-based regime had ensured that both low-income and high-income States applied equal levels of fiscal prudence).
[126] It envisaged the Commission making broad recommendations on debt trajectories of individual States. *See* FRBM Review Committee Report, Volume 1 (January 2017), at p. 98.
[127] This conclusion drew support from the limited effect of the FC-XII debt relief measures in the last most significant occurrence of subnational debt stress.

place since the Eleventh Finance Commission (FC-XI).[128] While this may be appropriate for natural disasters, it is not immediately clear how these factors differentiate significantly from the incentives for fiscal irresponsibility that would exist under a bailout regime. Even if States do not currently expect bailouts, the markets certainly seem to presume some safety nets to that effect.

D. Future Outlook for Subnational Borrowing Regulation

The FC-XII recommendations in 2004 put the States on a trajectory that sprung out of the tight grasp of Central intermediation and almost inevitably into the heady embrace of markets.[129] The reliance of State Governments on market borrowings has increased substantially in recent years, due to opt-outs from NSSF borrowing and redemption pressures rooted in the 2008 global financial crisis.

The share of market borrowings in deficit financing increased from 64.1% in 2016-17 to 66.1% in 2017-18 mainly due to the termination of NSSF financing facility.[130] The gross market borrowings of State Governments in 2017-18 has increased by 9.7% while the net borrowings declined by 0.7%, due to higher repayments.[131]

On an aggregate basis, States' gross borrowings are budgeted to rise to 2.9% of GDP, while net borrowings are expected to rise to 2.3% of GDP in 2018-19. This means that the budgeted borrowings for States will be similar to that of the Centre for the first time in liberalised India. States have budgeted to finance nearly 91% of their fiscal deficit through market borrowings as against around 66% by the Central Government. Gross borrowings by State Governments are projected to increase 28.5% year-on-year during 2018-19.[132]

Given the evolution of the State debt profile, a crucial response to consider is that of markets. The movement of State borrowings towards the market has happened alongside broader liberalisation in the financial sector. The benefits created by market discipline in ensuring incentives for responsible fiscal management depend considerably on the manner in which the markets reward prudent States with lower yield rates. As discussed above, however, there has not been much

[128] FRBM Review Committee Report, Volume 1 (January 2017), at p. 97.
[129] C. Rangarajan & Abha Prasad, 'Managing State Debt and Ensuring Solvency: The Indian Experience' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013), at pp. 115-16.
[130] RBI Annual Report (August 2018), at para VII.16.
[131] RBI Annual Report (August 2018), at para VII.17.
[132] *See* Speech by Shri B.P. Kanungo, Deputy Governor, Reserve Bank of India, 'State Government Market Borrowings - Issues and Prospects' (August 31st, 2018), available at https://www.rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=1063 (last accessed 30 October 2018); *see also* RBI, State Finances: A Study of Budgets of 2017-18 and 2018-19 (July, 2018), at para 2.24.

differentiation in the yield rates.[133] Further, it may be noted that markets are prone to becoming more responsible where they find that a weak federal fiscal position can affect the ability of a central government to support sub-nationals.[134]

In addition, the RBI has taken a number of measures to ensure that the SDL market becomes more liquid so that the higher trading volume translates into better yield spreads and market discipline. It has moved to more regular weekly auctions from fortnightly ones, begun publishing high frequency data on all relevant parameters, lowered Consolidated Sinking Fund (CSF) and GRF interest rates (so that an increase in these buffers promotes investor confidence), incentivised the credit rating of SDLs by providing advantages to the use of rated SDLs as collateral, and promoted the trade of the instruments by banks by requiring fair valuation to occur at the level of observed market prices.[135]

Trends in fiscal behaviour and the cumulative effect of the above Central Bank measures indicate a movement towards greater market dependency and a concomitant response towards nurturing market discipline forces. Such an approach increasingly calls for differentiation between States in determining borrowing policies.[136] This was after all the reasoning behind FC-XIII's recommendations in creating a differentiated fiscal adjustment roadmap, taking

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[133] It may be noted that a 2011 study found that conventional deficit indicators did not have a significant impact on the yield spreads between 2006-07 and 2010-11. This may, however, be explained by the fact that the prevalence of a rule-based fiscal policy ensured investor confidence in State-level fiscal discipline. *See* D. Bose et al, 'Determinants of Primary Yield Spreads of States in India: An Econometric Analysis', RBI Working Paper Series WP 10/2011 (2011); Similarly, a 2017 study also indicated that fiscal performance variables had no significant impact on yield spreads, suggesting that investors were indifferent to the credit quality of State debt. *See* Seema Saggar et al, 'State Government Yield Spreads: Do Fiscal Metrics Matter?' Mint Street Memo No.8 (RBI, December 8th 2017), available at https://www.rbi.org.in/Scripts/MSM_Mintstreetmemos8.aspx (last accessed 30 October 2018); However, it appears that a weak but positive correlation between outstanding debt and yield spreads was found during 2017-18, providing limited confidence regarding the future influence of market discipline. *See* Reserve Bank of India, State Finances: A Study of Budgets of 2017-18 and 2018-19 (July, 2018), at para 3.38 and Box III.2.

[134] Compounding concerns regarding the role of bailout expectations in creating a healthy market environment, evidence suggests that the yield spreads for subnational debt increase when central governments are under borrowing constraints due to high fiscal deficits or (as may be seen in the Indian context) if there is slippage on the part of the Central Government in meeting its targets. *See* R. Beck et al, 'Determinants of sub-sovereign bond yield spreads – The role of fiscal fundamentals and federal bailout expectations' 79 *Journal of International Money and Finance* 72 (2017); Reserve Bank of India, State Finances: A Study of Budgets of 2017-18 and 2018-19 (July, 2018), at para 3.38 and Box III.2.

[135] Speech by Shri B.P. Kanungo, Deputy Governor, Reserve Bank of India, 'State Government Market Borrowings – Issues and Prospects' (August 31st, 2018), available at https://www.rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=1063 (last accessed 30 October 2018); RBI Annual Report (August 2018), at Box VII.1; Reserve Bank of India, State Finances: A Study of Budgets of 2017-18 and 2018-19 (July, 2018), at paras 3.40 – 3.42.

[136] As has been pointed out previously, "the aggregate picture masks interstate disparities and vulnerabilities, which require customized reforms and correction packages rather than a 'one-size-fits-all' approach". *See* C. Rangarajan & Abha Prasad, 'Managing State Debt and Ensuring Solvency: The Indian Experience' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013), at pp. 136-37.

into account the special/non-special category status of States along with their revenue balance figures.[137] It was also the impetus behind the creation of flexibility in deficit targets as per the FC-XIV recommendations.[138]

A more robust issuance calendar for SDLs, mandatory investments in the CSF and GRF buffers, mandatory rating of SDLs on a standalone basis, timely disclosure of information etc. constitute further areas of improvement that require the urgent consideration of policymakers as the circumstances surrounding subnational debt continue to evolve.[139]

A final word on the outlook involves recognition of the changing dynamics on the institutional front. With the coming into place of the Goods and Services Tax (GST) regime and the operation of the GST Council as well as schemes such as the UDAY Scheme, it is increasingly clear that cooperative federalism has become an important mechanism for the resolution of a number of coordination problems, even where a particular level of government had previously been considered to have paramount legal competence. Such mechanisms are aimed at providing institutional arrangements for consultation between all relevant governments in a federal scheme and are especially relevant where the functions of different layers of government overlap.[140] Calls for independent institutions to oversee fiscal behaviour can be considered to have a similar salutary effect in relation with functional overlap while also ensuring that realistic and unbiased assessments can form the basis of forecasts, policy options and efforts at implementation.[141]

It may be seen that the tension between decentralisation and the moral hazards accompanying market access creates considerable scope for the above-mentioned overlap. This also contributes to the dissonance in functional assignment between the Centre and the States,[142] which occurs because both have a legitimate claim over regulating subnational debt. States need to be able to take autonomous fiscal decisions so that the benefits of decentralisation can be garnered but, at the same time, safeguards against subnational market failure must be put in place at the

[137] C. Rangarajan & Abha Prasad, ‘Managing State Debt and Ensuring Solvency: The Indian Experience’ in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013), at pp. 126, 128.
[138] Report of the Fourteenth Finance Commission (2015-20) (December 2014), at paras 14.55 and 14.57.
[139] Speech by Shri B.P. Kanungo, Deputy Governor, Reserve Bank of India, ‘State Government Market Borrowings - Issues and Prospects’ (August 31st, 2018), available at https://www.rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=1063 (last accessed 30 October 2018).
[140] For instance, *see* Report of the Fourteenth Finance Commission (2015-20) (December 2014), Chapter 12.
[141] for a history of recommendations of this kind, *see* FRBM Review Committee Report, Volume 1 (January 2017), Chapter 7.
[142] This is already the case with the FRBM Review Committee remarking on how fortunate it is that the implementation of the Finance Commission recommendations, the State FRLs and the Centre’s imposition of ceilings on State borrowings are all proceeding in a compatible manner. *See* FRBM Review Committee Report, Volume 1 (January 2017), at p. 98.

central level. Additionally, with the establishment of the GST Council, it may be appropriate institutional design to link revenue changes with borrowing policy decisions, so that repayment decisions can be coordinated. In light of these trends, it might be necessary to more fully consider cooperative institutions for lending policy, if not for fiscal policy as a whole.

Chapter 5: International Practice in Subnational Borrowing Regulation

As has been mentioned in the discussions above, there is an existing body of work on subnational borrowing regulations and considerable collation of practical experience from other jurisdictions that may be consulted fruitfully. Surveys of the various mechanisms employed across the world reveal four broad categories as far back as 1997, and this categorisation has persisted in literature since that time.[143] If borrowing by subnational entities has not been prohibited altogether, a country may rely on i) market discipline, ii) centrally-imposed or self-imposed fiscal rules, iii) centralised administrative regulation, and iv) cooperative regulation. These constitute various forms of ex-ante regulation that operate to ensure debt sustainability and fiscal stability. As in many situations defaults by subnational entities are not impossible, there are also mechanisms for ex-post regulation which deal with subnational insolvency and the allocation of the losses to be shouldered in the event of default.

It is interesting to note the manner in which the adoption of different ex-ante approaches has changed over time. Between 1990 and 2008, prohibitions on subnational borrowing have fallen, as has reliance on market discipline. On the other hand, there has been an increase in administrative regulation, centrally imposed rules and cooperative mechanisms. Where there is some measure of central control over borrowing, the imposition of legal sanctions has also seen a rise.[144]

A. Ex-Ante Regulations

1. Market Discipline

Market discipline relies on capital markets to send signals to subnational governments regarding the willingness of creditors to lend, with the same signals also indicating when borrowing is becoming unsustainable (signals are usually in the form of higher interest rates).[145] The reputation or creditworthiness of the borrower plays an important role in these dynamics as the market is structured to reward those who are able and willing to repay debt with this further being

[143] Teresa Ter-Minassian & Jon Craig, 'Control of Subnational Government Borrowing' in Teresa Ter-Minassian (ed), *Fiscal Federalism in Theory and Practice* (International Monetary Fund, 1997); Teresa Ter-Minassian, 'Decentralization and Macroeconomic Management', IMF Working Paper WP/97/155 (1997).

[144] Jorge Martinez-Vazquez and Violeta Vulovic, 'How Well Do Subnational Borrowing Regulations Work?', ADBI Working Paper Series No. 563 (2016) at pp. 9-10.

[145] Jorge Martinez-Vazquez and Violeta Vulovic, 'How Well Do Subnational Borrowing Regulations Work?', ADBI Working Paper Series No. 563 (2016) at pp. 10-11.

controlled by various economic, financial, political and institutional factors.[146] While in developed countries, there is scrutiny of the borrower's existing debt levels, sources of finance, administrative mechanisms and economic conditions, in developing countries, additional factors like the intergovernmental transfer scheme, default history, and pledged securities are also considered.[147] In making assessments on these metrics, credit rating agencies play a key role by providing risk-related information to investors.

