FISCAL REFORM

A PERSPECTIVE FROM THE FINANCIAL MARKET

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Fiscal Reform – A Perspective from the Financial Market

BACKGROUND

This paper will not enter various issues that are pertinent in determining the several inter-related issues of resource generation, public service provisioning, investment facilitation, tax reform and the sustainability or otherwise of (state) government debt, which are being addressed by the other participants in this conference. We will choose to restrict ourselves to a view of the issues and the process of fiscal reform from the capital market side, being as we are a part of the market process.

State governments are not direct issuers of debt securities in the Indian market – as their counterparts indeed are, in developed and a few developing countries. Till now, the securities they issue under the Open Market Borrowing (OMB) programme titled as State Development Loans (SDL) are – for the want of a better word – being intermediated by the Reserve Bank of India (RBI). The market perception of these securities is that they are "almost" a credit exposure on the central bank.

The use of the word "almost" is deliberate. A cursory examination of market yields of SDL securities and those of the central government (commonly termed G-Sec) would indicate that the differential in yield for paper of similar tenor is restricted to a range of 50 to 70 basis points (bps). Further, there does not seem to be a consistent discrimination between the securities issued by different state governments. Had the perception been that the risk exposure is entirely on the RBI there would indeed be no differential. And had the perception been that the risk exposure was directly on the underlying governments, the differential would not only have been very much larger, it would also have varied quite widely across states.

So what do we have here? It would appear that the information embedded in the yield is that market participants believe that the RBI will somehow make good any delay or default by the concerned state governments, and settle the issue (of the consequently overdrawn accounts) bilaterally with the respective state, if and when such an eventuality arises. However, there is an unsettling element of concern that there is a residual possibility that the process may not be entirely without a hitch – and hence the non-trivial premium. It would only be fair to say that there does not seem to have been a change in the magnitude of the premium despite the fact that credit perceptions on state governments have considerably worsened over the last few years. Which tend to indicate that the premium reflects on only the uncertainty embedded in how the RBI might react to persistent overdrawn positions of the concerned state(s), especially if simultaneously there are other unrelated pressures on the central bank.

In *Section I*, we discuss the delays and defaults that have happened on state governments backed paper and its consequences. *Section II* deals with the issues specific to state government guarantees. *Section III* takes an overview of some of the underlying realities and constraints. *Section IV* sketches the course of reform required for rebuilding confidence amongst other things – and eventually of more effectual governance.

Section I

CREDIT RATINGS

Credit rating agencies have entered the process of evaluating state government finances primariy by way of the off-Budget borrowings of state governments. Sine the mid-1990s, state governments facing (relatively) reduced central plan assistance have sought to use the instrumentality of guarantees provided by Art. 273(iii) of the Constitution to access the capital market to fund public investment in areas they deemed to be of critical importance.

Amongst the first entrants were the cash strapped State Electricity Boards (SEB) which have had a history of issuing debentures in earlier years, often being qualified to meet the Statutory Liquidity Ratio (SLR) requirements of commercial banks. Subsequently, several state governments hived off their irrigation departments into companies and used these vehicles to raise debt capital. In some instances other activities – such as industrial parks, road transport corporations and sometimes thinly disguised revenue requirements of the state governments – were so financed. Not all of these issuers obtained a rating. The extant securities regulation mandated credit rating only for public offerings and almost all of this issuance has been on "private placement" basis, which does not mandate a rating. However, a large proportion of this "private placement" issuance obtained credit ratings, respecting investor preference. It would not be a misstatement to say that those which chose not to use a rating, did so either because they did not or thought they would not obtain an acceptable credit rating, or in order to avoid the often onerous (or at least perceived by some) obligations that such ratings commonly enjoined.

The ratings issued to state government off-Budget borrowing programmes are structured obligations. That is, they are backed first by the full faith and credit of the concerned state government (i.e. irrevocable guarantee) operating within an overall structure supervised by a debenture trustee. This structure seeks to regulate the cash flow for debt service and provide embedded redundancies in so far as intimation to the state government's finance department and trigger points for invocation of the guarantee by the trustee. An example of such a payment structure is provided alongside. The illustration is for a bond issuance that requires budgetary provision, that is, where the entire quantum of debt service is by design expected to be met by the state government – an issue that we will be discussing later.

Payment Structure for a State Government Guaranteed Bond Illustrative

[For a bond issuance which requires budgetary provision]

