Chapter 12

Debt Position of States: Relief and Corrective Measures

12.1 Para 9 of our terms of reference (TOR) requires us to make an assessment of the debt position of the states as on the 31st March 2004, and suggest such corrective measures, as are deemed necessary, consistent with macro-economic stability and debt sustainability. While making recommendations, weightage is to be given to the performance of the states in the fields of human development and investment climate.

Approach of Earlier Finance Commissions

12.2 The Second Finance Commission was the first one to handle the issue of state debt and was required to make recommendation on rates of interest and terms of repayment of central loans made to states after independence and upto 31st March, 1956. Thereafter, a review of the state debt has been a term of reference from the Sixth Commission onwards. Till the Eighth Commission, the TOR of finance commissions required them to make an estimation of the non-plan capital gap of the states and to undertake a review of the debt position with particular reference to the central loans to states. These commissions were asked to suggest debt relief measures having regard to the overall non-plan capital gap and the purposes for which loans had been utilized and the requirements of the centre. From the Ninth Finance Commission onwards, finance commissions were mandated to review the debt position of the states as a whole and suggest corrective measures. The Ninth Commission was required to suggest corrective measures with particular reference to investments made in infrastructure projects and to link them to improvements in financial and managerial efficiency. While the Tenth Finance Commission had the mandate to suggest corrective measures keeping in view the financial requirements of the centre, the Eleventh Finance Commission (EFC) was required to consider the long-term sustainability of debt for both the centre and the states. Our TOR are at a slight variance with that of the EFC in that, apart from debt sustainability, the measures are to be consistent also with macro-economic stability. In addition, there is a reference to linking the recommendations to performance of the states in the fields of human development and investment climate.

12.3 We have examined the manner in which the finance commissions in the past have approached the problem of states' debt and the fiscal measures necessary for maintaining debt at sustainable levels. The finance commissions had commented on the need to consider the cost of debt, the use and the productivity of borrowed funds and the arrangements for amortization of debt while resorting to borrowings. In particular, the Ninth Finance Commission was of the view that the solution to the problem of public debt lay in borrowed funds (a) not being used for financing revenue expenditure and (b) being used efficiently and productively for capital expenditure so as to either earn returns or increase the productivity of the economy resulting in increased governmental revenues. The Tenth Finance Commission had, similarly, commented that the disturbing features of the debt profile of states were the diversion of borrowed funds for meeting revenue expenditure, use of loans in unproductive or non-performing enterprises and non-provision of depreciation or amortization of funds in respect of government owned assets. This led to repayments being made out of fresh borrowings. The EFC observed that the determination of stable and sustainable levels of debt would depend critically upon the rate of growth of (nominal) GDP/GSDP, the effective interest rate on borrowing by the concerned governments (centre/states), the rate of growth of revenue receipts and the proportion of primary expenditure (expenditure other than interest payments) relative to GDP/GSDP that may be considered desirable. Given other things, a state which had a higher growth rate relative to interest rate, would be able to sustain debt at a higher level relative to GSDP. The EFC also identified the steps desirable for reducing the debt burden of states as the following :- (i) incremental revenue receipts should meet the incremental interest burden and the incremental primary expenditure, (ii) a surplus should be generated on revenue account to go into a sinking fund to meet future repayment/obligation, and (iii) state should have and maintain balance in its revenue account.

12.4 As required by our TOR, we have already suggested in chapter 4 a restructuring plan that would restore budgetary balance and enable the states and the centre to achieve macro-economic stability and debt reduction along with equitable growth. We have analyzed the reasons for the mounting debt and the revenue and fiscal deficits of states. We have also looked at the various conditions for macro-economic stability. Our approach to debt sustainability and the fiscal discipline required for macro-economic stability have been outlined in that chapter. The suggestions contained therein provide the overall context for the corrective measures in regard to the existing debt to be considered in this chapter.