An effective market mechanism requires that a number of onerous conditions be met: free and open markets, availability of relevant information for lenders to make decisions, no possibility of central bailout and ability on the part of borrowers to respond to market signals.[148] Markets can be developed through municipal bonds or through loans, including loans from specialised banks.[149] Interestingly, countries like Mexico and Colombia regulate lenders instead of the subnational governments, with Colombia even setting lending conditions and limits which, if violated, result in the invalidity of the credit contract.[150] In Mexico as well, the market is regulated by regulating the lending banks. A capital risk weight is assigned to loans to subnational governments depending on the credit rating of the loan. Therefore, the pricing of credit should be a function of the creditworthiness of the State or municipality.

In addition to this, Mexico's hybrid quasi-regulated market system is characterized by an explicit renunciation of federal bailouts[151] and a high degree of transparency in the subnational debt market which facilitates a correct evaluation of subnational risk by lenders.[152] This has contributed to an orderly and functional subnational debt market.[153] It appears that this has been facilitated in large part

[146] George E. Peterson, 'Measuring Local Government Credit Risk and Improving Creditworthiness' World Bank Working Paper (March 1998); Paul B. Spahn, 'Decentralization, Local Government Capacity and Creditworthiness: Macroeconomic Aspects', ECSIN Working Paper 6 (World Bank, 1999).
[147] Jorge Martinez-Vazquez and Violeta Vulovic, 'How Well Do Subnational Borrowing Regulations Work?', ADBI Working Paper Series No. 563 (2016) fn 11 at p. 6.
[148] Timothy D. Lane, 'Market Discipline' 40(1) *IMF Staff Papers* 53 (1993).
[149] William Dillinger, 'Regulations and Markets: Brazil's Efforts to Control Subnational Borrowing', United States Agency for International Development (USAID) (2003).
[150] Otaviano Canuto and Lili Liu, 'Subnational Debt Finance: Make It Sustainable' in Canuto and Giugale (eds), *The Day After Tomorrow: A Handbook on the Future of Economic Policy in the Developing World* (World Bank, 2010), at p. 225.
[151] This was done by eliminating *mandatos* or the instructions that subnationals used to give to the Federal Government, asking them to service their debt out of the latter's transfers, and the creation of intercepts which are set up as trust funds established by subnationals and their creditors.
[152] This was achieved through the requirement that all collateralised debt must be registered with the Ministry of Finance, failing which the loan is automatically risk weighted by regulators at the penalty rate of 150%. This not only raises the cost of the loan directly but also makes banks reluctant to lend at all.
[153] *See* Ernesto Revilla, 'Subnational Debt Management in Mexico: A Tale of Two Crises' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013) at pp. 153-154, 167

due to rules enforcing some of the conditions required for market discipline to be functional.

Indications of the insufficiency of market discipline are also clear from the Canadian experience, where complete autonomy regarding provincial borrowing meant that even fully developed financial markets were not able to control excessive indebtedness.[154] Another example in this regard is Brazil, where in the 1980s, a market-discipline approach led to subnational debt increasing from 1% of GDP in the early 1970s to 20% in the mid-1990s.[155] This was due to a lack of effective control on borrowing, coupled with the reputational effects of repeated bailout operations, which ultimately resulted in reduced fiscal discipline.[156]

2. Fiscal Rules

A regime relying on fiscal rules constrains the fiscal behaviour of subnational governments so as to ensure that there is predictability and robustness in the fiscal outcomes that emerge. Rules that have this effect can impose debt ceilings, deficit targets, expenditure rules of both quantitative and qualitative nature, etc.[157]

Borrowing and deficit related rules have the considerable merit of being easy to understand, monitor, and enforce but may fail if there is debt accumulation through off-budget borrowing as these do not get accounted for in compliance.[158] There is considerable discussion regarding the different kinds of deficit parameters that a fiscal deficit target can rely on: overall budget deficit, primary deficit, revenue or current account deficit, operational deficit, structurally adjusted

[154] Jorge Martinez-Vazquez and Violeta Vulovic, 'How Well Do Subnational Borrowing Regulations Work?', ADBI Working Paper Series No. 563 (2016) at p. 12; Bird, R. M., and A. T. Tassonyi. 2001. Constraints on Provincial and Municipal Borrowing in Canada: Markets, Rules, and Norms. *Canadian Public Administration* 44(1): 84 (There are no federal controls on provincial borrowing and subnational debt was seen to reach 23% of the GDP in the mid-1990s).

[155] Jorge Martinez-Vazquez and Violeta Vulovic, 'How Well Do Subnational Borrowing Regulations Work?', ADBI Working Paper Series No. 563 (2016) at p. 12.

[156] Afonso Bevilaqua, 'State Government Bailouts in Brazil', Inter-American Development Bank Research Network Working Paper #R-441 (2002) at p. 46.

[157] Jorge Martinez-Vazquez and Violeta Vulovic, 'How Well Do Subnational Borrowing Regulations Work?', ADBI Working Paper Series No. 563 (2016) at p. 13.

[158] In China for instance, although direct borrowing by subnational governments is restricted by budget law, borrowing by off-budget entities like the Urban Development and Investment Corporations have proved to be non-transparent and difficult to monitor, creating a hidden market. In Germany as well, off-budget entities have been used to circumvent borrowing controls. *See* Jorge Martinez-Vazquez and Violeta Vulovic, 'How Well Do Subnational Borrowing Regulations Work?', ADBI Working Paper Series No. 563 (2016) at p. 13. *See also* Lili Liu and Baoyun Qiao, 'Transition from Direct Central Government Onlending to Subnational Market Access in China', in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013) at p. 407; Ehtisham Ahmad, Maria Albino-War, and Raju Singh, 'Subnational Public Financial Management: Institutions and Macroeconomic Considerations' IMF Working Paper WP/05/108 (2005) at p. 17.

deficit, etc. and this constitutes a separate and complex question given the nature of the economic questions involved.[159] Expenditure rules can involve rules regarding the maximum amount that can be spent in aggregate or may be about some qualitative constraint on expenditures. The most well-known of the latter type of rule is the "golden rule" which require borrowings to be put into capital investments for the growth of infrastructure and similar assets. There is some consensus that the primary objective of subnational borrowing should be infrastructural services delivery.[160] A rule that is anchored to a measure of capacity to repay debt is aimed at bolstering market discipline and countries like Colombia and Hungary have employed such approaches in the 1990s.

One common problem with fiscal rules is the trade-off it introduces between the credibility of a rule and compliance rates on the one hand and flexibility in the face of dynamic situations on the other. Studies on such rules have shown diverse results. For example, fiscal rules appear to have worked in Brazil[161] but not in Argentina.[162] In the Brazilian case, in 2000, a Fiscal Responsibility Law was adopted to prevent states and municipalities from running excessive budget deficits. It introduced borrowing restrictions and spending constraints, and imposed public reporting on key fiscal indicators for subnational governments.[163] The constraints imposed by fiscal arrangements have been effective in controlling expenditures, and long-term discipline in Brazil has therefore been maintained through rule-based and not market-based control.[164] In Argentina, on the other hand, it has been noted that institutional weakness, legally inflexible spending obligations, mismatches between fiscal and monetary (exchange rate) policies, and economic shocks hampered the credibility and binding capacity of numerical fiscal rules

[159] Raja J. Chelliah, 'Significance of Alternative Concepts of Budget Deficit', 20(3) *IMF Staff Papers* 741 (1973); 'Guidelines for Fiscal Adjustment', Fiscal Affairs Department, International Monetary Fund, Pamphlet Series No. 49 (1995) at pp. 13-15, available at https://www.imf.org/external/pubs/ft/pam/pam49/pam49.pdf (last accessed 11 November 2018); Vito Tanzi, 'Fiscal Deficit Measurement: Basic Issues' in Blejer & Cheasty (eds), *How to Measure the Fiscal Deficit* (International Monetary Fund, 1993), at p. 13 (Tanzi mentions, for instance, "A deficit may be like an elephant: one always recognizes it when one sees it, even though it may be difficult to measure or describe it in a way that is satisfactory to everybody and for every purpose.")

[160] Mila Freire et al in Mila Freire et al (eds), *Subnational Capital Markets in Developing Countries: From Theory to Practice* (World Bank and Oxford University Press, 2004) at p. 1; James Leigland, 'Accelerating Municipal Bond Market Development in Emerging Economies: An Assessment of Strategies and Progress' 17(2) *Public Budgeting and Finance* 57 (1997); George E. Peterson and Sonia Hammam, *Building Local Credit Systems* (World Bank, 1998).

[161] Christine R. Martell, 'Fiscal Institutions of Brazilian Municipal Borrowing' 28(1) *Public Administration and Development* 30 (2008).

[162] Miguel Braun, 'The Political Economy of Debt in Argentina, or Why History Repeats Itself' World Bank (2006), available at http://siteresources.worldbank.org/INTDEBTDEPT/Resources/20061012_03.pdf (last accessed 11 November 2018).

[163] OECD, 'Brazil', available at https://www.oecd.org/regional/regional-policy/profile-brazil.pdf (last accessed 8 November 2018).

[164] Jorge Martinez-Vazquez and Violeta Vulovic, 'How Well Do Subnational Borrowing Regulations Work?', ADBI Working Paper Series No. 563 (2016) at p. 7; Christine R. Martell, 'Fiscal Institutions of Brazilian Municipal Borrowing', 28(1) *Public Administration and Development* 30 (2008).

despite there being hierarchical budgeting processes. The institutional weakness was observed to arise from a serious common pool problem caused by large variation in provincial wealth and size, unequal (malapportioned) representation of provinces, a high degree of vertical fiscal imbalance, and the ease of subnational borrowing (the combination of the last two of these features is apparently unique to Argentina).[165] There is also evidence to suggest that there has been a negative correlation between rules limiting debt and fiscal deficits in Latin America.[166]

Lastly, under a rule-based regime, there also appears to be high positive correlation between changes in fiscal balances at the national and subnational levels, mitigating concerns regarding loss of coordination with the onset of decentralisation.[167]

3. Centralised Administrative Regulation

At the opposite end of the spectrum from market discipline is the approach of giving the Central Government direct control over subnational borrowing. This approach is more frequently used by unitary countries and less by federal countries.[168] It can go to the extent of requiring the centre to evaluate and approve each different credit transaction itself, resulting in micromanagement of state debt. This acts against the efficiencies of fiscal decentralisation which have been described above. At the same time, it also does not solve the moral hazards problem since the involvement of the Central Government in the processes can result in there being difficulty in denying financial support for subnationals where there are impending defaults.

Denmark, Greece, Ireland, Mexico, and the United Kingdom are some examples of countries with administrative regulation. In the United Kingdom for instance, a local authority may not, without the consent of the Treasury, borrow from a lender from abroad or in a currency other than pounds sterling.[169] Similarly, in Spain, foreign debt as well as bond issuances by subnational governments are subject to

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[165] Miguel Braun, 'The Political Economy of Debt in Argentina, or Why History Repeats Itself', World Bank (2006), at pp. 4-5, 18-26, available at http://siteresources.worldbank.org/INTDEBTDEPT/Resources/20061012_03.pdf (last accessed 11 November, 2018).

[166] Alberto F. Alesina et al, 'Budget Institutions and Fiscal Performance in Latin America', 59(2) *Journal of Development Economics* 253 (1999).

[167] John Thornton and Armine Mati, 'Fiscal Institutions and the Relation between Central and Sub-National Government Fiscal Balances', 36(2) *Public Finance Review* 243 (2008) (studying a sample of 17 OECD countries)

[168] Jorge Martinez-Vazquez and Violeta Vulovic, 'How Well Do Subnational Borrowing Regulations Work?', ADBI Working Paper Series No. 563 (2016) at p. 15.