Credit Enhancement	Government of ____ shall give an unconditional, irrevocable and continuing guarantee for the repayment of principal and interest due thereon during the entire tenure of the bonds. The invocation of the guarantee will be operated by a trigger mechanism as stipulated below.
Issue Account & Escrow Account	The Entity will open two no-lien Accounts viz., an Issue account and an Escrow account with a Designated Bank in ____ (in city of issuance) before the allotment of the Bonds. The proceeds raised from the issue of the bonds shall be credited in the Issue account and the amount to be paid to the bondholders is to be credited in the Escrow account. The bondholders shall have an exclusive charge on the amount credited in the Escrow account. All withdrawal from the said Escrow account shall be made only after obtaining the approval from the Trustees to the Bondholders and such withdrawal shall be exclusively for (a) payment of principal and/or interest to the bondholders and/or (b) for making investments, as provided herein below. Any credit balance lying in the Escrow account can be withdrawn, with the approval of the Trustees, by The Entity at the end of the tenure of the bonds when all the dues to the bondholders have been paid.
Tripartite Agreement	The transaction envisages a tripartite agreement between The Entity, Government of _____ and the Trustee to the Bondholders. The tripartite agreement is to be signed before the date of allotment of bonds.
Compliance	The proceeds of the bonds will be available to The Entity only after obtaining of compliance certificate from Trustees to the bondholders towards fulfilment of all the conditions set out for the structured obligation.
Appropriation by the State Government	The amount of interest and/or the principal payable by The Entity to the bondholder in a financial year shall be provided for in the Annual Financial Statement (i.e. Annual Budget) as an estimated expenditure under an appropriate head by the Government of ____ . Such interest and/or principal shall be declared by the State Legislature by law as expenditure charged to the Consolidated Fund of the State. The Government of ____ shall also pass an Appropriation Bill each year for appropriating the said expenditure (i.e. interest and/or principal payable in a financial year) out of the Consolidated Fund of the State.
Intimation to the State Government	At least 45 days prior to forthcoming due date, the Trustee shall intimate the Finance Secretary, of the Government of ________, about (a) the forthcoming due date; and (b) the amount payable to the bondholders as interest and/or principal on the said due date and shall also request Government of ________ to ensure that adequate funds are available in the Escrow account for servicing the bondholders on the forthcoming due date.
Payment Mechanism	The Entity shall credit adequate funds in the Escrow account for servicing the bondholders on the forthcoming due date. As and when funds are credited in the Escrow account. The Entity and/or the Designated Bank shall send to the Trustees intimation regarding the balance of funds in the said Escrow Account. The interest and/or principal payment cheques shall be dispatched to the bondholders at least 3 working days prior to the due date for payment.

Investment of funds in the Escrow Account	The Funds in the Escrow Account may from time to time be invested in highest rated debt instrument/highest rated deposits of Banks which is rated AAA for medium term or A1+ for Short Term, or in Central Government securities. The maturity date of the investments should be at least 15 days prior to the forthcoming due date. The bondholders shall have exclusive charge on such investments and returns on such investments. The proceeds realised from the sale/encashment of the investments including the returns thereon shall forthwith be credited in the Escrow account.
Monitoring of the Escrow Account	The Trustee will monitor the balance in the Escrow account from time to time and shall take all the necessary steps (including invocation of the guarantee) as provided herein in case of shortfall.
Event of Shortfall	If, on the Nth (pre-specified) day prior to every due date for payment of interest and/or principal, the amount in the said Escrow account is not sufficient for servicing the bondholders on the forthcoming due date, then the Trustees shall forthwith intimate the Finance Secretary, Government of ________to transfer adequate funds in the Escrow Account to make up the shortfall at least M (pre-specified) working days prior to the due date failing which the Trustees shall proceed to invoke the Guarantee.
Invoking of Government Guarantee	In the event of Government of ______ failing to transfer funds in the Escrow Account to make up the shortfall within M number of working days prior to the due date for payment of interest/principal, the Trustees shall forthwith invoke the Guarantee issued by Government of ______. On invocation of the guarantee, the Government of _____ must transfer funds into the Escrow Account to the extent of shortfall without any delay.
Other terms	Over-subscription if any, to be refunded to the investors after completion of the allotment process.

Note: In actual practice these clauses may be modified depending on the specific context and some of the trigger dates – here referred to as "M" and "N" – are generally specific to the peculiarities of the issue and related liquidity conditions.

It may be observed that the illustration provided here specifies a number of trigger dates and prescribes consequential course of action. It is self-evident that the provision of such covenants in no way fundamentally alters the quality of the underlying credit, but simply provides for facilitation of the payment mechanism in the expectation that inadvertent inefficiencies of communication and co-ordinated action might indeed become a source of trouble.

The underlying assumption is recognition of the willingness of the state governments to honour their commitments. But a simultaneous awareness that the smooth transmission of such willingness and its conversion into timely discharge of obligation may not be seamless and automatic. It can be obstructed if the payment call comes like a bolt out of the blue, especially if there is a temporary liquidity crunch – a feature that has become a near-permanent state of affairs in the more recent past. Obstruction can also come from another familiar quarter – the kind of muddle that is not uncommon in our administrations, geared as they are to "managing" contradictions, mostly by the age-old technique of obfuscation and procrastination. One that takes a terrible toll on the capacity for time-bound decision-making and implementation of decisions taken.

A MARKET FOR STATE GOVERNMENT DEBT

In the absence of true state government securities, state-guaranteed paper began to operate as some kind of proxy. The RBI has on several occasions sought to encourage the state governments to directly approach the market for their OMB borrowings. The objective was to build the link between market perception of fiscal risk and the pricing of this risk – something that was being lost in the prevalent system of RBI-intermediated SDL issuance. For a truly federal system to work, the enhanced autonomy of the federating units that seek greater non-discretionary fiscal resources, must also be able to achieve corresponding autonomy in accessing capital markets. In a very real sense therefore, the creation of a market for state-government guaranteed paper offered the possibility of a true market developing for state government securities, paralleling that in existence for central government securities.

In fiscal years 1997-98, 1998-99 and 1999-2000 there were considerable issuance of state government guaranteed structured obligations, with commercial banks and provident funds accounting for a large quanta of the subscription. Most of the issuance was to support the creation of fixed assets in areas of physical infrastructure – electricity, irrigation, roads etc. Significant premium over the SDL yield of the underlying state government and relatively shorter tenors of the securities operated as added incentives. The subscribers' understanding of the income tax benefits of section 10(23)-G operated as a powerful incentive, particularly for banks. The pace of issuance reduced in 2000-01 and fell sharply in subsequent years – in response to worsening fiscal position of state governments, rating downgrades of several issues, increased mandated risk weight for capital adequacy and the realisation that 10(23)-G provisions were far less enticing. But without doubt it was the recurring delays in debt servicing by some of the issuers that has damaged the development of this market.