Debt Position of the States

12.5 We have made an assessment of the debt position of the states as on 31st March, 2004. We have also collected data from the states on their estimates of outstanding debt as on 31st March, 2005. The public debt of states comprises internal debt [(including market borrowings, loans from banks and financial institutions, special securities issued to the National Small Savings Fund (NSSF)], loans from the centre, and small savings and provident funds, etc. The total outstanding debt of states, including short term borrowings, is estimated at Rs 865859 crore at the end of March 2004 and is expected to rise to Rs 963870 crore by the end of March 2005 as per data collected from states. The share of market borrowings (including loans from banks and ways and means advances) and provident funds and deposits was 35.60 and 14.94 per cent respectively at the end of 2003-04 and is likely to be 37.23 and 14.74 per cent respectively at the end of 2004-05. The state-wise composition of debt at the end of 2003-04 and 2004-05 are at annexures 12.1 and 12.2.

12.6 Previous finance commissions had followed the practice of excluding the short-term components of debt viz. ways and means advances and reserve funds and deposits, while looking at the debt position of states. Table 12.1 shows the results of a similar exercise carried out on the basis of information provided to us by the states in regard to estimated debt of state governments, excluding ways and means advances and reserve funds and deposits.

Table 12.1

Total Outstanding Debt of State Governments

(Rs. in crore)

	At the end of Financial Year	**2003-04**	**2004-05**
1)	Market Loans	200690	230292
2)	Loans from Banks etc.	102531	124236
3)	Loans from Centre*	252809	261416
4)	Provident Funds & Deposits etc.	129376	142103
5)	Others@	97906	123303
	TOTAL	**783312**	**881350**

Source : State governments
*** May include NSSF loans also.**
@ Includes NSSF loans for some states

12.7 In recent years, market borrowings have emerged as the cheapest source of funds for state governments, with interest rates declining continuously from 14 per cent in 1995-96 to around 6 per cent by 2003-04. The states' access to market borrowings is, however, regulated by the central government keeping in view its own requirements and the liquidity in the market. The central loans to states form the largest component of the states' debt. These are often market loans raised by the centre at the prevailing interest rates but onlent to states at rates of interest very different from the market rates. The practice of the central government providing loans to the states enables the centre to exercise control over the borrowings of states, as under article 293 of the Constitution, a state cannot raise any loan without the consent of government of India, if any part of a loan which has been made to a state by the central government or a guarantee is still outstanding.

12.8 The loans given by the central government to states comprise :

a) loans for state plan schemes as a part of normal central assistance, additional central assistance for state projects funded by external agencies and the loan component of the schematic portion of several state plan schemes (state plan loans), which are consolidated as one loan on October 1 every year, carrying the same rate of interest and other terms of conditions;

b) small savings loans comprising of loans given prior to April 1, 1999, when the National Small Savings Fund was created;

c) loans for centrally sponsored schemes/central plan schemes and other miscellaneous loans provided through central ministries;

Table 12.2

Profile of Central Loans to States

(Rs in crore)

At the end of	1999-2000	2000-01	2001-02	2002-03	2003-04	2004-05
Central loans outstanding*	209882	218380	228902	227343	193034	196346
Total outstanding debt @	415142	489768	576171	667891	788401	885700
	(50.48)	(44.59)	(39.73)	(34.04)	(24.48)	(22.17)

*** Source : Receipts Budget, government of India 2004-05**
@ Source : States' finance accounts/state government data (excludes reserve funds and deposits but includes W&M Advances)
Figures in parenthesis are percentage share of central loans to total outstanding debt for all states.

d) medium term loans given by the Ministry of Finance; and

e) ways and means advance loans by the Ministry of Finance.

12.9 The outstanding central loans to states at the end of each year from 1999-2000 onwards, as indicated in the Receipts Budget 2004-05 of the government of India, are shown in Table 12.2. It would be observed that there has been a gradual reduction in the dependence of the states on the centre for borrowing requirements. While central loans constituted over 50 per cent of outstanding loans of states in 1999-2000, in 2002-03 this figure has declined to 34.04 per cent and is expected to come down further to 22.17 per cent at the end of 2005. One of the reasons for the decline is that the central loans no longer include the borrowings against small savings as the investments made in special securities of states against collections in the NSSF are maintained in the public account with effect from 1.4.99. The other reason for the decline is the debt-swap allowed by the central government. This has been dealt with later in this chapter.