[169] Jorge Martinez-Vazquez and Violeta Vulovic, 'How Well Do Subnational Borrowing Regulations Work?', ADBI Working Paper Series No. 563 (2016) at p. 15.

the approval of the (central) Ministry of Finance.[170] It is important to note that India is also considered to be a country with centralised administrative regulation as has been discussed in chapter 2.[171]

4. Cooperative Regulation

Mechanisms involving cooperative regulation facilitate the active involvement of subnational governments in determining borrowing controls, including through negotiation processes, so as to arrive at overall fiscal targets for the general government as well as more specific constraints on separate governments. While combining the advantages of the other three approaches, cooperative systems promote information symmetry and dialogue between all the stakeholders who have an interest in the common pool of resources of the nation. A strong central government can be a key pivot for such an approach as it can effectively guide intergovernmental negotiations.[172]

Austria, Australia, Belgium, and South Africa appear to have adopted this approach most faithfully. In Belgium for instance, the High Council of Finance, consisting of members nominated by the federal, national, and community levels as well as the National Bank of Belgium, supervises subnational borrowing. It monitors and analyses the borrowing requirements of all levels of government at regular intervals, and formulates recommendations regarding medium and long-term budgetary targets. Based on its recommendations, agreements between the Central Government and regions are formulated which cover 5–6 years. Moreover, on the recommendation of the High Council of Finance, the Central Government can limit the borrowing capacity of a noncompliant region.[173] Similarly, Austria implemented a consultation mechanism between different levels of Government and a Stability and Growth Pact in 1999 to ensure lowering and maintaining the overall deficit to 3% of GDP.[174]

B. Ex-Post Regulations

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[170] Ehtisham Ahmad, Maria Albino-War, and Raju Singh, 'Subnational Public Financial Management: Institutions and Macroeconomic Considerations' IMF Working Paper WP/05/108 (2005) at p. 16.

[171] For the manner in which administrative regulation in India is designed and implemented, *see* chapter 2.

[172] Isabelle Joumard and Per Mathis Kongsrud, 'Fiscal Relations across Government Levels', *OECD Economic Studies* No.36, 2003/1 (2003).

[173] Jorge Martinez-Vazquez and Violeta Vulovic, 'How Well Do Subnational Borrowing Regulations Work?', ADBI Working Paper Series No. 563 (2016) at p. 16.

[174] Jorge Martinez-Vazquez and Violeta Vulovic, 'How Well Do Subnational Borrowing Regulations Work?', ADBI Working Paper Series No. 563 (2016) at p. 16; Thöni, Garbislander, and Haas, 'Local Budgeting and Local Borrowing in Austria' in Dafflon (ed), *Local Public Finance in Europe: Balancing the Budget and Controlling Debt* (Cheltenham-Northampton: Edward Elgar, 2002).

Debt markets will inevitably fail from time to time. Bearing this in mind, a well-structured regulatory framework should not ignore ex-post mechanisms to deal with insolvency and restructuring.[175] Mechanisms to deal with subnational insolvency ensure that there are increased costs for the violation of ex-ante rules and this ensures that the ex-ante rules are also strengthened.[176] The merits of these processes have much in common with insolvency laws for private entities, and also include enforcement of hard budget constraints, assurances on the continuation of operations including essential public services, and restoration of financial health in order to re-enter markets eventually. Ex-post regulation processes ensure that demands for preferential treatment by some creditors (what is referred to as a "hold-out problem") do not derail insolvency processes and become essential features of borrowing regulation as markets develop and the number of creditors rise to the thousands (increasing the need for coordinated responses).[177]

There are two main types of ex-post regulations, namely judicial and administrative.[178] In the judicial approach, courts lead the restructuring process and take key decisions in that regard, and they coordinate the interaction of debtors, creditors, citizens, and government auditors.[179] The advantage of this type is that it is apolitical and neutralises political pressure, but the ability of courts to impose fiscal adjustments on subnational governments is limited.[180] The administrative approach usually allows intervention of higher levels of government in resolution of subnational insolvency.[181]

In Hungary, under the Municipal Debt Adjustment Law, 1996, municipal insolvency can lead to a court-supervised bankruptcy and reorganization process that is led by an independent receiver or trustee. So far as implementation is concerned, it has been observed that the moral hazard of bailouts has been minimized, essential

[175] Ernesto Revilla, 'Subnational Debt Management in Mexico: A Tale of Two Crises' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013) at p. 166.
[176] Otaviano Canuto and Lili Liu, 'Subnational Debt Finance: Make It Sustainable' in Canuto and Giugale (eds), *The Day After Tomorrow: A Handbook on the Future of Economic Policy in the Developing World* (World Bank, 2010), at p. 225.
[177] Otaviano Canuto and Lili Liu, 'Subnational Debt Finance: Make It Sustainable' in Canuto and Giugale (eds), *The Day After Tomorrow: A Handbook on the Future of Economic Policy in the Developing World* (World Bank, 2010), at p. 226.
[178] Jorge Martinez-Vazquez and Violeta Vulovic, 'How Well Do Subnational Borrowing Regulations Work?', ADBI Working Paper Series No. 563 (2016) at p. 17.
[179] Ehtisham Ahmad, Maria Albino-War, and Raju Singh, 'Subnational Public Financial Management: Institutions and Macroeconomic Considerations' IMF Working Paper WP/05/108 (2005) at p. 21.
[180] Jorge Martinez-Vazquez and Violeta Vulovic, 'How Well Do Subnational Borrowing Regulations Work?', ADBI Working Paper Series No. 563 (2016) at p. 17.
[181] Some countries, such as South Africa and the United States, prefer a combination of judicial and administrative approaches. *See* Jorge Martinez-Vazquez and Violeta Vulovic, 'How Well Do Subnational Borrowing Regulations Work?', ADBI Working Paper Series No. 563 (2016) at p. 17.

services have been maintained, and local assemblies have cooperated with the court and trustee in each bankruptcy procedure.[182]

On the other hand, Colombia offers a good example of a country that has adopted an administrative approach within a legal framework. Law 550 (1999) deals with bankruptcy proceedings for subnational governments, and it specifies the Superintendency of Corporations (SOC) to fill the role played by bankruptcy courts in many countries. The unique role played by the SOC is a result of the particular historical context in Colombia, characterized by a weak and ineffectual court system. The SOC administers bankruptcy procedures for both corporations and government entities. It works in coordination with other institutions such as the Ministry of Finance and Public Credit.[183] Another example is France, where in the event of subnational insolvency, the Central Government intervenes to enforce fiscal adjustment and facilitate debt negotiations between the creditors and borrower.[184]

C. Conclusion and Relevance for India

From the time of the original classification of approaches to subnational debt regulation, it has been indicated that sole reliance on markets and market-based regulations for fiscal discipline is not advisable and that a rule-based regime is better than a centre-driven regime of administrative control.[185] Nonetheless, it must be considered whether India should, in combination with its fiscal rules, liberalise financial markets further, apart from bolstering market discipline through transparency measures, subnational fiscal flexibility and removal of bailout expectations.[186]

Another study finds that the effective regulation of subnational borrowing requires there to either be some strong hierarchy in the oversight mechanism or strong market mechanisms at play.[187] Therefore, it must be considered how far the two can be made to operate in combination in the first place. Studies of European

[182] Charles Jókay, 'Hungary: Subnational Insolvency Framework' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013) at pp. 261, 301.
[183] Azul del Villar, Lili Liu, Edgardo Mosqueira, Juan Pedro Schmid, and Steven B. Webb, 'Colombia: Subnational Insolvency Framework' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013) at pp. 179-180.
[184] Lili Liu, Norbert Gaillard, and Michael Waibel, 'France's Subnational Insolvency Framework', in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013) at p. 220.
[185] Teresa Ter-Minassian & Jon Craig, 'Control of Subnational Government Borrowing' in Teresa Ter-Minassian (ed), *Fiscal Federalism in Theory and Practice* (International Monetary Fund, 1997)
[186] International Monetary Fund, 'India: Selected Issues', IMF Country Report No.18/255 (August 2018), at pp. 12-18.
[187] Jonathan Rodden and Gunnar S. Eskeland, 'Lessons and Conclusions' in Rodden et al (eds), *Fiscal Decentralization and the Challenge of Hard Budget Constraints* (MIT Press, 2003).

countries and industrialised countries have each arrived at findings that no particular type of regulation has worked better than the other[188] and the outcomes from the different approaches has often depended on the peculiarities of the country under consideration.[189] Past and recent single-country and cross-country empirical evidence appears to corroborate these findings and conclusive evidence on whether one approach is objectively better than the other has been lacking.[190]

As aforesaid, India may be categorised as a country with administrative regulation. However, as discussed above, every Indian State has enacted their own FRL which prescribe specific targets, such as regarding fiscal deficit to be maintained at a particular percentage of GSDP.[191] Moreover, market borrowings by Indian States, which are carried out through auctions conducted by the RBI, constituted a 66.1% share in financing Gross Fiscal Deficit in 2017-18.[192] Therefore, India appears to show several aspects of rule-based regulations, as well as an increasing movement towards market discipline.

In addition to this, the manner in which the administrative control in India is applied also reveals certain cooperative features. The role of the Finance Commission as an independent, expert, advisory body, which takes into account the views of both Centre and State Governments in formulating its recommendations, is particularly relevant in this regard. As discussed previously, the Central Government has over the years by convention accepted the recommendations given by the Finance Commission, giving effect to them via the consent mechanism under Article 293(3).[193]

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[188] Jørn Rattsø, 'Fiscal Controls in Europe: A Summary' in Dafflon et al (eds), *Local Public Finance in Europe: Balancing the Budget and Controlling Debt* (Edward Elgar, 2002); Suzanne Kennedy et al, 'The Role of Fiscal Rules in Determining Fiscal Performance', (Department of Finance, Government of Canada, 2003), available at http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.847.1129&rep=rep1&type=pdf (last accessed 11 November 2018).

[189] Alexander Plekhanov and Raju Singh, 'How Should Subnational Government Borrowing Be Regulated? Some Crosscountry Evidence', 53(3) *IMF Staff Papers* 426 (2006).

[190] Jorge Martinez-Vazquez and Violeta Vulovic, 'How Well Do Subnational Borrowing Regulations Work?', ADBI Working Paper Series No. 563 (2016); James M. Poterba and Jurgen von Hagen (eds), *Fiscal Institutions and Fiscal Performance* (The University of Chicago Press, 1999); Gilles Dufrénot et al, 'The French Regions' Borrowing Behaviours: How Heterogeneous Are They?' Banque de France Document de Travail No. 289 (Banque de France, 2010); Antonio Afonso and Sebastian Hauptmeier, 'Fiscal Behaviour in the European Union: Rules, Fiscal Decentralization and Government Indebtedness', European Central Bank Working Paper 1054 (2009); Francesca Fornasari et al, 'The macroeconomic impact of decentralized spending and deficits: international evidence', 1(2) *Annals of Economics and Finance* 403 (2000).

[191] For a discussion on State FRLs, *see* chapter 2.

[192] For a discussion on the RBI, *see* chapter 2.

[193] For a discussion on the Finance Commission, *see* chapter 2.

The Indian Finance Commission appears to be derived from the Australian Commonwealth Grants Commission,[194] which provides advice to the Australian Federal Government regarding distribution of tax revenue to subnational governments.[195] But, unlike the Indian Commission, it does not cover subnational borrowing. In Australia, this is regulated by a Loan Council, which is an example of a cooperative framework containing representatives from the Centre and States.[196] In this context it is worth noting that in countries with more centralised systems in place, there is a lesser need for special institutions to coordinate fiscal discipline across governments. However, decentralisation and market decontrol increase the need for coordination.[197] Since these trends have been observed in India, this observation is particularly relevant. Therefore, due to the passage of time and change in policies, it may be worth considering the possibility of a similar cooperative framework in India.

As far as ex-post mechanisms are concerned, it appears that the constitutional arrangements for revenue sharing among the Indian federation and the consultative mechanism among the Centre and States have tended to reduce the risk of explicit State defaults.[198] Moreover, the States do not seem to have bailout expectations from the Centre.[199] In the event of state-specific shocks, these are inevitably absorbed and shared across the general government.[200] Due to these

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[194] *See* Constituent Assembly Debates, Vol 9, speech by Shri T.T. Krishnamachari, 10th August 1949, available at http://cadindia.clpr.org.in/constitution_assembly_debates/volume/9/1949-08-10 (last accessed 8 November 2018); An analogous institution, comparable with the Indian Finance Commission, is the Financial and Fiscal Commission of South Africa. It is also a constitutional body, and it aims to provide proactive, expert, and independent advice on promoting a sustainable and equitable Intergovernmental Fiscal Relations System. Under the South African Constitution, provinces may raise loans in accordance with national legislation, but such legislation may only be enacted after giving consideration to recommendations of the said Commission. *See* Financial and Fiscal Commission (South Africa), available at http://www.ffc.co.za/ (last accessed 9 November 2018); The Constitution of the Republic of South Africa, 1996, Articles 230 & 220-2.