For any bond market to develop, it must pass the test of stability over at least a couple of payment cycle. In the event, the nascent market in state government backed paper failed to pass this test in the first payment cycle itself – brought down by the fatal combination of delays on interest servicing by some entities and the fact of worsening position of state government finances. In all fairness it must be pointed out that at least on the latter count, state governments have perhaps received a worse press than they might have deserved. For it is surely nobody's case that the state of Union finances have anything but got worse over the past several years. But the flak that state governments have caught comes in great measure by the persistence of poor management of some guaranteed debt obligations, and the brazenness on the mishandling of this situation. If anything can be worse than a sinner, it is an unrepentant one – and the veracity of this goes much further in the financial world, where the smooth functioning of the system is intrinsically dependant upon individual participants abiding by their commitments – day in day out, hour in hour out. Leave along every contract, but even if a small percentage of contracts needed to be enforced by the coercion of statutory authority – all commerce would come to a standstill.

PROBLEMS WITH SOME STATE GOVERNMENT GUARANTEED PAPER

It is indeed unfortunate that defaults and delays have occurred to the extent that it has in the very first payment cycle – which owing to the relatively short average tenor of five years, the market would otherwise have soon completed. It must be pointed out that the experience of delays have not attended on every state government guaranteed issuer – leave alone a majority of them. Even where some state government guaranteed paper have had delays in debt service, other issuers of the same state government have honoured their commitments. But all it requires are a few bad eggs to spoil the batch – and in this case, the bad eggs have been individually rather large.

All bond (and loan) markets operate on re-financing. No financial intermediary and most corporate borrowers ever pay down their entire debt – nor do they ever intend to do so. This is true even more true for governments. What in practice happens is that old debts are paid off, and new debts incurred and for governments and financial intermediaries at the *net* level the debt generally rises. However, the confidence that the discharge of maturing debt is not explicitly dependent on the incurring of a new one, is of vital importance for the credibility of the borrowing entity in the eyes of the investor. For the absence of an explicit link provides the investor the option of taking his maturity proceeds and not re-invest in the entity's debt. It is a different matter that some other investor might choose to do so. For at the aggregate level for a given class of creditworthy borrowers, the aggregates on both sides must add up – but the individual investor suffers no compulsion and is free to migrate between different assets.

This is a fairly trivial point some might think, but many (where it matters) do not, it would seem, quite realise it. While analogy has its limitation – but here we can conceive of a fairly straightforward one. While at the end of the day, the total volume of sales in all of the shops in a given community is a given, there is a great difference in outcome, if we were to substitute all the shops by a single government-run store – even if the total basket of goods available were to remain unchanged in both situations. Nobody likes a monopoly – especially the consumer.

Or to put it another way. The expected yield (price) of a security *ceteris paribus* is a function of its tenor: the longer the tenor, the higher the price. So, when an issuer tells you that he wants you to roll the debt over – "restructure" in the polite parlance – what he is doing is to unilaterally extend the tenor. When the issuer is – even indirectly – a government, which unlike ordinary mortals can choose to flout both law and custom, the request to "restructure" is akin to converting what was a five-year bond into at least potentially, a perpetual bond. Given that this "request" is conveyed with the advice that the debt service payment might (or maybe will) not be met, provided the "request" is not acceded to, transforms the transaction into an intolerable one. In mitigation it might indeed be pointed out that in instances, a similar course of action has been adopted by a few central organisations. However, these were not centrally guaranteed paper and the fact that the malady is not restricted to governmental circles at (some) state levels, only underscores the importance of the issue of timeliness of debt servicing and the huge costs associated with not sticking to such commitments.

It may be argued that there are many commitments that government in Independent India (and for that matter throughout the world) has failed to keep in its social contract with the citizenry in general. For which default, on occasion, the voters throw out one government and bring into being another one, which may not be particularly efficacious, but that is the manner of the beast and the limits of the human condition. Commercial commitments require more exactitude in compliance – but admittedly there can be grounds for dispute on details of contract and many routinely land up in the courts or in arbitration.

Plain vanilla financial instruments – as are all straight bonds – are however not just commercial contracts. There is no allowance for interpretation, no provision for *force majeure*, acts of God or of man. The terms are simple – so much of interest payable on this day and that day, and principal to be paid thus on these days. So if the terms are not complied with, it is a default and there is no cure – except that is of not worsening the situation by further defaults. In more complex instruments where structures might have covenants, then there can be provision for cure if a covenant is broken, but there too if the payment to the investor is not made on due date it is a default. We have been adopting the politer language by terming the defaults on state government guaranteed paper as "delays" – but that is purely in a manner of speaking.

Section II

STATE GOVERNMENT GUARANTEES – ITS MIXED CHARACTER

Legitimate concern has attended on the sharp increase in the stock of outstanding guarantees of the state governments. The RBI in its annual publication "State Finances" states:

> "The outstanding guarantees issued by the State Governments have been rising in recent years. As the States' fiscal position has deteriorated in recent years, devolvement on State Governments due to defaults by entities for whom guarantees have been issued would place additional burdens on State finances."[1]

Further, it makes the pertinent point that:

> "... non-adherence to the payment obligations committed by the States in respect of guarantees already provided by them, would have adverse implications on the sovereign credibility...... this may pose difficulties for the States to raise resources from the market in future .... as many banks and financial institutions have exposure to State guaranteed debt, prompt discharge of guarantee related obligations is important from the point of view of health of the financial sector as well"[2]

The RBI in its recent annual report says:

> "4.27 The growing size of contingent liabilities has implications for the sustainability of Government finances. The volume of guarantees in the case of States has shown some signs of improvement in the year 2002-02. The contingent liabilities of State Governments also reflects the practice of setting up of special purpose vehicles (SPVs) to borrow from the market. Given the low user charges and inefficient operations of PSUs, these contingent liabilities are a potential threat to the stability and sustainability of the fiscal system (Table 4.16)".[3]

In the above-referred table the stock of outstanding guarantees of the states is shown to have risen from 4.4 per cent of gross domestic product (GDP) in 1995-96 to 8.0 per cent in 2000-01 and provisionally (likely to be revised upward) for 2001-02 at 7.2 per cent. For the record, central government guarantees have in the same period fallen from 5.5 to 4.1 per cent.