12.10 The rates of interest on central loans to states have varied from 7.5 per cent to 13 per cent in respect of plan and non-plan loans (other than small savings loans) from the years 1984 to 2004. In regard to loans against small savings collections given before the NSSF was formed, the rate of interest had varied from 6.25 per cent from 1.8.74 to 31.5.81 to a maximum of 15 per cent from 1.6.93 to 1.9.93, after which it was 14.5 per cent from 2.9.93 to 31.12.98 and 14 per cent from 1.1.99 to 31.3.99. Since central loans formed the largest component of the state debt in the past, increasing interest rates on central loans has contributed, to a large extent, to the growing burden of debt servicing of states. Annexure 12.3 indicates details of the rates of interest applicable on central loans from time to time.

12.11 The standard criterion for determining the sustainability of debt of states has been to arrive at the acceptable levels of debt-GSDP ratios and the ratio of interest payments to total revenue receipts. An analysis of the relative position of the debt-GSDP ratios of states and the percentage share of each state in the total outstanding debt of states for the year 2002-03, which is the latest year for which the finance accounts are available, shows the results indicated in Table 12.3.

Table 12.3

Debt-GSDP Ratios and Percentage Share of States in Overall Debt in 2002-03

Sl. No.	State	Debt GSDP ratio	Share in total debt of states	Sl. No.	State	Debt GSDP ratio	Share in total debt of states
General Category States							
1	Andhra Pradesh	28.85	7.50	16	Uttar Pradesh	39.08	11.90
2	Bihar	55.33	4.79	17	West Bengal	41.15	10.46
3	Chhattisgarh	25.46	1.20	**Special Category States**			
4	Goa	28.15	0.45				
5	Gujarat	33.93	6.61	18	Arunachal Pradesh	55.45	0.18
6	Haryana	27.85	2.70	19	Assam	33.91	1.94
7	Jharkhand	24.28	1.29	20	Himachal Pradesh	63.25	1.71
8	Karnataka	25.12	4.72	21	Jammu & Kashmir	53.80	1.65
9	Kerela	36.34	4.65	22	Manipur	43.08	0.31
10	Madhya Pradesh	32.28	4.07	23	Meghalaya	32.17	0.22
11	Maharashtra	21.56	9.51	24	Mizoram	81.56	0.27
12	Orissa	62.93	4.23	25	Nagaland	52.10	0.38
13	Punjab	48.51	5.52	26	Sikkim	60.27	0.13
14	Rajasthan	45.38	6.31	27	Tripura	37.78	0.46
15	Tamil Nadu	26.80	6.02	28	Uttaranchal	32.37	0.80

Debt excludes reserve funds and deposits

The aggregate Debt-GSDP ratio for all states works out to 34.21 per cent. At the end of 2002-03, all states, except Maharashtra and Jharkhand, have debt-GSDP ratios exceeding 25 per cent. Year-wise figures of debt-GSDP ratios upto 2002-03 are at annexure 12.4.

12.12 In the context of sustainable levels of debt, the EFC had recommended that the proportion of interest payments to revenue receipts, including tax devolution and grants, should be reduced to about 18 per cent compared to the then average of 22 per cent. We, however, find that from 2000-01 to 2002-03, the average ratio in respect of 17 states has been above 18 per cent and in respect of 11 states has been above 22 per cent. In terms of this criterion, therefore, 17 out of 28 states have unsustainable levels of debt. The relative position of states is indicated in Table 12.4.

Table- 12.4

Interest Payments as a percentage of Revenue Receipts

Percentage of Interest Payments to Revenue Receipts (Average of 2000-01 to 2002-03)	States
Above 35 %	Orissa, Punjab, West Bengal
28-35%	Himachal Pradesh, Rajasthan, Uttar Pradesh
22-28%	Andhra Pradesh, Bihar, Gujarat, Haryana, Kerala
18-22%	Goa, Jharkhand, Karnataka, Madhya Pradesh, Maharashtra, Tamil Nadu
10-18%	Assam, Arunachal Pradesh, Chhattisgarh, Jammu & Kashmir, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, Tripura, Uttaranchal

State-wise and year-wise data on the ratio of interest payments to total revenue receipts are at annexure 12.5. The aggregate position of the ratio of interest payments to revenue receipts for all states for the year 2003-04 (RE) is found to be 26.07 per cent and in the year 2004-05 it is estimated at 25.19 per cent.