[195] Australian Government, Commonwealth Grants Commission, 'About us', available at https://www.cgc.gov.au/about-us (last accessed 8 November 2018);

[196] Ehtisham Ahmad, Maria Albino-War, and Raju Singh, 'Subnational Public Financial Management: Institutions and Macroeconomic Considerations' IMF Working Paper WP/05/108 (2005) at p. 17. As discussed previously, the Expert Committee on the Financial Provisions of the Union Constitution appointed by the Constituent Assembly of India had considered, but ultimately decided against, setting up a similar Ministerial Conference or a Loan Council in India.

[197] Otaviano Canuto and Lili Liu, 'Overview' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013) at p. 4.

[198] C. Rangarajan and Abha Prasad, 'Managing State Debt and Ensuring Solvency: The Indian Experience' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013) at p. 112.

[199] FRBM Review Committee Report, Volume 1 (January 2017) at p. 97.

[200] This is a result of the particular politico-institutional arrangement in India, and it has been systematically institutionalised since the time of FC-XI. For example, FC-XI had made recommendations regarding the disaster management and calamity relief funds maintained at the level of Centre and States. In the State-level fund, the Centre contributes a substantial proportion, as per Finance Commission recommendations. *See* FRBM Review Committee Report, Volume 1 (January 2017), at p. 97; *See also* Report of the Eleventh Finance Commission (2000-2005) (June 2000), Chapter 9; Report of the Fourteenth Finance Commission (2015-20) (December 2014), at paras 10.4 and 10.40.

factors, the extent to which ex-post mechanisms have been incorporated in India and how effective they would prove in an exigency is unclear. As such, where the possibility of filling this gap may be considered, the options offered by examples of other countries as discussed above may be helpful, though not determinative.

Chapter 6: Recommendations on the Exercise of Articles 293(3) and (4)

The previous chapters in this report each examined a facet of the complete picture in the broader study of Articles 293(3) and (4) of the Constitution. In this chapter, these various facets are tied together to arrive at recommendations regarding the operation of those provisions. After identifying crucial issues regarding the present implementation of the provisions, the chapter focuses on how subnational borrowing regulation can be structured going forward under the present constitutional scheme.

A. Review of Findings

Chapter 2 examined the present constitutional provisions and institutional frameworks and found that the Centre's appropriate legal role in relation with subnational borrowing should be limited to ensuring macroeconomic fiscal stability and sustainability of State debt. This analysis of the present legal position streamlined the considerations of this study, directing the analysis towards those policies that effectively ensure fiscal stability in the context of subnational borrowing. A survey of economic and policy literature on this subject was therefore made in chapter 3, which concluded that there is a need to reconcile tensions between securing the benefits of decentralisation and safeguarding against instability. Chapter 4 pursued a closer examination of the Indian experience on State borrowing regulation so as to understand the peculiarities of the Indian context and appreciate the reasons behind the current status of State debt. It found that there has been a noticeable shift in State borrowings towards the market even if the operation of market discipline can still be doubted. It also made clear that the current structure of regulation has been one that respects State autonomy and displays forbearance to an extent on the part of the Centre.

These chapters collectively point towards the need for striking a balance between the competing objectives of decentralisation and autonomy of a State on the one hand, and centralised control and fiscal stability on the other. It is not only a consideration for effective policy-making but is also relevant for the appropriate allocation of roles to the Centre and the States under constitutional fiscal federalism. In light of this, chapter 5's comparative study of regulatory models in other countries moved the focus towards solutions. A number of jurisdictions have had to strike the balance described above and have done so in different ways. The study noted how no single model is objectively superior and how the choice of model often depends on country-specific considerations. Accordingly, when viewed in light of India's recent experiences and current position, attention is directed

towards strengthening market discipline along with improvements in coordination/cooperation mechanisms.

B. Subsidiarity in the Regulation of State Borrowing

The study thus far has outlined a core objective for the regulation of State borrowing going forward: it needs to be able to ensure the fiscal stability of States on the one hand while securing the benefits of decentralisation under market discipline and respecting the autonomy of States under our Constitution, on the other. In striking this balance and respecting the constitutional demarcation of functions, State autonomy should not be mistakenly viewed as a binary issue. Balancing levels of autonomy will require calibration, especially if a path of gradual reform is to be shaped instead of a reactionary and sudden shift in priorities.[201]

While the evolution of policy over the last two decades has gradually increased State autonomy, a pressing issue that remains is the implicit guarantee that the Centre continues to give for State debt in the eyes of the market. This bailout expectation may be significantly limiting the benefits that can be drawn from fiscal decentralisation.[202] Since the present scheme presupposes the constant

[201] The existence of a range of autonomy levels is also apparent from the existence of a range of possible approaches for subnational borrowing regulation (as seen in chapter 5). The range is best exemplified, however, by measurements of such autonomy in the form of a borrowing autonomy index. The index focuses on whether subnational borrowing is prohibited, permitted but only with authorisation, constrained by numerical limits, or constrained in terms of the use of funds. *See* Inter-American Development Bank, *Economic and Social Progress in Latin America, 1996 Report: Special Section, Making Social Services Work* (IDB, 1996), at pp. 173-176 and 188; further adapted by Rodden in Jonathan A. Rodden, 'The Dilemma of Fiscal Federalism: Grants and Fiscal Performance around the World', 46(3) *American Journal of Political Science* 670 (2002). *See also* Jonathan A. Rodden, *Hamilton's Paradox: The Promise and Peril of Fiscal Federalism* (Cambridge University Press, 2006), ch 4 (for a discussion on the interaction between borrowing autonomy, vertical fiscal imbalance and fiscal responsibility). The index focuses on whether subnational borrowing is prohibited, permitted but only with authorisation, constrained by numerical limits, or constrained in terms of the use of funds.

[202] *See* International Monetary Fund, 'India: Selected Issues', IMF Country Report No.18/255 (August 2018), at p. 13. A necessary element for striking the right balance in this scheme would additionally involve exposure to market discipline to the extent of allowing States the "freedom to fail". Paul E. Peterson & Daniel Nadler, 'Freedom to Fail: The Keystone of American Federalism', 79 *The University of Chicago Law Review* 253 (2012). The risks of taking such a leap are obvious with a key concern being the lack of capacity regarding public financial management. Decentralisation raises a "chicken-and-egg problem" in the sense that efficiencies from decentralisation may be necessary for building subnational capacity but decentralised decision-making may itself require capacity. This makes it important to allow subnationals to "learn by doing" with capacity-building measures of the centre supplementing such learning. *See* Tom Hart & Bryn Welham, 'Fiscal decentralisation: A public financial management introductory guide', *Overseas Development Institute* (November 2016), at p. 18, available at https://www.odi.org/sites/odi.org.uk/files/resource-documents/11063.pdf (last accessed 15 October 2018). Another concern is the loss of coordination following market decontrol. Coordination between Finance Commission recommendations, State-level FRLs and consents given the Centre under Article 293(3) may, to some extent, be considered a fortuitous outcome driven by necessities and convention.

threat of central intervention in State borrowing, it needs to be considered how this effect can be mitigated. Allowing the Centre or the Finance Commission to strike the balance for each State or for all states collectively may not be the appropriate paradigm for regulation in the market context. This is because the proximity of central bodies to subnational debt markets can result in potential creditors believing that the role of these bodies goes beyond balancing and extends to providing a guaranteed safety net.

Mitigating these bailout expectations within the current constitutional scheme may thus require a regulatory structure that operates in line with a principle of subsidiarity.[203] This principle requires that central institutions refrain from acting, even though they may be constitutionally permitted to do so, if their objectives could effectively be achieved by actions taken by a lower level of government. Subsidiarity thus expresses a preference for governance at the most local level that is consistent with achieving the relevant governance objectives. Generally, the advantages in applying this principle include: self-determination and accountability, political liberty, flexibility and responsiveness to local needs, preservation of identities, diversity, and respect for internal divisions.[204]

In this context, it is relevant to note that Articles 293(3) and (4) provide for a potentially flexible gateway for the introduction of almost any regulatory structure, provided that the Centre is willing to practice forbearance. The regulatory structure proposed below capitalises on this flexibility. Such a structure can work in a layered manner with each layer (as described below) representing degrees of separation between State autonomy on the one end and more centralised control on the other. Under this scheme, higher levels of regulation would only come into operation when there are failures on the part of lower levels. This layered approach ensures that the Centre or central agencies do not enter into the picture unless market and State-level mechanisms fail, ensuring that there are safeguards for autonomy and incentives for responsibility.

C. PROPOSED REGULATORY STRUCTURE

The different layers referred to above are outlined below:

[203] Treaty of Lisbon Amending the Treaty on European Union and the Treaty Establishing the European Community, 13 December 2007, 2007 O.J. (C306) 1, Article 5(3) ("Under the principle of subsidiarity, in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level.")
[204] George A. Bermann, 'Taking Subsidiarity Seriously: Federalism in the European Community and the United States', 94(2) *Columbia Law Review* 331 (1994) at pp. 334, 339-344.

1. Layer 1: Market Discipline

As discussed above, capital markets have not been adequately sensitive to the variations in fiscal health and behaviour across different States with creditors meting out limited yield spreads. Measures to augment market discipline may require reduction of transfer dependence on the part of States as transfers may be seen as a route for implicit bailout guarantees. While untied transfers from tax devolution are determined partly on the basis of need, a return to weightage on fiscal discipline and efficiency (which have been included by Finance Commissions in the past) may provide appropriate incentives for responsibility under the formula-based mechanism.[205]

Further steps may also be taken to enhance market discipline. The RBI's ability to impose stop-payments and have first claim over State revenues for the purposes of repayment obligations may be seen to create the conditions for an implicit debt guarantee.[206] The RBI plays this role in relation with all States, to ensure that they do not renege on their borrowings. This has an equalising tendency, and prevents the market from appropriately distinguishing between States on the basis of fiscal performance, thereby hampering the operation of market discipline. Equally, it may be appropriate that the RBI-mandated Standard Liquidity Ratio (SLR) be lowered further. Due to the SLR requirement, it is mandatory for banks to invest in SDLs, which negatively affects market discipline as banks cannot take decisions based on creditworthiness. It has been noted that past reductions in SLR have increased bond market liquidity and this is seen as further bolstering market discipline.[207]

On another note, how to best create a credible commitment against central bailouts needs to be considered. At one level, there may be a perception that the Centre's involvement in the enforcement of debt ceilings (as recommended by FC-XIV) may be viewed as some form of a repayment guarantee; at another level, previous instances of rescheduling, waivers and subsidies may be viewed as willingness on the part of the Centre to engage in bailouts.[208] A framework

[205] Report of the Fourteenth Finance Commission (2015-20) (December 2014), at para 8.22.
[206] International Monetary Fund, 'India: Selected Issues', IMF Country Report No.18/255 (August 2018), at p. 13.
[207] International Monetary Fund, 'India: Selected Issues', IMF Country Report No.18/255 (August 2018), at p. 16.
[208] International Monetary Fund, 'India: Selected Issues', IMF Country Report No.18/255 (August 2018), at p. 17. Markets perceive the Centre's close involvement to be one that ensures debt sustainability as it does not allow States to take risks according to their specific circumstances. Such controls can even include implicit bailouts that limit the availability of information regarding the gravity of debt distress that a State may be in. To a limited extent, the explicit declaration that a State is being bailed out can ensure that markets are better aware of the responsibility (or lack thereof) of the relevant States.

providing for explicit bailouts instead of implicit ones may thus be preferable.[209] In the long term, situations of debt distress may also be viewed as opportunities for the Central Government to make a clear and credible commitment against blank cheque bailouts.[210] Commitments towards a no-bailout rule can also be hardcoded into the political economy of the country through the constitutionalisation of this commitment with specific triggers and legislative majorities in place to deal with exceptional situations.[211]

2. Layer 2: State-Level Mechanisms

The current rule-based regime places some reliance on the quality and operation of the State-level FRLs. It may be that the operation of the consent mechanism under Article 293 has not allowed these legislations to fully function as a self-sufficient mechanism in tandem with the markets.[212] Consequently, it is felt that this self-sufficiency may emerge if effective oversight is undertaken by State-level bodies (i.e. State Legislatures and independent agencies appointed under State FRLs).[213]

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[209] If, as part of this new framework, bail-in features are incorporated with creditors facing the risk of losses through haircuts of some kind, they would be incentivised to differentiate between States. Alternatively, an insolvency framework for States that does not involve Central bailouts could rely upon debt restructuring and asset sales though this may only become relevant for India as markets mature further and creditor coordination problems are aggravated. International Monetary Fund, 'India: Selected Issues', IMF Country Report No.18/255 (August 2018), at p. 17; Otaviano Canuto and Lili Liu, 'Subnational Debt Finance: Make It Sustainable' in Canuto and Giugale (eds), *The Day After Tomorrow: A Handbook on the Future of Economic Policy in the Developing World* (World Bank, 2010), at p. 226.