[1] Reserve Bank of India: *State Finances: A Study of Budgets of 2002-03*, February 2003, p.32
[2] *ibid*.
[3] Reserve Bank of India: *Annual Report 2002-2003*, August 2003, p.67

But let us pause just a bit. Is it that there are no differentiating elements in the stock of outstanding state government guarantees? A stock that has risen by the RBI's reckoning from Rs. 52,631 crore in 1995-96 to Rs. 168,712 crore in 2000-01 (from the above-referred table in the RBI Annual Report). The following questions are pertinent:

(a) Do all of these guarantees constitute contingent liabilities in a substantive sense?
(b) Do all of these guarantees represent likely claims by private domestic entities or foreign entities?
(c) Is there uniformity in the quantification of all these guarantee obligations and is the estimate comprehensive?

THE NATURE OF CONTINGENT LIABILITIES

A contingent liability is one where there is uncertainty in regard to the liability crystallising. That is, there is an associated probability, which would determine whether the liability will indeed crystallise or not. This is the character of most risk – just like accidental death and such like. In the world of commerce and finance, guarantees are routinely provided by financial intermediaries, specialised agencies termed guarantee agencies, and less routinely by corporates on behalf of their subsidiaries. In extending a guarantee, banks and financial institutions take a view as to the likelihood of the risk devolving on the guarantor and a compensating payment – the guarantee fee (or in the case of insurance, the premium).

There is however a major difference between a guarantee fee and an insurance premium. In the case of insurance, the claim loss is set off against the pool of premium – and other non-underwriting income. In the business of guarantees, financial intermediaries, having paid off the beneficiary of the guarantee, will generate an equivalent claim in the form of a loan against the entity on behalf of whom the financial intermediary had extended the guarantee facility. Following upon which, loan recovery is vigorously pursued. The (non-administrative) cost of having extended the facility is the likely loan loss that might arise from the new loan claim raised (in addition to possible deterioration of existing loans on the same firm) *less* the fee received.

Government guarantees operate similarly. Having discharged the guarantee, an equivalent loan is created on the underlying entity. However, in the case of government the issue of loan loss provision does not arise and in a sense the entirety of the burden may become an additional and unforeseen expenditure. However, if things work normally (which admittedly they are not in these days) the new loan may be readily adjusted against future financial commitments made by the government to the underlying state-owned company.

To illustrate, suppose the case is a bond issued by an electricity utility, and the (historical) context was in a happier era when most power was metered, billed and collected and such utilities generated a small financial surplus. Now, a bond has come due for principal discharge and the amount involved is Rs. 150 crore. The utility finds that some payments that it had expected have not materialised and it is Rs. 50 crore short. The state government pays up the amount of the shortfall and writes a loan for Rs. 50 crore on the utility. Two possibilities exist: One, the utility once it has obtained its delayed payments pays the state government off (with interest) and settles the claim. Or since, there are ongoing budgetary subventions for creation of new fixed assets, the Rs. 50 crore is adjusted against a future subvention in the same year. The cost to the state exchequer is trivial in this case, except to the extent that it is discommoded.

In the less happier days of the present day, the public utility is not covering its cost. As this year's *Economic Survey* reminds us[4] the aggregate commercial losses of the state power sector as per the revised estimates for 2002-03 is Rs. 24,614 crore before subsidy or 1 per cent of GDP. In order to achieve a mandated 3 per cent return on assets, the pre-subsidy loss would be in excess of Rs. 37,000 crore or 1.5 per cent of GDP. In such an event, the provision of additional funds to meet a guaranteed obligation will in all likelihood become net additional expenditure. This is not a sustainable situation, for all loss-making commercial enterprises are intrinsically unsustainable – a fact which was always recognised by government and lies at the heart of the mandated minimum return on assets. It is socially even less sustainable for resources are drawn away ever more from competing needs in non-commercial areas, principally social expenditure.

But whether sustainable or not, the expectation at the time of issuing a guarantee was indeed that the public utility would be able to find the resources from its own cash flows – operating or otherwise – and hence the guarantee was in the nature of a contingent liability.

ALL GUARANTEES DO NOT HAVE A CONTINGENT CHARACTER

All guarantees that have been extended by state governments to back bond issuance of its state sector units are not however in the nature of contingent liabilities. Irrigation companies are the prime examples. Several state governments in the second half of the 1990s, hived off their irrigation departments into public sector companies or set up SPVs to generate finance for irrigation works. At no time was it ever envisaged that irrigation facilities would pay for either the interest or principal obligations. The best hope, (and sheer hope it mostly is) was that water charges might meet the recurring operation and maintenance (O&M) costs of the irrigation works so created, and policy was crafted along these lines. It was understood that the entirety of the debt service obligations of such concerns would be met from budgetary subventions. The provisions in the annual budget would correspond to the actual cash required by the agencies for meeting debt service and that component of capital works that was to be funded directly by state resources.

There is no contingent character in this liability. The concerned state governments always recognised that the entirety of the debt service would be forthcoming from budgetary resources and the instrumentality of bond issuance served the sole purpose of garnering financial resources greater than could be generated within the existing government system. The motivation was to accelerate asset creation in the sector, in part driven by timelines drawn up by high-power awards on river water sharing.