12.13 The deteriorating debt situation of states is reflected both in terms of the debt-GSDP ratio and the ratio of interest payments to revenue receipts. The position seems particularly grim for the states with high debt-GSDP ratios (i.e. over 35 per cent) coupled with high ratios of interest payments to revenue receipts (over 22 per cent). These states are Bihar, Himachal Pradesh, Kerala, Orissa, Punjab, Rajasthan, Uttar Pradesh and West Bengal.

12.14 The Ministry of Finance, in its review of the Fiscal Reform Facility, has worked out sustainable levels of debt as a percentage of total revenue receipts. In its formulation, debt has been defined as inclusive of guarantees. It considers non-special category states as 'highly stressed' in terms of debt and debt servicing, if this ratio exceeds 300 per cent. In the case of special category states, the threshold is 200 per cent. The ratio in respect of 20 states considered in the review, in the year 2002-03, ranges from 96.09 per cent for Sikkim to 500.93 per cent for West Bengal. The corresponding figures are estimated at 98.26 per cent to 529.69 per cent for the year 2004-05. In 2002-03, out of 20 states, 7 non-special category states and 2 special category states were highly stressed.

12.15 An examination of the debt profile of states indicates that the total outstanding debt of states (excluding reserve funds and deposits) has risen steadily from 18.62 per cent of GDP in 1993-94 to 27.04 per cent of GDP in 2002-03. The corresponding figures for 2003-2004 and 2004-05 are 28.43 per cent and 28.53 per cent respectively. The rising debt of states is a reflection of the deterioration in the fiscal performance of states and signifies a long- term mismatch between the growth of revenues and expenditures of the states. It is the consequence of persistent increases in non-plan revenue expenditure, such as interest payments, subsidies, salaries and pensions, together with sluggish growth in tax-GDP ratios, inadequate returns from public investments and insufficient growth in central transfers. Large revenue deficits have led to large fiscal deficits and spiraling debt, resulting in the emergence of a vicious cycle of deficit, debt and debt service payments.

Debt-Swap Scheme

12.16 In the context of the debt of states, a mention needs to be made of the recent initiatives taken by the government of India to tackle the high level of interest payments. Taking advantage of the falling interest regime, the central government introduced the debt-swap scheme in September, 2002 to give relief to the states on the 'high-cost debt' owed by the states to the central government. High-cost debt was defined as the debt which carried interest rate of 13 per cent or above. Only state plan loans and small savings loans given upto 31.3.99 qualified for debt-swap. We have been informed that on March 31, 2002, such high-cost debt amounted to Rs 114325 crore. Two borrowing sources were identified for swapping the 'high-cost' central government loans - additional open market borrowings and state governments' investment in small savings securities. It was expected that additional market borrowings could be raised at around 7 per cent. As the states had over Rs 65000 crore of small savings debt, which carried interest in excess of 14.5 per cent, this swap was expected to give the state governments a clear interest savings of over 6 to 8 per cent in respect of small savings loan swapped with additional market borrowings. The states' investments in the NSSF securities carried an interest obligation of 9.5 per cent. This stream was expected to result in interest savings of 3.5 per cent to 5.5 per cent. The scheme envisaged that during the year 2002-03, 20 per cent of net small savings loans payable to states from September, 2002, would be used to pre-pay the past debt. Use of 30 per cent of net small savings in the year 2003-04 and 40 per cent of net small savings in the year 2004-05 were envisaged for effecting debt-swap. The small savings are supplemented with additional market borrowings by the state governments depending upon the liquidity position.

12.17 The Ministry of Finance has informed us that the total debt-swap has so far been Rs 87672 crore, the year-wise details of which are indicated in Table 12.5.

Table 12.5

Position of Debt-Swap Already Effected

(Rs. in crore)

	With Small Savings	With Additional Open Market Borrowings	Total
2002-03	3766	10000	13766
2003-04	17943	26623	44566
2004-05 upto Sept.04	15559	13781	29340

12.18 In the year 2004-05, the total debt expected to be swapped is approximately Rs 46000 crore. The debt-swap is expected to provide a total interest relief of Rs 31000 crore over its lifetime and Rs 14500 crore and Rs 28000 crore respectively in the first five and ten years. We have been informed that these calculations of savings in interest payments are based on the assumption that high cost of loans of Rs 1.14 lakh crore have equal amortization schedule of 20 years and annual payment of Rs 6017 crore and that the average interest on swapped loans is 7 per cent for additional open market borrowings and 9.5 per cent for small savings. The Ministry of Finance has calculated the savings in the revenue expenditure of states as a result of the scheme as 0.75 per cent per annum.