[210] "There are basically two ways to organize spending and borrowing authority in a federation: the central government can exercise hierarchical control over borrowing and spending by the subunits, or it can leave those subunits fiscally sovereign … If the federation takes the first approach, then the central government will generally be responsible for the subunits' fiscal health and will guarantee their debts. … In the absence of hierarchical controls, however, it is critical that the central government commit not to bail out the subunits. … Ever since Congress allowed several states to default in the 1840s, its "no-bailout" commitment has been perceived as highly credible." Emily D. Johnson and Ernest A. Young, 'The Constitutional Law of State Debt', 7(1) *Duke Journal of Constitutional Law & Public Policy* 117, at pp. 146-147 (2012).

[211] The Maastricht Treaty for the European Union thus has a provision eliminating any liability on the part of the Community or any Member State for the commitments of any other Member State and even prevents the voluntary assumption of such liability (Article 104b(1), Treaty on European Union, 31 ILM 247 (1992)). However, Article 103a of the Treaty also permits Community financial assistance for a Member State in "severe difficulties caused by exceptional occurrences beyond its control" on a proposal from the European Commission and on the unanimous approval of the European Council. Where the difficulties are caused by natural disasters, this assistance can be given on a "qualified majority" short of unanimity.

[212] Non-compliance with the rules or sustained readjustments to the targets can be viewed by the market as fiscal irresponsibility. The operation of these mechanisms thus has synergies with market signals and require some degree of State-level monitoring, legislative oversight and alertness on the part of executive bodies to prevent non-compliance where market signals are not forthcoming.

[213] State FRLs provide for legislative oversight as well as oversight by independent agencies in some cases (*see* Annexure 1).

Further, it is significant to note that while numerical ceilings have been imposed centrally in the past, qualitative fiscal behaviour of States is decided almost entirely at the subnational level.[214] Rules regarding expenditure on salaries or taking on of guarantees appear to have been unilaterally placed by State legislatures in their own FRLs.[215]

Unless exceptional situations of macroeconomic instability arise, which are closely linked to the uses of borrowed funds by the State, it is not only appropriate but also constitutionally sound for core policy choices to be kept out of the Centre's purview. While State FRLs impose a number of transparency requirements, lags in publication of accounts still need to be cut short and information on public sector undertaking debt needs to be included in FRL disclosures to allow for a comprehensive picture.[216]

3. Layer 3: Centralised Regulation

The final layer of regulation is composed of the actions of central agencies, constitutional bodies and the Central Government. Entities like the RBI and the Finance Commission have come to occupy key positions in the oversight and coordination of State borrowing. The RBI's role as banker to State Governments obliges it to monitor and manage their finances and allows it to oversee these fiscals on an ongoing basis. In this capacity, it has already been attempting to enhance market discipline.[217]

On the other hand, previous Finance Commissions have played key roles in coordinating fiscal behaviour by consolidating information and expert opinion to

[214] One broad exception has been the central imposition of revenue deficit targets which affect the ability of States to determine the nature and extent of capital and revenue expenditure in their budgets.
[215] What is more, in the course of the fiscal corrections following 2004-2005, a number of reforms were put into place by States themselves that went beyond the "realm of fiscal space". *See* World Bank, *State Fiscal Reforms in India: Progress and Prospects* (November 10, 2004), at p. 11, available at http://documents.worldbank.org/curated/en/464751468771276830/pdf/288490IN.pdf (last accessed 12 November 2018). Expenditure reforms pursued without central imposition included recruitment restrictions, limits on administrative expenditures, cuts in pension costs, reduced subsidies, and privatisation of public sector undertakings. *See* C. Rangarajan & Abha Prasad, 'Managing State Debt and Ensuring Solvency: The Indian Experience' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013) at p. 122; For example, the FRLs of Jharkhand and Odisha require these State Governments to limit the ratio of salary to State's own revenue at 80%. *See* Annexure 1.
[216] International Monetary Fund, 'India: Selected Issues', IMF Country Report No.18/255 (August 2018), at pp. 16-17; Report of the Fourteenth Finance Commission (2015-20) (December 2014), at paras 14.20 – 14.24; FRBM Review Committee Report, Volume 1 (January 2017), at pp. 90-91.
[217] The RBI is also well-placed to be able to build State capacity to navigate capital market signals as these markets mature. RBI's Standing Technical Committee on State Borrowings can also be considered to be a forum for coordination and cooperation that is available on a more regular basis during the five-yearly periods between Finance Commission reports.

arrive at independent and unbiased recommendations for effective public finance management. However, its interventions have been on a five-yearly basis and involve long-term planning. The operation of the National Statistical Commission and the Comptroller and Auditor General of India is also crucial as these agencies operate to coordinate statistics and ensure their veracity.[218]

Lastly, the Centre's power to give consent and impose conditions under Articles 293(3) and (4) forms part of this layer. In exercising this power, the Centre should differentiate between actions that it has already been taking under these provisions, and other potential applications. The imposition of debt ceilings under this mechanism has been the basis of regulation until this point, and it is recommended that this should remain so for the near future, as an exception to this structure (as discussed below). Where this mechanism should operate as a regulatory tool of last resort is in relation with impositions other than debt ceilings. Such other impositions may be for enforcement purposes where State-level implementation fails to occur or where States have not adopted critical rules, institutions, and market-enhancing solutions.

4. Significance of and Exceptions to the Proposed Regulatory Structure

The structure proposed above attempts to resolve the core dilemma in guiding Indian subnational markets towards greater market discipline, which is the fear that hierarchical control can blunt effective market forces.[219] Nurturing market discipline is important because it serves as a further useful channel to maintain prudent State finances. The movement of the debt profile of Indian States towards market borrowings also indicates the need to shift away from central impositions.

However, as aforesaid, one exception to the above structure is proposed. It is important to remember that Article 293(3) has played an important role for stable fiscal consolidations in the past. FC-XIV underscored the effectiveness of the existing mechanisms, and further relied on the same for its own award period.[220] If

[218] The Gazette of India, Notification No.85, Ministry of Statistics and Programme Implementation, Government of India (1st June, 2005), available at http://mospi.nic.in/sites/default/files/notifications/nsc_notifc85.pdf (last accessed 12 November 2018); Constitution of India, 1950, Article 148.

[219] Jonathan Rodden and Gunnar S. Eskeland, 'Lessons and Conclusions' in Rodden et al (eds), *Fiscal Decentralization and the Challenge of Hard Budget Constraints* (MIT Press, 2003); Emily D. Johnson and Ernest A. Young, 'The Constitutional Law of State Debt' 7(1) *Duke Journal of Constitutional Law & Public Policy* 117, at pp. 146-147 (2012). Bailout expectations arising from the close involvement of a central government in financing subnational units may be difficult to dislodge, creating plausible justifications that it is "only fair" for the Centre to do so. *See* Emily D. Johnson and Ernest A. Young, 'The Constitutional Law of State Debt' 7(1) *Duke Journal of Constitutional Law & Public Policy* 117, at p. 148 (2012).

[220] "We expect the Union Government to enforce the fiscal roadmap through the powers it has to approve any borrowing by the States during our award period under Article 293(3) of the Constitution. … We urge that all stakeholders recognise the predominant role of the Union in fiscal

such practice is to continue effectively, it cannot be reduced to an intervention that occurs only after markets and State-level mechanisms have failed. In light of the merits of the existing system, the imposition of debt ceilings under Article 293(3), pursuant to Finance Commission recommendations, may continue to operate as an exception to the above proposed structure for now.[221] This means that, for the purpose of these debt ceilings, the impositions of the Centre cannot realistically be viewed as a Layer 3 intervention, but rather a primary or frontline mechanism. This will enable a gradual but clear reform path, as market discipline is nurtured with careful calibration in the withdrawal of Central involvement. In other words, the proposed regulatory structure distinguishes between the present operation of the provisions under study and other interventions which may be envisaged in the future, especially under Article 293(4).

It is pertinent to note that the recommendations of this study (as discussed above) do not go to the extent of requiring constitutional amendments, as these are not absolutely necessary in order to effectuate the proposed regulatory structure. However, so far as the specific question of ensuring a credible no-bailout commitment by the Centre is concerned, there may be some merit in implementing this through a constitutional amendment which formally removes the Centre's power to bail out irresponsible States. This would effectively eliminate any need to rely on the forbearance of the Centre, and may be worth considering as several jurisdictions have faced significant difficulty in fully removing bailout expectations. The problem lies in the fact that the legal competence of the Centre to interfere can often be enough to create this expectation. Thus, to the extent that a firm and explicit in-principle commitment against bailouts is sought to be made, a constitutional amendment may also be considered.

D. Recommended Criteria/Conditions Under Articles 293(3) and (4)

As the Centre moves towards utilising the conditionality mechanism under Article 293(4), it is necessary to differentiate between the kinds of impositions that are possible under Articles 293(3) and (4). This differentiation will not only provide clarity on which provision is being activated in which scenario but will also allow future policy-makers to have a complete view of all options available. The Centre

management, while considering our roadmap for the Union and the States that treats a conducive fiscal environment as the joint responsibility of both. … While the Union Government has been generally able to enforce fiscal rules on the States, its own record of adherence to fiscal rules has not been impressive. …" Report of the Fourteenth Finance Commission (2015-20) (December 2014), at paras 14.61, 14.87 and 14.99.

[221] For debt ceilings recommended by FC-XIV, *see* Report of the Fourteenth Finance Commission (2015-20) (December 2014), at para 14.64.

can either formalise the criteria for the grant of consent under Article 293(3)[222] or impose conditions under Article 293(4),[223] with these conditions further being distinguished as conditions precedent and subsequent.[224]

As conditions here are being attached to the Centre's approvals of State borrowings, an important question is whether the violation of the conditions would invalidate the approval itself, thus making the borrowing illegal. At present, these approvals are being given if a State is not crossing its borrowing limit as per the FC-XIV formula and this formula requires the *estimation* of GSDP levels.[225] It would appear that where the actual GSDP figures turn out to vary from the estimations made for the purpose of loan approvals, the relevant borrowing shortfalls below or overruns above the revised borrowing limit are carried forward for the calculation of the limit in the subsequent year. This year-on-year mechanism shows how enforcement can take place on a continuing basis. The consent in relation with debt ceilings is thus always subject to an implicit condition that the estimate is accurate. Where this is not realised, implying that the State in fact crossed its borrowing limit, this implicit condition carries forward into the next year as a criterion for borrowing approvals.