[4] *Economic Survey 2002-2003:* Ministry of Finance & Company Affairs, Government of India, Table 9.4, p.183.

The debt thus created was not by the greatest stretch of imagination a contingent liability. It was wholly and properly state government debt, thinly disguised to be not one, in deference to the constitutional provisions that restricted state governments to borrow without the prior written permission of the Centre.

The RBI in its annual report referencing the *Group to Assess the Fiscal Risk of State Government Guarantees* lists the major recommendations. Here we cite the first and fourth ones:

> "The major recommendations of the Group are:
> - Guarantees to be met out of budgetary resources should be identified and treated as equivalent to debt
> - Central financial institutions should amend their Acts/policies and do away with the practice of insisting on guarantees"[5]

This is welcome, *albeit* delayed recognition of the facts. Presumably, such guarantees would be appropriately re-classified as a specific category of state government debt.

It is not clear however, if the ambiguities that exist in this area have entirely been resolved. For there are many kinds of transactions where state government entities – called water & sewerage board in some states and by other names in some states – issue guarantees for loans (and bonds on the odd occasion) – on behalf of underlying municipalities for which they undertake works contracts. Part of the funding (sometimes scheme-linked) is met from budgetary resources of the state government, though in only a few cases (bonds) there might be specific referencing of budgetary provisions.

Some clear rules need to be adopted and the re-classification be done as early as possible, since there might be lenders who have guarantee claims outstanding on the same bodies and who would perhaps certainly like to have such claims re-classified as outright debt. Which brings us to another problem – the tangle of guarantees within the governmental system *per se*.

GUARANTEE CLAIMS HELD BY CENTRAL GOVERNMENT AGENCIES

We have inherited a raft of relationships that parallel the principal routes of federal transfer – the Finance and Planning Commissions. This is the array of institutions owned, managed and (primarily) funded by the Centre that lend (primarily) to state government agencies. Prominent amongst them are the Power Finance Corporation (PFC), Rural Electrification Corporation (REC), National Co-operative Development Corporation (NCDC) and Housing & Urban Development Corporation (HUDCO). These agencies under a raft of schemes have been lending to agencies of the state governments (in the case of NCDC it is not state agencies, but co-operatives) and the primary security for these loans have been guarantees. In the case of at least one of these worthies, the charter of the agency compulsorily requires a state government guarantee.

[5] *Annual Report 2002-03*, Reserve Bank of India, Box IV.6, p. 68,

The institution of agencies such as PFC, REC, HUDCO and NCDC have been inspired by a desire to enlarge the sphere and access of central finance, presumably on the belief that specialist agencies might show greater discrimination in financing and supervision, than the counterpart departments of the central government. Be that as it may, the issue here is that the Centre could just as well have directly provided the same financing to the states through additional plan assistance. In which case, instead of guarantees, we would have had a higher corpus of state government debt to the Centre. As also, a higher outstanding stock of central government debt – for the borrowings made by these Central agencies from outside of the government system would then have become greater issuance of central debt.

Does the fact that instead of this more direct method of financing, the Centre chose to create intermediaries who have no other function but route what could otherwise have been plan assistance, make a fundamental difference in either the character of the actual liability or aggregate fiscal risk?

I would argue not. The guarantees that state governments have extended to these special purpose agencies of the Centre are a business and concern of the governmental system with no bearing on the outside world. Just as on a consolidated basis these transactions are little different from normal plan assistance, so too are they on a real and effective basis.

So, this is another category of guarantees that need to be flagged for special treatment. These are firmly embedded in the dynamic of federal finance and it is up to the Centre and the states to find an early end to the misuse of sovereign power, that is guarantees, in this particular kind of transactions. For by terming it as a guarantee, when the relationship is not determined by the normal rules of the market, conflict is sown at the very outset. The pre-conditions are created for the idiosyncrasies of intra-governmental behaviour to intrude upon and colour market perception of the entirety of the obligations that state governments have to the investing public and the financial market in general.

Reverting to the fourth major recommendation of the *Group to Assess the Fiscal Risk of State Government Guarantees*, it is certainly recognition of the inappropriateness of the use of guarantees in intra-governmental transactions. But the nature of the recommendation neither addresses the problem of the existing stock, nor does it try outline a path for dealing with such transactions in the future, which both the central agencies concerned and the state governments might find acceptable and useful.

MEASURE OF GUARANTEES IS NOT COMPREHENSIVE

There also exist *open-ended* guarantees. Principally these are part of the Power Purchase Agreement (PPA) with Independent Power Producers (IPP). The PPA provides for a stipulated rate of return for the IPP. These contracts were signed mostly shortly after the mid-1990s. The cost of power supplied by such IPPs is for the most part higher than other source of power.

The different State Electricity Regulatory Commissions (SERC) adopt merit order based choice of suppliers for purposes of tariff fixation. As a result in many cases the IPPs deliver none or little power to the system and the state power utility has to pay out the fixed charges – which are not inconsiderable. With the power utilities staggering under the load of losses, it is effectively the state governments, which are obliged to find the finance somehow, for they have stood guarantee. The best-known instance is of course Dabhol Power Corporation and the extent of the liability of the state of Maharashtra and of the Centre (which provided the counter-guarantee) of course do not figure in the measure of guarantees set forth in the annual report of the RBI.

ON THE OTHER RECOMMENDATIONS MADE BY THE GROUP TO ASSESS THE FISCAL RISK OF STATE GOVERNMENT GUARANTEES

Reference has been made to the recommendations of this Group earlier in respect of its first and fourth recommendations. The other major recommendations are:

“
- For other guarantees, prospects/activities need to be classified and assigned appropriate risk weights;
- Mapping of guarantees and future devolvement;
- Regular publication of data regarding guarantees in budget documents;
- State Level Tracking Unit for guarantees;
- At least one per cent of outstanding guarantees to be transferred to the Guarantee Redemption Fund (GRF) each year specifically to meet the additional fiscal risk. ”

While better account keeping and greater transparency are certainly laudable objectives, it is unclear how useful it will be try and assess risk weights for individual guarantees.