12.19 The central government has used the proceeds of debt-swap for pre-paying its debt to the NSSF assumed at the time of its creation in 1999. There would, however, be a loss of revenue for the centre as the high cost loans were effectively yielding an average annual interest of 14 per cent, whereas even where the centre uses the entire debt-swap proceeds to effect pre-payment of its debt to the NSSF, carrying a rate of interest of 10.5 per cent, there would be an interest rate differential of 3.5 per cent per annum. For the states, the debt-swap scheme results only in a change in the composition and maturity profile of debt, but not the overall stock of debt. The benefits, however, are that over a period of time, savings by way of lower interest payments would reduce the pressure on the states' revenue account and, consequently, the overall borrowing requirements. Further, the role of the central government as an intermediary in respect of loans to state governments gets reduced.

Debt Relief by Earlier Finance Commissions

12.20 Before formulating our approach to debt relief, we have looked into the measures of debt relief provided to states by successive commissions. We find that debt relief has been granted in the form of (i) consolidation of loans on common terms and with reduction in the interest rates for the future, (ii) revision in the terms of repayment of loans given to states without a lowering of interest rates, (iii) moratorium on interest payments and repayment of principal due in certain years, (iv) write-off of loans or repayments falling due during a specified period, (v) introduction of schemes of debt relief linked to fiscal performance etc. While the Second, Seventh and Eighth Finance Commissions consolidated some of the earlier loans and rescheduled them at lower rates of interest, the Sixth Finance Commission revised the terms of repayment of outstanding loans. The Seventh Finance Commission also recommended that small savings loans outstanding at the end of 1978-79 be converted into loans in perpetuity. This recommendation was, however, not accepted by the central government. Write- off of specific loans also constituted a part of the recommendations of these commissions. We would, however, like to delve in greater detail on the recommendations of the three immediately preceding commissions in regard to debt relief as these are considered to be more relevant to us. The Ninth Finance Commission, in its second report, recommended write-off of loans given to states on account of drought during 1986-89 and outstanding on 31st March, 1989 and those given to Madhya Pradesh during 1984-89 in connection with the Bhopal Gas Leak Tragedy with the stipulation that repayment on account thereof, already made by the state government by way of principal and interest shall be adjusted against other payments due from the state government. The commission also suggested a moratorium of two years on repayment of principal and payment of interest in respect of special loans given to Punjab during 1984-89. Further, the state plan loans advanced during the five-year period of 1984-89 and outstanding as on 31st March, 1990 were recommended for consolidation and reschedulement for 15 years in the case of all states. During the first five years i.e. 1990-95, repayments were to be less than those due on the then existing basis to the extent of 10 per cent in the case of Andhra Pradesh, Karnataka, Madhya Pradesh, Maharashtra, Orissa, Tamil Nadu, Goa and special category states, 7.5 per cent in the case of Gujarat, Rajasthan and Uttar Pradesh and 5 per cent in the case of Bihar, Haryana, Kerala, Punjab and West Bengal.

12.21 The Tenth Finance Commission stated that, since many of the relief measures recommended by previous commissions continued to operate, any future relief should be viewed only as incremental. The Commission recommended a debt relief scheme in two parts, namely, (i) a scheme for general debt relief for all states linked to fiscal performance and (ii) specific relief for states with high fiscal stress, special category states and states with debt problems warranting special attention. This was in addition to a scheme for encouraging retirement of debt from proceeds of disinvestment and equity holding of state governments. The general debt relief scheme of the Tenth Finance Commission measured improvement in fiscal performance by comparing the ratio of revenue receipts (including devolution and grants from the centre) to total revenue expenditure in a given year with the average of the corresponding ratio in the three immediately preceding years. The performance of each state was measured against its own past performance. Twice the excess of the ratio over the average ratio of fiscal improvement during the preceding three years was recommended for relief on loans contracted during the period 1989-95 and falling due for repayment after 31st March, 1995. The relief was admissible only to the extent of ten per cent of the amount due for repayment from these loans in any year. We observe that the actual relief sanctioned to states based on the Tenth Finance Commission recommendations was Rs. 212 crore during the period 1995-2000 compared to the relief of Rs. 565.51 crore (assuming increase in performance by 2.5 percentage points) estimated by the Tenth Finance Commission. A specific relief in the form of write-off of 5 per cent of repayments due in regard to fresh central loans given during 1989-95 and outstanding as on 31.3.95 was also recommended by the Tenth Finance Commission for special category states and three other states (Orissa, Bihar and Uttar Pradesh), considered to have high fiscal stress, as their average ratio of interest payments to revenue expenditure exceeded 17 per cent during 1989-90 to 1993-94. In the case of Punjab, one-third of repayment of principal on special term loans falling due during 1995-2000 was recommended to be waived.