On the basis of the above considerations, consents under Article 293(3) may be given subject to the following conditions under Article 293(4):[226]

1. Debt ceilings: Debt ceilings are already being enforced through this mechanism and this scheme of implementation appears to be sound and does not appear to raise any issues of constitutionality. Going forward, a relaxation of this ex-ante role of the Centre would perhaps create room for

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[222] The formalisation of some criteria for consent may already be seen in the form of debt ceilings. Any approach to regulating State debt must consider how the choice of criteria for granting consents affects the behaviour of States.
[223] This apparent interchangeability of criteria and conditions is largely dependent upon whether the satisfaction of a requirement is verifiable at the time of giving the approval. Requirements that are verifiable at the time become criteria and requirements verifiable only at a future point become conditions.
[224] A condition precedent would permit the borrowing to take place only if the condition is satisfied first. A condition subsequent must be satisfied by the borrower after the borrowing has already happened. A failure to meet a condition precedent can result in the borrowing becoming impermissible before it can even be done. A failure to meet a condition subsequent triggers a default in private transactions and can be considered to result in the invalidity of the borrowing in the context of Article 293(4). *See* 'Condition precedent', Thomson Reuters Practical Law, available at https://uk.practicallaw.thomsonreuters.com/7-200-1382?originationContext=document&transitionType=DocumentItem&contextData=(sc.Default) (last accessed 12 November 2018)); 'Condition subsequent', Thomson Reuters Practical Law, available at https://uk.practicallaw.thomsonreuters.com/4-382-3093?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1 (last accessed 12 November 2018).
[225] Report of the Fourteenth Finance Commission (2015-20) (December 2014), at para 14.66.
[226] These may, however, be considered criteria for the consent, depending on the timing of the imposition.

market discipline. While complete withdrawal of the Centre is not presently recommended, the consent mechanism can eventually be modified by introducing greater flexibility in fiscal targets. The existing flexibility afforded under the FC-XIV recommendations can be enhanced through the creation of a deficit range instead of a ceiling. It may also be done by identifying other triggers for enhanced borrowing capacity.[227]

2. Transparency and reporting rules: While a broad range of transparency measures are already envisaged under the State FRLs (see Annexure 1), the Centre can apply conditions that disclosures be made in two ways. First, the conditions can act to ensure that State Governments comply with their own FRLs. Second, the conditions can fill gaps where some form of reporting requirement is crucial for a clear understanding of a State's finances and such reporting is currently not mandated in the State's FRL.[228] So long as the disclosures pertain to fiscal stability and sustainability of debt, such conditions should be in conformity with the Constitution.
3. Other market-enhancing requirements: A range of measures for the enhancement of market discipline can also be put into effect under this mechanism. The RBI has been taking measures to incentivise credit ratings for SDLs and investments in the CSF and GRF.[229] In the event of difficulties that may arise in implementing these through incentives, it may be appropriate to impose them as conditions instead. This may ensure comprehensive credit rating coverage of all Indian States and regular as well as universal contributions to these funds. Both these measures relate significantly to debt sustainability and should be within the bounds of the Constitution.
4. Cash surplus elimination requirements: Surplus unutilised cash balances constitute another concern. These received some scrutiny on the part of the FRBM Review Committee and recent RBI proposals have pointed towards the need to ensure that existing cash balances are utilised before resorting to

[227] Such flexibility criteria may include recent fiscal trends, overall accumulated debt, counter-cyclical requirements, uneven levels of growth, distinct capital investment roadmaps etc. Where this is pursued, it may be appropriate to impose conditions to ensure that funds are used for the purpose for which flexibility has been permitted.

[228] In the present circumstances, the latter gap appears to have arisen in relation with high-frequency fiscal data, data on the debt of State public sector undertakings and data on guarantees given by State Governments. *See* International Monetary Fund, 'India: Selected Issues', IMF Country Report No.18/255 (August 2018), at pp. 16-17; Report of the Fourteenth Finance Commission (2015-20) (December 2014), at paras 14.20 – 14.24; FRBM Review Committee Report, Volume 1 (January 2017), at pp. 90-91.

[229] Speech by Shri B.P. Kanungo, Deputy Governor, Reserve Bank of India, 'State Government Market Borrowings – Issues and Prospects' (August 31st, 2018), available at https://www.rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=1063 (last accessed 30 October 2018); RBI Annual Report (August 2018), at Box VII.1; Reserve Bank of India, State Finances: A Study of Budgets of 2017-18 and 2018-19 (July, 2018), at paras 3.40 – 3.42.

fresh borrowings.[230] In light of these concerns and recommendations, it may be appropriate to impose conditions to this effect.

5. Expenditure rules: Rules regarding expenditure can be particularly intrusive. While a numerical ceiling prevents any expenditure beyond a threshold, a qualitative expenditure rule restricts particular kinds of expenditure. Numerical ceilings are thus more respectful of State autonomy. While such a quantitative imposition may not be unconstitutional, it may still hamper the operation of market discipline.[231] On the other hand, qualitative rules enter into a State's policy domain. Even the effectiveness of a broad qualitative rule like the "golden rule" for the promotion of capital expenditure is not beyond doubt.[232] Accordingly, it may be appropriate to avoid qualitative conditions entirely.[233] Expenditure impositions that restrict policy choices without having any positive effect on fiscal stability would likely be unconstitutional as well.
6. Guarantee ceilings: States do not need the Centre's approval under Article 293(3) before they give guarantees. However, given the language of clause (4), guarantee ceilings may be imposed as conditions for the approval of fresh State borrowings as such contingent liabilities have a considerable impact on debt sustainability.[234]
7. Cooperative forum conditions: In light of functional overlaps in relation to subnational borrowing regulation, cooperative mechanisms may be an appropriate solution. The balance between stability and autonomy could be better dealt with at a cooperative forum with negotiations being guided by a strong Centre. The formation of such a forum under the present

[230] FRBM Review Committee Report, Volume 1 (January 2017), at p. 89; RBI Annual Report (August 2018), at Box VII.1.

[231] This could be due to its effective action as a stop-payment measure or debt ceiling (as States would be forced to choose between continued access to debt markets and high expenditures) and these could in turn appear to be an implicit guarantee against default. *See* International Monetary Fund, 'India: Selected Issues', IMF Country Report No.18/255 (August 2018), at p. 13.

[232] Arvind Subramanian, Annex-V, FRBM Review Committee Report, Volume 1, 'FRBM: A Dissent Note – Outlining an Alternative Architecture of Fiscal Rules' (January 2017), at p. 173 (arguing, in relation with revenue deficit targets, that capital spending is not always better than current spending, that intergenerational equity should benefit present living Indians instead of future richer ones, and that multiplicity of targets is harmful for the credibility of the overall framework due to incentives for non-compliance); Panchanan Das, 'Debt Dynamics, Fiscal Deficit, and Stability in Government Borrowing in India: A Dynamic Panel Analysis', ADBI Working Paper Series No. 557 (2016), 1 ("government borrowing is more responsive to revenue expenditure than capital outlay and has more growth-augmenting effect through revenue expenditure.")

[233] Except perhaps to enforce the conditions for the application of escape clauses (in the context of debt ceilings).

[234] It has been claimed that contingent liabilities have had one of the costliest impacts amongst different fiscal risks and such liabilities also form the bulk of "hidden deficits" that are not apparent in headline fiscal balances. *See* International Monetary Fund, *World Economic Outlook—Public Debt in Emerging Markets* (September 2003); H. Kharas and D. Mishra, 'Hidden Deficits and Contingent Liabilities', Part 1 of the study "Opportunities and Risks in Central European Finances' co-sponsored by the European Commission and the World Bank (World Bank, 2000); Elba Bova et al, 'The Fiscal Costs of Contingent Liabilities: A New Dataset,' IMF Working Paper No. WP/16/14 (January 2016).

constitutional scheme is possible if State borrowings are permitted on the condition that the States come together to attend the forum and bind themselves to accepting the decisions of the forum as a collective.[235] Further, a cooperative forum for borrowing decisions may be useful insofar as revenue decisions are now made in the GST Council and it may be good institutional design to tie debt issuance decisions with tax increases or new revenue sources.[236]

8. Ex-post rules for defaults and enforcement: A way to ensure that a credible "no-bailout" commitment is made by the Centre is to require that States put in place a statutory mechanism to address their own insolvency. In the future, the enactment of such a legislation could be made a condition for borrowing approvals.[237] This could ensure that responsible lending and borrowing is incentivised while still leaving room for some amount of debt relief by the Centre. Such a framework should still account for natural disasters and other events beyond the control of a State. Alternatively, the conditionality mechanism can allow for a debt ceiling enforcement system. An approval of a loan can thus be done subject to the condition that the breach of debt ceilings will result in sanctions.[238]

The above route for the evolution of regulation is aimed at safeguarding fiscal decentralisation going forward, while also creating greater room for market discipline. Where Central intervention is envisaged, it is designed such that the application of its own discretion is limited, fiscal autonomy of States is respected, market discipline is enhanced, and the overall objective of ensuring fiscal stability and debt sustainability is kept foremost in mind.

E. Recommendations for when States will no longer be indebted to the Centre

[235] The merits of a cooperative framework and its relevance for India are discussed in chapter 5.
[236] It is a matter of some concern that with the coming into force of the GST regime and the GST Council, States have lost revenue autonomy. What this means is that the broader push for market discipline would lose a crucial signal by which markets could gauge fiscal behaviour of different States. While revenue flexibility would have supported market discipline, buoyant GST earnings may ensure that States at least do not face revenue constraints. *See* International Monetary Fund, 'India: Selected Issues', IMF Country Report No.18/255 (August 2018), at pp. 17-18. *See also* Otaviano Canuto & Lili Liu, 'An Overview' in Otaviano Canuto and Lili Liu (eds), *Until Debt Do Us Part: Subnational Debt, Insolvency, and Markets* (The World Bank, Washington D.C. 2013) at pp. 27-28.
[237] This mechanism should only be employed in the event of the abandonment of implicit bailout routes and practices by which State-specific shocks are spread across the general government; Of course, it is possible that State legislatures may renege on statutory promises through retrospective amendments. Even if the Centre were to impose conditions that directly require distressed States to take a Centrally-defined insolvency route, it could still suffer from the same issues as the Central Government remains free to alter its requirements ex-post. Despite these issues, such measures remain significant as their main objective is to send the right signals to the market.
[238] Such sanctions could include reduction in the following year's borrowing quota, sale of assets, or even complete prohibition of access to debt markets.

Given the award period of FC-XV, there is reason to put into perspective an imminent scenario which will be playing out in India from the year 2025. As long as a State is indebted to the Centre or has outstanding loans guaranteed by the Centre, Article 293(3) requires the consent of the Centre to be taken before the State can raise loans. This provision has formed the bedrock of subnational borrowing regulation in India till date because States have remained indebted to the Centre. However, as FC-XIV has noted, some States are likely to discharge their debts towards the Centre by 2025.[239] While this was not addressed by FC-XIV as it was outside its award period, it would now be within the purview of the considerations of FC-XV.

As the above scenario arises, it is clear that the legal pre-requisites for the Centre's powers in relation with State loans will no longer be met, making it largely helpless to check subnational fiscal irresponsibility. It may also not be able to continue enforcing debt ceilings according to fiscal consolidation plans that may be considered in the future. As may be understood from an examination of the appropriate policy objectives of subnational debt regulation and prior experiences in the Indian context, this outcome would result in complete borrowing autonomy on the part of States and needs to be planned and accounted for.[240] Given the language of Article 293(3), ensuring that the Centre retains some limited powers in the future would require a constitutional amendment explicitly providing for such powers and appropriate limitations on the same. Short of this, the other alternative would be for the Centre to extend its powers by ensuring that States continue to be indebted to it.[241]

The regulatory structure proposed earlier in this chapter may also thus be considered a transitory one insofar as it hinges on the exercise of powers under Article 293 as it currently stands. It is equally important to remember that some aspects of the structure, such as the direct imposition of rigid debt ceilings, are considered to be temporary measures in any case, leading up to a gradual (but not complete) withdrawal of the Centre from subnational debt markets. The post-

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[239] Report of the Fourteenth Finance Commission (2015-20) (December 2014), at para 14.103 (this is a direct result of the discontinuance of Central intermediation of loans recommended by FC-XII).

[240] Prior research into subnational fiscal policy especially warns against the simultaneous existence of high borrowing autonomy and high vertical imbalance. *See* Jonathan A. Rodden, *Hamilton's Paradox: The Promise and Peril of Fiscal Federalism* (Cambridge University Press, 2006) ch 4. This scenario has been particularly damaging in the past for Argentina. *See* Miguel Braun, 'The Political Economy of Debt in Argentina, or Why History Repeats Itself', World Bank (2006), at pp. 21-22, available at http://siteresources.worldbank.org/INTDEBTDEPT/Resources/20061012_03.pdf (last accessed 11 November 2018).