The reason for having such reservation is as follows. We assume that for non-commercial undertakings – such as rural drinking water and irrigation – the exposure of the state government will be treated as debt equivalent. Therefore what we are talking about are commercial undertakings – that is, activities which under present policy is (or at least should be) capable of generating resources through user charges to service debt obligations. Activities like electricity utilities and urban economic infrastructure for instance.

The problem here is that the commercial viability, and hence the debt servicing capability and hence presumably the “appropriate risk weights” derive in the first instance from the unreformed bad practices embedded in these institutions. The reform process is driven by the state governments, hence whether things improve or deteriorate, is greatly dependent on how the state government discharges its commitment to improve the functioning of these agencies.

Secondly, prompt and decisive functioning (or lack of it) of the state government can by itself be a factor impacting on the cash flows of the concerned entity. In the case of a power utility, whether the state government pays up the subsidy element in cash and on time, will determine to a great extent the ability of the power utility to meet its debt service obligations. Similarly, the early clearance or extended procrastination in approving revision of water charges will have a bearing on the financial position of water utilities and municipal corporations. The chief executive of these agencies are officers of the state government and what they do or do not (for example taking up revisions of properties for the assessment of tax) directly bears on the finances of the concerned agencies.

In short, it is conceptually not possible (for government) to separate the policies and acts of omission and of commission of the state governments (and on occasion of the central government) from the underlying ability of the entities in question to discharge their debt obligations. Hence, any attempt to assign unbiased risk weights will tend to be caught up in a circular argument, stripping the risk weights of any real meaning.

For a third party making an assessment of state entities on a standalone basis is possible for it makes realistic assumptions regarding the behaviour of government – based on the views that it has on the state government own strengths and weaknesses and the evidence of behaviour in the recent past. But for a state government or for a governmental agency itself it will never be possible to acknowledge these shortcomings – and hence it will colour any determination of the financial condition of the government entity in question.

Section III

UNREAL ESTIMATION OF REVENUES AND REAL EXPENDITURES

With average inflation coming down to below 5 per cent, the growth of nominal incomes has slackened even more than has the rate of growth in real incomes. Nominal GDP used to grow at 12 to 15 per cent till the end of the nineties; now they are restricted to the 8 to 10 per cent range – a state of affairs that is likely to continue in the foreseeable future. In 2001-02, GDP at current market prices grew by 9.1 per cent and in 2000-01 by 8.6 per cent. In 2002-03 the counterpart figure was possibly under 8 per cent. In consequence, tax growth on a year-to-year basis has also slowed down and this trend should be expected to persist.

However, one would not realise this from an examination of the budget documents of the states. In drawing up the budget for 2001-02, (all) states projected a growth from states own revenues (tax and non-tax) of 18.3 per cent. In the event the revised estimates indicate a shortfall of states own revenues of nearly Rs 12,000 crore and a growth of 10.3 per cent. In drawing up the budget for the 2002-03, the projections imply a growth of 15.5 per cent, and it is little surprise that there was another large shortfall.[6]

This systemic over-estimation of the revenue stream has permitted the accommodation of correspondingly higher expenditures. Thus, the RBI in its State Finances notes that:

> "During 2001-02, the revenue receipts at Rs. 2,70,901 crore showed a rise of 13.8 per cent over the previous year. While the States' own revenue receipts (tax and non-tax receipts) rose by 10.3 per cent.......(t)he aggregate expenditure of States at Rs. 4,01,571 crore during 2001-02 showed a rise of 15.7 per cent over the previous year. While capital expenditure increased by 26.0 per cent, the increase in revenue expenditure was 13.7 per cent. The (increase in) revenue expenditure accounted for 73 per cent of the increase in total expenditure."

... and the consequence?

> "The revised estimates for 2001-02 show that all the major deficit indicators were higher than their budgeted levels. The gross fiscal deficit in 2001-02 (RE) was higher than the budget estimate by 12.1 per cent, while the revenue deficit was higher by 28.6 per cent. Similarly, the primary deficit was higher by 39.2 per cent than the budget estimates."[7]

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[6] *State Finances–A Study of Budgets 2002-03,* Reserve Bank of India, February 2003, Table-3, pp.83-84
[7] *ibid*. pp. 19-20.

Expenditures are always more sticky than are revenues. The motivation to construct budgets with patently unrealistic revenue projections is primarily in order to accommodate items of expenditure that are difficult to exclude or cut. The unhappy consequence of this encompasses several levels:

- First, it generates an ever-worsening fiscal position;
- Second, it gradually erodes the integrity and credibility of the budgetary process which lies at the very heart of public finance discipline and replaces accountability with cynicism;
- Third, it makes the process of fiscal reform ever harder.

PRESSURE OF OTHER EXPENDITURE AND RESOURCE ITEMS

Growing Pension Liabilities

Pensions have been the fastest growing expense item in government finances. People are living longer and the entitlements following on recent revisions are substantial. The RBI State Finances notes that:

> "During the period 1995-96 to 2000-01, the annual average increase in pension expenditure was as high as 27.1 per cent. In 2000-01, pension payments pre-empted more than 10 per cent of the revenue receipts. With the increase in the number of retirees, the pension liabilities are expected to increase and could, therefore, emerge as an important expenditure item for the States."[8]

Even if it does not continue to grow at an annual rate of 27 per cent, pension obligations are set to continue mounting faster than will government revenues in the foreseeable future. The recently introduced funded schemes will turn relevant only some three decades hence. With state government finances under considerable stress, these rising pension liabilities are going to add greatly to the stress. It is unclear if government has any plan as to how to met these liabilities, or even if there exist any credible projections of future liabilities.