12.22 The EFC did not consider any special debt relief for the fiscally stressed states, but continued the general debt relief scheme of the Tenth Finance Commission with the following modifications :-

(i) instead of a factor of 2, a factor of 5 was applied on the ratio of fiscal improvement in terms of revenue receipts to total revenue expenditure

(ii) the ceiling of stipulated relief was set at 25 per cent of repayment due in any one year instead of 10 per cent and

(iii) in the calculation of revenue receipts, the revenue deficit grants recommended by the EFC under article 275 were to be excluded.

This relief was to be available in respect of fresh loans granted during 1995-2000 and outstanding on March, 2000. Although the estimated debt relief was Rs. 600 to Rs. 700 crore, we have been informed by the Ministry of Finance that till September, 2004, the states qualified for a relief of Rs. 131.77 crore only. The states which have benefited under the scheme are Andhra Pradesh (Rs. 77.52 crore), Arunachal Pradesh (Rs. 1.72 crore), Manipur (Rs. 2.47 crore), Tamil Nadu (Rs. 7.89 crore) and Punjab (Rs. 42.11 crore).

Views of State Governments

12.23 We have considered the suggestions made by the state governments in their memoranda in regard to debt relief. A large number of states have pleaded that interest rates on central loans to states may be brought down. Suggestions have been made for waiver of interest, consolidation of loans, writing-off of principal, rescheduling and moratorium on repayments. Many states have requested for a consolidation and reschedulement of loans with or without moratorium on interest and repayment. Some states have also suggested that a portion of the consolidated loans may be written-off. The continuation of the debt-swap scheme is another demand of states with some states suggesting that the scheme should be extended to all outstanding high-cost loans including those from financial institutions. Some states have suggested modifications to the scheme of debt relief linked to fiscal performance recommended by the EFC. The other suggestions made by states are summarized below:

a) External assistance received by the government of India as grant-in-aid should be passed on to the states as grant and a fee may be collected from the states for covering the transaction cost.

b) The repayment of the borrowings from external agencies, passed on to states, should be on the same terms and conditions as prescribed by the external agency and the central government should charge only a fee for meeting the transaction cost.

c) In respect of small savings, central government may recover from the states only the amount which is to be paid to the investor plus a nominal cost not exceeding half per cent for administration of the schemes.

d) Debt-swap scheme should be applicable to all high-cost loans and states should be allowed to raise low-cost loans from the market, both internal and external, to repay high-cost loans within certain limits to be imposed by the central government.

e) Plan assistance given in the form of special term loans for meeting emergencies like insurgency or natural calamities should be converted into grant. In future, such assistance should come in the form of grants-in-aid only.

f) Additional plan assistance given to special category states under Accelerated Irrigation Benefit Programme and Rural Electrification Programme should, like other plan schemes, be converted into 90 per cent grant and 10 per cent loan, instead of 100 per cent, loan as is the case at present.

g) The Non-Lapsable Central Pool of Resources, which consists of the unspent balance of funds earmarked in various ministries for the north-eastern states should be given to the states concerned as 100 per cent grant as against the current pattern of 90 per cent grant and 10 per cent loan.

h) The rate of interest charged by the government of India on loans granted to the states should be reviewed every year and should be closely aligned to the prevailing market rate of interest.

i) The central plan assistance should generally be in the form of grants and the states should have the option to contract the loan component from the open market.

j) Financial institutions should be advised to extend loans to public sector undertakings on the basis of the viability of a project without insisting on the state guarantee.