[241] *See* Arghya Sengupta, Anisha Sharma, and Ritwika Sharma, 'Research Report on Queries raised by the Fourteenth Finance Commission: On Central Control over Sub-National Debt in India', Finance Commission of India (2014), available at https://fincomindia.nic.in/writereaddata/html_en_files/oldcommission_html/fincom14/others/42.pdf (last accessed 10 October 2018) at pp. 15-19. The recommendations of this 2014 report were geared towards the circumstances prevalent at the time, which did not include the predominance of market borrowings by States that is now the norm.

discharge scenario that renders Articles 293(3) and (4) redundant is thus an opportune moment for a larger reformulation of federal relations with regard to subnational borrowing. This will require amendments to Article 293 permitting the continued exercise of central power in appropriate circumstances.

What would such appropriate circumstances be? Within a market paradigm, the role of the Centre may eventually be restricted to an ex-post one, with tough sanctions (such as curtailment of budgetary or borrowing powers) for subnational governments that miss fiscal targets and with carefully demarcated provisions for an explicit but limited bailout that is necessarily supplemented with bail-in features.[242] For the activation of the bailout provision in the first place, it may be necessary to incorporate certain statutory triggers. Not every form of subnational debt distress should attract the same response from the Centre. Instances of fiscal irresponsibility must be dealt with differently from unforeseeable crises outside the control of the State.

For the purposes of imposition of sanctions for the violation of debt ceilings, the appropriate federal level at which to formulate these ceilings will be a matter of considerable relevance. If these ceilings are only to be set at State-level, there may need to be a constitutional rule that limits the ability of States to alter the ceilings too often or without sufficient justification. If constitutional provisions are to continue to allow for ceilings to be set at the central level, barriers to market discipline would linger and it may become necessary to ensure that these ceilings remain flexible and State-specific.

In the impending post-discharge scenario, it would thus be appropriate to have in place a constitutional scheme that reduces the Central role to be an ex-post one. It should also replace the current trigger for Central control (State indebtedness towards the Centre) with triggers that afford more State autonomy (such as failure to meet targets or the occurrence of insolvency or default). The default related provisions may be seen to come into play when safeguards such as CSFs and disaster relief funds prove inadequate for an exigency. The speed with which these reforms can be brought in will largely depend on how soon India may be able to arrive at sufficiently stable levels of fiscal consolidation that can serve as a springboard for such reforms. In the interim, a subsidiarity-based regulatory structure that relies on Central forbearance can hold things together and pave the way.

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[242] International Monetary Fund, 'India: Selected Issues', IMF Country Report No.18/255 (August 2018), at p. 17 (regarding the bail-in features); For an example of constitutionalised bailout provisions, *see* Article 104b(1) read with Article 103a, Treaty on European Union, 31 ILM 247 (1992); The possibility of suffering losses from a bail-in should create incentives for responsible lending.

CHAPTER 7: CONCLUSION

The changing dynamics of State debt and the evolution of the Indian political economy towards greater decentralisation have informed this study and catalysed the specific reforms that have been suggested in the previous chapter. In doing so, the study has given due consideration to constitutional limitations, appropriate policy considerations, past Indian experience, and international practice, to shape solutions for the future fiscal relations of our polity.

Briefly, the recommendations of this study can be summarised as follows:

- The regulatory structure for subnational borrowing needs to strike a balance between State autonomy and fiscal responsibility. The proximate control of the Centre in maintaining State fiscal responsibility is unlikely to strike this balance well in the long run.
- A layered regulatory structure based on the principle of subsidiarity is a better option for striking the above balance. It ensures that the Centre does not interfere with subnational debt markets unless market discipline and State-level mechanisms are seen to be failing.
- In consideration of the existing demands of fiscal consolidation and the need for a gradual reform path, it is not recommended that the Centre should stop enforcing debt ceilings yet. This may operate as an exception to the above structure.
- Until States discharge their debts towards the Centre, the application of Articles 293(3) and (4) is envisaged to include the enforcement of debt ceilings, transparency and reporting rules, other market-enhancing requirements, cash surplus elimination requirements, broad expenditure rules, guarantee ceilings, cooperative forum conditions, and ex-post rules for defaults and enforcement.
- For the impending scenario in which States discharge all their debts towards the Centre, constitutional amendments will be necessary to enable the Centre to exercise some power regarding subnational borrowing. Depending on the extent to which satisfactory fiscal consolidation has set in and the maturity of subnational debt markets at the time, the Constitution may limit the Centre's role to one that is largely ex-post (in terms of sanctions for violation of ceilings, and in the event of default).

The story of subnational borrowing in India has been one that has moved almost inexorably towards greater State autonomy, with markets being nurtured to play a greater role eventually. The crossroads are fast approaching, and we may have to commit clearly to the necessary implications of the path we are on. It is hoped that the above proposals can serve as the fitting next steps on this journey.

Annexure 1: Survey of State Fiscal Responsibility Legislations and Rules

A. Table 1: Fiscal Indicators and Targets[243]

S. No.	Fiscal Indicators and Targets		Followed by
1.	Reduce/maintain fiscal deficit to a certain percentage of GSDP.	Above 3%	Jharkhand (3.25% by 2019-20),[244] Haryana (4.27% including UDAY and 2.47% excluding UDAY, in 2016-17)
		Below 3%	Uttar Pradesh (2.97% in 2016-17)
		Equal to 3%[245]	Andhra Pradesh and Telangana (by the year ending March 2009),[246] Arunachal Pradesh (2010-15), Assam (by 2010-11), Bihar (in 2015-16), Chhattisgarh (in 2015-16), Goa (2013-14 and maintain thereafter), Gujarat (by 2011-12 and maintain thereafter), Himachal Pradesh (2015-16), Jammu and Kashmir (in 2014-15), Karnataka (2015-16), Kerala (2017-18 to 2019-20), Manipur (2013-14 and maintain thereafter), Madhya Pradesh (by 31st March, 2016), Maharashtra (in 2010-11 and maintain thereafter) Meghalaya (during 2015-2020), Mizoram (2014-15), Nagaland (2016-17), Odisha (2011-12 and maintain thereafter), Punjab (in 2014-15), Rajasthan (by 2011-12), Sikkim (by 31st March, 2014), Tamil

[243] The fiscal targets are mandatory in all State FRLs, except in the case of Nagaland ('shall strive to'). Himachal Pradesh and Manipur did not have mandatory targets in their FRLs initially, but they were made mandatory by subsequent amendments. Also, all States have specified major fiscal targets in their FRL itself, except in the case of Maharashtra, where these have been specified in the rules made thereunder.

[244] Fiscal deficit target set at 3.5% for 2015-16 and 2016-17, and at 3.25% from 2017-2020.

[245] In many States, the 3% requirement carries an additional flexibility of 0.5% (0.25%+0.25%) in specified circumstances, as recommended by FC-XIV.

[246] The Andhra Pradesh Fiscal Responsibility and Budget Management Act, 2005 was adapted by Telangana as the Telangana Fiscal Responsibility and Budget Management Act, 2005 in accordance with Section 101 of the Andhra Pradesh Reorganisation Act, 2014. *See* Telangana Gazette, 'G.O.Ms. No. 45, Law (F)', Law Department, Government of Telangana (1 June 2016), available at http://law.telangana.gov.in/pdf/go45.pdf (last accessed 31 October 2018).

		Nadu (by 31st March, 2012), Tripura (2015-16), Uttarakhand (2016-20), West Bengal (2014-15)
2.	Reduce revenue deficit as a percentage of GSDP to eliminate it/reduce it to nil	Andhra Pradesh and Telangana (by 31st March, 2009), Assam (by 2011-12 and maintain thereafter), Bihar (2015-16), Goa (by 31st March, 2015), Gujarat (by 2011-12), Jharkhand (by 31st March, 2012 and maintain thereafter), Karnataka (2006), Kerala (2017-18 to 2019-20), Madhya Pradesh (by 31st March, 2009), Maharashtra (by 31st March, 2009), Mizoram (2008-09 and maintain thereafter), Nagaland (by 2016-17), Odisha (2011-12 and maintain thereafter), Punjab (2014-15), Rajasthan (from 2011-12), Tamil Nadu (by 2019-20), Uttarakhand (by 31st March, 2015), West Bengal (during 2014-15)
3.	Maintain revenue surplus as a percentage of GSDP	Assam, Arunachal Pradesh (during 2010-15), Chhattisgarh (2015-16), Haryana (2.09% including UDAY and 1.10% excluding UDAY in 2016-17), Himachal Pradesh, Jammu and Kashmir, Karnataka, Manipur, Meghalaya (during 2015-20), Sikkim (2010 onwards), Tripura (2015-16), Uttar Pradesh (Rs. 28,201 crores in 2016-17)
4.	Limit outstanding debt as a percentage of GSDP	Arunachal Pradesh (50.1% during 2014-15), Assam (28.4% in 2012-14), Bihar (25% in 2015-16), Chhattisgarh (13.73% in 2015-16), Goa (27% by 31st March, 2015 and 25% thereafter), Gujarat (27.1% for 2011-15), Haryana (23.69% including UDAY and 19.27% excluding UDAY in 2016-17), Himachal Pradesh (35.42% by 2015-16), Jammu and Kashmir (49.3% in 2014-15), Jharkhand (26.9% in

			2014-15), Karnataka (25% in 2015-16), Kerala (29.67% in 2019-20), Madhya Pradesh (25% in 2015-16), Maharashtra (16.2% in 2016-17), Manipur (54.3% in 2014-15), Meghalaya (31.7% during 2014-15), Nagaland (33% in 2016-17), Punjab (38.7% in 2014-15), Rajasthan (36.5% in 2014-15), Sikkim (55.9% by 2014-15), Tamil Nadu (25.2% in 2014-15), Tripura (35% in 2015-16), Uttar Pradesh (30.30% in 2016-17), Uttarakhand (37.20% in 2014-15), West Bengal (34.3% in 2014-15)
5.	Reduce outstanding total liabilities[247] to a certain percentage of GSDP		Andhra Pradesh and Telangana (27.6% in 2014-15), Assam (28.5% in 2014-15), Chhattisgarh (23.9% in 2014-15)
6.	No guarantees to be given beyond a certain limit[248]	Provision in the FRL	Andhra Pradesh and Telangana, Assam, Arunachal Pradesh, Chhattisgarh, Himachal Pradesh, Jammu and Kashmir, Karnataka, Madhya Pradesh, Nagaland, Punjab, Tamil Nadu, Tripura, Uttar Pradesh, Uttarakhand
		Provision in other legislations	Goa, Gujarat, Karnataka, Kerala, Manipur, Mizoram, Sikkim, West Bengal
7.	Limit expenditure on account of salaries and wages of employees	to a certain percentage of total tax and non-tax revenue including devolutions	Assam (60% by 2010)

[247] Includes borrowings by Public Sector Undertakings, Special Purpose Vehicles and other equivalent instruments, where the principal and/or interest are to be serviced out of the State Budget.
[248] Some State FRLs apply this limitation as a certain percentage of total revenue receipt, or in some cases as a percentage of GSDP, and in some cases as either, whichever amount may be lesser. Further, some States express this limitation in terms of 'risk weighted guarantees' to be limited to a certain percentage. Risk weighted guarantees are guarantees whose values have been assessed on the basis of risk weights assigned to factors impacting the possibility of such guarantees being called for honouring.

		from the Central Government	
		Ratio of salary to revenue expenditure net of interest payments and pensions	Nagaland (61%)
		Ratio of salary to State's own revenue	Jharkhand (80% by 31st March, 2008), Odisha (80% by 31st March 2008)
8.	Limit the ratio of non-interest committed revenue expenditure[249] to State's own and mandated revenue		Jharkhand (55% by the year ending 31st March, 2008), Odisha (80% by 31st March 2008)
9.	Take appropriate measures in cash management to avoid recourse to overdraft from the RBI		Goa, Jharkhand, Odisha
10.	Generate a primary surplus[250] equal to a certain percentage of GSDP.		Jharkhand (3% by the year ending 31st March, 2008)
11.	Limit interest payment as a percentage of revenue receipt		Jharkhand (18% to 25%), Odisha (15%)
12.	Limit total debt stock as a percentage of revenue receipt		Jharkhand (300% by 2007-08), Odisha (300% by 2007-08)

B. Table 2: Transparency Mechanisms

S. No.	Transparency Mechanisms	Followed by
1.	Statement on significant changes in accounting standards that are likely to affect the computation of fiscal indicators to be made when presenting budget.	All states
2.	Statement on details of borrowings by way of WMAs /Overdraft from the RBI to be made when presenting budget.	Andhra Pradesh and Telangana, Bihar, Chhattisgarh, Haryana, Jammu and Kashmir, Madhya Pradesh, Manipur, Meghalaya, Mizoram, Nagaland, Rajasthan,

[249] 'Non Interest Committed Revenue Expenditure' means the total of salary and pension expenditure of the State in the revenue account of the Consolidated Fund of the State.
[250] Primary surplus means the non-interest fiscal surplus.