Tax Potential

Evaded and avoided taxes may be an undesirable phenomenon, but it at least holds out the promise of a resource that can be tapped to finance the fiscal restructuring process. In past years there have been positive developments on sales tax (Uniform Sales Tax) rates. Then the sustained pressure of

[8] *ibid*. p.31

inadequate revenues to fund the demand for expenditures is likely to have reinforced enforcement and hence of compliance. If the latter premise is indeed true, a potential resource for fiscal restructuring has perhaps been greatly exhausted.

The Infrastructure Deficit – Physical & Social

The deficit in physical and social infrastructure challenges the institution of the state in India. The state governments are enjoined to provide a significant proportion of public services and are primarily responsible to initiate the construction of critical infrastructure assets. It is a fact of life that private investment will only enter where it makes commercial sense to do so. If policy and systemic changes transform the power sector from a black hole into the thriving commercial business that it ought to be, private investment interest will be perhaps adequate to take care of a significant component of additional asset creation.

However, there are many areas of physical asset creation – from rural drinking water and roads to low income housing – where state intervention either as a co-investor or sole investor is inevitable. For these are areas where a (risk adjusted) commercial rate of return – unsupported by some form of state intervention – is neither possible nor perhaps desirable.

This is even truer of social infrastructure – from public health to primary and secondary education to social security for children, the handicapped and the aged. The issues here are not restricted to constraints of finance alone, but of re-working outmoded designs of service delivery. It goes without saying that the quality of government schools are not going to improve if the concerned department in the state secretariat were to suddenly be awash with funds. There are serious structural issues of transferring ownership of these assets to the beneficiaries and their communities. But that said, there are yet questions of inadequate financial resources and the state governments will have to come up with it.

It is completely unrealistic to think that the peoples' representatives will be content to face re-election with nothing to show for their five-year term in office in terms of bridging this palpable deficit. In the absence of good policy and sound systems, by default we will have bad solutions: ones that perpetuate the inefficient application of public funds and aggravate the stress in public finances.

Section IV

REFORM ISSUES

Without recasting expenditure, all initiatives to push fiscal reform is condemned to flounder. Even if through rate increases or tax reform and better processes not involving rate hikes, or by way of new taxes on services, the level of aggregate tax revenues are successfully increased, in the absence of expenditure reform, all these gains on the revenue front will be frittered away. Incremental revenues will be swallowed up by expenditures that are as bad (from an efficiency point of view) as they are powerful. Imbued with power in terms of enjoying strong political backing. In our context we must take this as being given. The unfortunate fact is that the order by which the excess demand for funds queue up at the exchequer has often little to do with social merit, but much to do with sectional lobbying within the polity.

In the state governments, the path of fiscal consolidation has much to do with improving the functioning of levels of government and enterprises that function below it.

Municipalities and other local bodies

There is considerable scope for improvement of both the revenue position and organisational capability to execute more asset creation and service provision by these agencies. In many states, these agencies do not reel under the load of large debt and enjoy some scope for enhanced revenue collections from overhauling assessing properties to tax and collecting such taxes, besides enlarged scope of metering and realistic user charges for water and other municipal services. Stronger municipal finances and organisational capability has the potential of relieving the state government of three sets of loads:

- First, the load of guarantees given to various agencies for resources that ultimately go to create assets at the municipal level, will be reduced to the extent of the greater evidence (and hence the confidence) that they will be able to meet debt service obligations on their own.
- Second, by creating conditions conducive to the initiation of physical infrastructure facilities by local bodies – for instance in water and sewerage, in building and maintenance of connecting roads and initiating construction of housing projects.
- Third, as in the case of physical infrastructure, so also in the case of social infrastructure – especially schools and health care. It might be recollected that in many states the public school system were originally under the municipalities and were transferred to the state in the centralisation process that began with a vengeance in the 1960s.

Public Enterprise Reform

The prime candidate for reform, is of course, the state owned power sector. Bringing this sector back to the level of efficiency that it enjoyed even a decade and a half ago, would be able to generate an additional 1 to 1.5 per cent of GDP for the respective state governments as additional fiscal resources. If done properly it could eliminate the burden of subsidy, create a solvent agency and make the process of privatisation of the distribution companies both an easy process and for the state finances a lucrative proposition.

The pace of change in the power sector is so slow that one must deduce that the effort in making any progress at all is proportionate to the quantum of haemorrhaging that the sector has been experiencing. Or proportionate to the entrenched interests that have been feeding on this haemorrhage.

Aside from the power sector there are state road transport corporations, warehousing companies, tourism assets, dairy farms and a host of commercial activities that need to be leveraged. In order to both bring in financial resources to the state exchequers and focus the government's effort on what it ought to be focused on – namely, achieving efficiency in expenditure, improved allocation of resources and better governance, with all that it entails.

Redesigning Service Delivery

It is difficult to measure the output of services – and even more so in the case of public services. Over the decades past, it became the norm to use expenditure as a proxy for the output of service – a most unfortunate development. It is obvious to the layperson that spending more money on tube wells does not necessarily translate into better water availability in homes. And certainly spending more on schools does not mean more widespread and/or better quality of education.

Clearly given the substantial fiscal resources that are being channelled into various social service provisions, the greater need of providing such services and obvious lacunae in both the quanta and quality of such services, there is an urgent need to redesign the process in which tax (and borrowed) rupees are sought to be converted into public services. The state governments as important intermediaries in the process require to take the necessary steps, in consultation with other states and the Centre so that common approaches and standards are adopted.