Views of the Central Government

12.24 The central government in its memorandum has stated that an appropriate fiscal management plan for bringing down the ratio of state debt to GDP during the award period is an imperative. It has further been stated that, while the central government has been making efforts to reduce burden of states through debt-swap and reduction in interest rates on plan loans and small savings transfers, state debt to the centre should not be written-off or rescheduled, as the centre is no longer in a position to bear any additional burden on this count. In any case, debt relief to states should not be unconditional and across the board.

12.25 The memorandum also states that guarantees given by state governments have risen sharply over the years and at the end of March 2002, stood at Rs. 166116 crore, constituting 7.2 per cent of GDP for 17 major states. While steps, administrative and legislative, have been initiated by some state governments to cap the level of guarantees, it may be appropriate if the Commission recommends an appropriate level of guarantees that may be given by an individual state government. In so far as the central government is concerned, efforts will be made to limit fresh guarantees to 0.5 per cent of GDP each year, as provided in the Fiscal Responsibility and Budget Management Bill.

12.26 In a subsequent reference, it has been stated that in the case of states, the issue of debt sustainability is being addressed through the medium-term fiscal reform framework. Many states have also been working towards fiscal correction through adoption of fiscal responsibility legislation, ceilings on guarantees etc. and it is believed that these will favourably impact on their future borrowing requirement and thereby on their overall stock of debt.

12.27 On the issue of linking debt relief to progress in human development index, the Commission has been urged to balance the considerations of efficiency with equity so that the concerns of states with lower than India's average human development indices, are taken care of. In any case, debt relief should specifically address the issues related to cost of debt rather than write-off, which the centre is not in a position to bear, given the restraints being put into effect by the Fiscal Responsibility and Budget Management Act.

12.28 In a further submission on the issue of linkage of debt relief to progress in human development index (HDI), the Ministry of Finance expressed the view that, given the diverse methodologies, incomplete coverage of states and infrequency of data, it may not be appropriate to link HDI to debt relief to states. There is merit in adhering to pure "financial" and "fiscal" indicators in the matter of debt relief.

12.29 Since the central government stated that the problem of debt sustainability is being addressed through the medium-term fiscal reform framework, we specifically studied the features of the fiscal reform facility (FRF) related to debt. The mid term review of the FRF by the Ministry of Finance has noted that, instead of the conventional definition of sustainable debt based on the Domar principle, the assessment of debt as a percentage of total revenue receipts has been found more appropriate, as there is a methodological problem in using state GSDP as a denominator. Since there is a correspondence between GSDP growth and growth in states' revenues, anchoring of debt as a percentage of total revenue receipts (TRR) was not inappropriate. In the formulation contained in the mid term review, the definition of debt includes guarantees. Sustainable debt (including guarantees) to TRR ratio has been worked out as 300 per cent for non-special category states, keeping in view the need for the gross fiscal deficit to stabilize at 3 per cent of GSDP. The review states that general category states can be considered as highly stressed, if the ratio is greater than 300 per cent. For special category states, if the ratio is more than 200 per cent, they can be classified as highly stressed. It has been estimated that by 2004-05, the number of highly stressed states is likely to be to eight (special category – Assam and Himachal Pradesh and non-special category – Kerala, Maharashtra, Orissa, Punjab, Rajasthan and West Bengal).

12.30 The mid term review of the FRF further suggests that a practical approach would be to divide states in three categories, viz., (a) severely debt stressed, (b) moderately debt stressed, and (c) non-stressed. For severely debt stressed, a modified form of IMF-World Bank HIPC Initiative covering all loans should be conceptualized. Further, the debt-swap scheme must continue and for meeting reform costs, a blend of loans and grants should be adopted where the loan part should not exceed 50 per cent of the mix.

12.31 We are given to understand that assistance has been made available to states for restructuring of debt with financial institutions to take advantage of the low interest regime. The assistance is for debt reschedulement or refinancing and government of India, through the FRF, shares a part of the premium cost of restructuring by allocation of additional open market borrowings. Nagaland and Himachal Pradesh have availed the benefit of this assistance till now. Further, under the scheme for financing the cost of reforms like voluntary retirement scheme (VRS) etc. through a blend of grants and open market borrowings, Jammu and Kashmir, Manipur, Himachal Pradesh, Kerala and Nagaland have benefited.