		Tripura
3.	Whenever the State Government undertakes to substantially and unconditionally repay the principal amount or interest of any separate legal entity, such liability to be reflected as State borrowing	Andhra Pradesh and Telangana, Bihar, Chhattisgarh, Haryana, Jammu and Kashmir, Manipur, Nagaland, Tripura
4.	Statement on number of employees in the State Government, public sector and aided institutions, with salaries and pensions to be made when presenting budget.	Andhra Pradesh and Telangana, Arunachal Pradesh, Assam, Bihar, Chhattisgarh, Goa, Gujarat, Haryana, Himachal Pradesh, Jammu and Kashmir, Jharkhand, Madhya Pradesh, Maharashtra, Meghalaya, Odisha, Punjab, Rajasthan, Sikkim, Tamil Nadu
5.	Statement on claims and commitments made by the State Government having potential budgetary implications[251] to be made when presenting budget	Andhra Pradesh and Telangana, Assam, Arunachal Pradesh, Chhattisgarh, Goa, Gujarat, Haryana, Himachal Pradesh, Jammu and Kashmir, Jharkhand, Karnataka, Kerala, Meghalaya, Mizoram, Madhya Pradesh, Maharashtra, Odisha, Punjab, Rajasthan, Sikkim, Tamil Nadu, Tripura, Uttar Pradesh, Uttarakhand, West Bengal
6.	Statement on the details of the Guarantee Redemption Fund to be made when presenting budget.	Andhra Pradesh and Telangana, Goa, Gujarat, Haryana, Jammu and Kashmir, Kerala, Madhya Pradesh, Meghalaya, Rajasthan, Chhattisgarh, Tripura, West Bengal
7.	List of ongoing projects with targeted date of completion and deviation, if any, in previous years, to be furnished	Jharkhand, Odisha

[251] Generally including some among the following: contingent liabilities created by way of guarantees, actual liabilities arising out of borrowings by entities such as Public Sector Undertakings and Special Purpose Vehicles where liability for repayment is on the State Government; committed liability in respect of major works and supply contracts; revenue demands raised but not realised; tax expenditure; losses incurred in providing public goods and services through public utilities and undertakings; subsidy payments and the impact of the same on the fiscal position of the State; off-budget borrowings; etc.

	when presenting budget	
8.	Statement on the compliance costs of major tax proposals to be made when presenting budget	Karnataka
9.	Statement on the revenue consequences of capital expenditure along with related liabilities to be made when presenting budget	Karnataka
10.	Statement on the explicit and implicit liabilities in public private partnerships to be made when presenting budget	Karnataka
11.	Consolidated position in respect of all demands to be brought out in the budget at a glance.	Jharkhand, Odisha
12.	Statement on the summary of the Financial Position of the State to be made when presenting budget.	Punjab
13.	Statement on estimated yearly pension liabilities worked out on actuarial/realistic basis for the next ten years to be made when presenting budget	Gujarat, Jharkhand, Mizoram, Odisha, Punjab, Rajasthan
14.	Statement on values of parameters underlying projections for receipts and expenditures and the band within which they can vary while remaining consistent with targets to be made when presenting budget	Karnataka
15.	Statement on assets of the State Government to be made when presenting budget.	Andhra Pradesh and Telangana, Haryana, Meghalaya, Mizoram, Jammu and Kashmir, Karnataka, Kerala, Madhya Pradesh, Chhattisgarh, West Bengal
16.	Statement on the Consolidated Sinking Fund[252] to be made when presenting budget.	Andhra Pradesh and Telangana, Chhattisgarh, Goa, Gujarat, Haryana, Jammu and Kashmir, Kerala, Mizoram, Madhya

[252] Funds set up for amortisation of all loans including loans from banks, liabilities on account of NSSF etc. FC-XII recommended the formation of these funds by all States, to be maintained outside the Consolidated Fund of the States and the Public Account and not to be used for any other purpose, except for redemption of loans. *See* Report of the Twelfth Finance Commission (2005-2010) (December 2004), at para 12.59.

		Pradesh, Tripura, West Bengal
17.	Statement on select fiscal indicators to be made when presenting budget, such as fiscal deficit, revenue deficit, total liabilities, own revenue, etc.[253]	Andhra Pradesh and Telangana, Arunachal Pradesh, Assam, Chhattisgarh, Goa, Gujarat, Haryana, Jammu and Kashmir, Kerala, Punjab, Mizoram, Madhya Pradesh, Rajasthan, Sikkim, Tripura, West Bengal
18.	Statement on components of the State Government's liabilities and interest, cost of borrowings/mobilisation of deposits to be made when presenting budget.	Haryana, Jammu and Kashmir, Kerala, Mizoram, Madhya Pradesh, Tripura, West Bengal

C. Table 3: Enforcement Measures

S. No.	Enforcement measures		Followed by
1.	Review report by State Finance Minister, containing trends in receipts and expenditure in relation to the budget, to be placed before the Legislature	Quarterly	Andhra Pradesh and Telangana, Bihar, Chhattisgarh, Goa, Gujarat, Jammu and Kashmir, Karnataka, Maharashtra, Manipur, Meghalaya, Nagaland, Punjab, Sikkim, Tripura
		Half-yearly	Arunachal Pradesh and Telangana, Haryana, Himachal Pradesh, Madhya Pradesh, Mizoram, Rajasthan, Tamil Nadu, Uttar Pradesh, Uttarakhand
		Yearly	Assam

[253] The rules made under Punjab's FRL require a further breakdown and analysis of these heads. For instance, it requires statements showing an analysis of tax and non-tax revenue, development and non-development expenditure, receipts and disbursements on capital account, etc.

		Not specified	Jharkhand, Odisha
2.	The State Finance Minister to explain deviations from fiscal targets in the review report placed before the Legislature		All states
3.	Establishment of an independent agency or mechanism to review compliance with the respective FRL, or assigning the same to an independent external agency.[254]		Andhra Pradesh and Telangana, Bihar, Goa, Haryana, Himachal Pradesh Jammu and Kashmir, Jharkhand, Kerala, Madhya Pradesh, Manipur, Meghalaya, Mizoram, Nagaland, Punjab, Rajasthan, Sikkim, Tamil Nadu, Tripura, Uttar Pradesh, West Bengal
4.	State Government to take measures for increasing revenue and/or reducing expenditure in case of shortfall of revenue or excess expenditure over targets, in the course of a financial year		Andhra Pradesh and Telangana, Arunachal Pradesh, Bihar, Chhattisgarh, Haryana, Jammu and Kashmir, Kerala, Madhya Pradesh, Maharashtra, Manipur, Meghalaya, Nagaland, Punjab, Tripura, West Bengal
5.	Statement of remedial measures to neutralise increased expenditure or loss of revenue to accompany any proposal which may lead to an increase in revenue deficit, either through increased expenditure or loss of revenue, to be placed before the Legislature		Andhra Pradesh and Telangana, Bihar, Goa, Haryana, Jammu and Kashmir, Manipur, Meghalaya, Nagaland, Punjab, Sikkim, Tamil Nadu, Tripura
6.	Requirement of curtailment of sums authorized to be paid out of the Consolidated Fund of the State, or of interim measures to augment revenue, whenever there is a prospect of either shortfall in revenue or excess of		Arunachal Pradesh, Gujarat, Himachal Pradesh, Jharkhand, Karnataka, Odisha, Pradesh, Uttarakhand, Uttar Pradesh

[254] For example, in the rules made under Punjab's FRL, the State Government opted for the Comptroller and Auditor General of India as the 'independent external agency'.

	expenditure for a given year on account of any new policy decision[255]	
7.	Review report before the Legislature on total value of sanctioned capital works exceeding the specified limit for two successive quarters	Andhra Pradesh and Telangana
8.	Proposal for supplementary or additional demands for grants to be accompanied by statement indicating the corresponding curtailment of expenditure or augmentation of revenue	Arunachal Pradesh, Assam, Goa, Gujarat, Jharkhand, Karnataka, Odisha, Sikkim, Uttar Pradesh, Uttarakhand
9.	Bar on submission of more than one supplementary/additional statement of expenditure in a financial year.	Jharkhand, Odisha
10.	Consistency of the budget presented with the Medium Term Fiscal Policy Statement[256]	Arunachal Pradesh, Goa, Gujarat, Jharkhand, Karnataka, Mizoram, Odisha, Rajasthan Sikkim, Tamil Nadu, Uttar Pradesh, Uttarakhand
11.	Consistency of the budget presented with the Five Year Fiscal Plan	Assam
12.	Government to identify net fiscal cost of unforeseen demand on finances due to a calamity, and such cost shall be a ceiling for extent of non-compliance specified revenue and fiscal deficit targets	Arunachal Pradesh, Goa, Gujarat, Jharkhand, Odisha, Punjab, Sikkim
13.	Triggers i.e., intra-year benchmark on deficits, to be a part of the budget, as well as corrective actions that shall be initiated upon activation of such triggers.	Gujarat, Kerala, West Bengal
14.	Officers responsible for undertaking liability outside budgetary provision without approval of Finance	Jharkhand, Odisha

[255] The FRLs of Arunachal Pradesh, Karnataka, Uttar Pradesh and Uttarakhand further provide that, while adhering to the fiscal targets, the State Government will give priority to protecting certain expenditure defined in the Medium Term Fiscal Restructuring Policy or Medium Term Fiscal Plan as "High Priority Development Expenditure" (including, *inter alia*, elementary education, basic health and rural water supply) from curtailment or may impose a reduced or partial curtailment.

[256] The Medium Term Fiscal Policy Statement sets forth the fiscal management objectives of the State Government and three-year rolling targets (in most states) for the prescribed fiscal indicators with clear enunciation of the underlying assumptions.

	Department to be made personally liable with respect to such unauthorised liability.	
15.	No liability to remain unpaid beyond a certain period of time, and no fresh liabilities to be incurred if previous liability still unpaid beyond said period of time	Punjab (3 months)

D. Table 4: Supplementary Measures to ensure Fiscal Discipline

S. No.	Supplementary measures	Followed by
1.	Codification of rules and procedures for issue of administrative approval, financial sanction, procurement of goods and services, award of work and contract in government transactions	Assam
2.	Restrictions on creation of new posts and appointments of employees[257]	Assam, Meghalaya
3.	Before awarding any work or starting a construction work, or before awarding an order of supply of goods and services, which create liability on the Consolidated Fund of the State, the State Government to first issue administrative approval/financial sanction in compliance with rules, procedures, and guidelines	Assam, Meghalaya
4.	Limit on the total value of works sanctioned by any Department of the State Government, if outstanding liabilities of such Department exceeds such limits as may be prescribed	Assam, Meghalaya

[257] This is primarily to ensure timely discharge of current liabilities towards employees. Some of the restrictions include: appointments to be made only against sanctioned posts which are vacant, no new post to be created by any public sector undertaking, statutory body, etc., without concurrence of Finance Department, no appointments for vacancies arising out of transfers and leaves of incumbents, no appointment in anticipation of post falling vacant in the future, etc.