Tighten tax collections

Tightening tax collections is of particular importance in the present juncture, since the states are proposing to soon move to Value Added tax (VAT). The unpleasant fact remains that the energies of many enterprises are geared towards the avoidance of tax, often in collusion with individuals employed by the state. In the event what comes into the treasury is the culmination of an ongoing struggle between the authorities and the non-compliant taxpayer in collusion with corrupt elements in the government bureaucracy. Prevailing in this context on a day-to-day basis is a difficult and challenging task. The one metric that is most powerfully used by the authorities is the tax collections of the previous period and the goad is used to maximise the increment. Every good tax collection year raises the metric and a bad year lowers it. For those elements in the tax administration who serve themselves more than they serve the state, a major change in the tax regime, like VAT, offers a potential to shift the metric down – once and for all times.

New taxes should follow expenditure reform

There is an ongoing demand by states that they be permitted to levy taxes on services. Often in support of this demand the quite erroneous argument is made that the economy has changed – with the service sector generating more value added, while the share of manufacturing has remained stagnant.

Since, one hears it even now, it is perhaps necessary to point out that in the sources of value addition, that is GDP by industry or origin, what we have are factor incomes. Do state governments levy taxes on factor incomes – wages, rent, profit and interest? Of course they do not. Except in the case of agricultural income – where the state government has the authority to levy taxes on the mixed income of agriculture. An authority that state governments used with vigour only in tea plantations and on rarer occasions with greater moderation in coffee plantations. In any event they never had the authority to levy taxes on the factor income of manufacturing, so of what consequence is it that the structure of the economy has changed in terms of industry of origin of income. That was the preserve of the Centre and the state governments got what the respective Finance Commissions ordained.

So what was it that state governments were and are levying taxes on? On the disposition of the factor income – that is on expenditures. Income is disposed on consumer goods – durable and non-durable – investment (capital) goods and final services. The state governments levy taxes on the sale (consumption) of various articles of manufacture and some services – from processed foods and alcoholic beverages, to gasoline and cooking gas, to kitchen appliances to automobiles; from mid-market restaurants to works contracts (like printing) to movie theatres to luxury hotels. Surely some final services fall outside of the tax net – including lawyers' fees and final public services (a large component of GDP).

The argument to levy taxes on some *El Dorado* of services is in the first instance misconceived; and in the second has the potential of befouling the business environment. As the state's commercial taxes department seek to extent their outreach (including all that it entails) to all manners of business from financial intermediaries to consultants, from hairdressers to doctors, from accountants to distributors, from realtors to software companies. But not lawyers, of course – greed does bow to consequences.

Identifying and eliminating poorly designed subsidies

This is perhaps less of a problem at the state level than it is at the Centre. However, in the case of state governments, there are substantial implicit subsidies in terms of inadequate cost recovery on service provisioning. A classic example is the case of irrigation, which has accounted for very large capital expenditure and much of the trouble with guaranteed bonds in recent times. There was a time not that long ago, when the capital expended used to be recovered – at least partially, if not in its entirety – in the form of betterment levies. O&M and other recurring expenses were recovered through water charges. It has been some three decades – perhaps much more in some states – that betterment levies have been assessed, leave alone collected. The irrigation user charges in many instances have not been revised for years, not been notified often and collection seems to be more of an exception than the rule.

There is also reported abuse of incentives like sales tax exemptions, where production in a non-exempt unit is reported from an exempt one. It is not unknown that cash reimbursements have been made on account of cleverly engineered and fraudulent claims relating to such exemptions. Clearly there needs to be a complete overhaul to prevent the perpetuation of such abuse.

Restoring the credibility of state finances

Without the pain of restructuring, the health of state government finances cannot be restored. And it must be, for the state governments are the vehicles of much of public service provisioning, and for that matter responsible for the basic law and order system itself.

But the restoration of this credibility is key to restoring the bank-ability of the state governments in the perception of the investing community. Restoration of credibility enjoins a process of confidence building and restitution – in the sense that past errors are acknowledged and credible steps taken to allay apprehensions that there would be a relapse in the habits of engagement with the investing community.

The federal arrangement that was visualised, surely envisage the state governments take considerable initiative in moving their respective state ahead. And as we can see that is indeed happening. However, for the process to express itself to any extent, the state governments must acquire a measure of financial autonomy. The ability to borrow, and on competitive terms, is as much a symbol of sovereignty and freedom, as any other. The autonomy that state governments seek is contingent on their being able to transact business on their own without being tied to the apron strings of the Centre. For the demands of tomorrow are going to make the challenges of today pale in comparison.

The Centre must let go in the matter of access to the capital market. The overly protective nanny role that it (and the RBI) plays cannot and should not continue. If state governments do not wish to exercise their willingness to submit themselves to the financial discipline that is expected of a sovereign (or sub-sovereign) issuer, it is better that the OMB auction of SDL securities be dispensed with. It is not conceivable that in all times to come, the bulk of borrowed resources will be raised by the Centre and the conflict between need and means, between fiscal rights and accountability will continue to accumulate as they have in the recent past. The opportunity of those state governments that perform to harvest the fruits of their efforts cannot remain perpetual hostage to the unwillingness of others to submit themselves to financial discipline. Requiring at least the major states to go forth and place their own SDL paper, without overt or covert secretarial or other assistance from the RBI could be a start.

Given the fact that the delinquent behaviour of a few state governments and their agencies has made the water murky, in the initial period, explicit ***partial guarantee structures*** could be used to bring the credit quality up somewhat. In any event a beginning has to be made, and saying that this is not the right time, is to ensure that it never will be.

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