12.32 We also note that the Medium Term Fiscal Policy Strategy of the government of India placed before Parliament in July, 2004 intends to encourage states to approach the market directly rather than routing state debt through central budget and to consider on-lending external loans to states on a back-to-back basis. Further, in the National Common Minimum Programme, it has been stated that a structured and transparent approach to alleviate the burden of debt on states will be adopted to enable them to increase social sector investments and that the interest rates on loans to states will be reduced.

Studies Assigned by the Commission

12.33 A study was assigned by the Commission to the Indian Institute of Management, Ahmedabad to develop a suitable methodology for assessing the fiscal sustainability of debt of the states in India and identifying the major factors that have led to the deterioration of the debt profile in the recent past. Using case studies in respect of six states, the study was required to suggest a model programme of reforms and policy interventions for resolving the debt related issues. The study has recommended linking of the resource transfers (tax and grants) from the centre to the states to states' own revenue generation and their own account primary deficit. Once the finance commission determines the level of transfers to a state on whatever basis, its ratio to states' own revenues stands determined and should form the basis of an incentive scheme. It has further been recommended that all high interest loans given for calamity/disaster relief should be considered separately for either writing them off fully or partially or giving a five-year moratorium, apart from reducing interest rates thereon. It has been concluded that four states would need restructuring of about 15 per cent of their debt through a five-year moratorium on interest payments and for two of the states, this level would be 30 per cent and 50 per cent respectively. All this should be subject to strict adherence to the achievement of targeted growth in states' own revenues and in primary expenditure of 13.5 per cent and 10 per cent per annum respectively, failing which, the interest should be added back with penal interest of additional 2 per cent. It has been suggested that since loans from the centre have the highest effective interest rate compared to other sources of funds for a state, there should be at least a 200 basis points reduction in the effective interest rate charged by the centre and over a five-year period, it should be brought in line with the market rate of interest. It has further been suggested that the existing cap on market borrowing by states should be reviewed and more freedom should be given to states based on their credit rating and overall economic performance. Regarding small savings, which carry a higher interest cost, the centre should give an option to states in the matter of availing of these loans. The centre can supply excess of small savings from one state to another in need of such loans. Alternatively, the centre could bear the difference in the interest cost of these loans and the market rate of interest. The study has also suggested that the central government should facilitate the pre-payment negotiations of loans by state governments to the public sector financial institutions, since they carry a very high effective interest rate due to their loan vintage.

12.34 A paper on Debt Sustainability/Debt Relief was also outsourced by the Commission. The paper covered various aspects of debt sustainability, measures of debt relief and the suggested policy for future borrowings. It stresses the importance of the elimination of the revenue deficit with an additional limit on the size of the fiscal deficit. A fiscal deficit target of 3 per cent of GSDP for every state and a targeted debt ratio of 25 per cent of GSDP has been suggested. The achievement of this would, inter alia, require three different forms of debt relief in the case of central loans to states, namely (a) reduction of interest liability by lowering the interest rate on central loans to states to an appropriate level, (b) write-off of debt owed by states to the centre, eliminating future budgetary outflows on amortization and interest payment together with modification of the policy of central lending to states, and (c) reschedulement of debt over a longer period to reduce the annual budgetary outgo for states in terms of amortization. In order to explore the possibility of linking debt relief to performance in human development, we examined the reports prepared by the

Planning Commission and UNDP. For measuring inter-state differences in investment climate, two indices, namely, index of investment attractiveness and index of investment climate were developed by M/s Indicus Analytics using a number of variables. 20 states were ranked on the basis of percentage change between 1996-2001.

Our Approach

12.35 We have taken into account the existing levels of debt of states, their fiscal situation, the corrective measures recommended by previous finance commissions, the suggestions made by the central government and the submissions of the state governments while formulating our views. We have also taken into account the suggestions made by the two studies assigned by us as well as other studies. Considering all these factors, we are of the view that unless concrete and immediate measures are taken to tackle the debt of states, fiscal sustainability of states cannot be achieved. We agree with the approach of the EFC that the incremental revenue receipts should meet incremental interest burden and incremental primary expenditure. We, however, feel that the pre-requisite to this is the achievement of revenue balance by instituting measures for augmenting revenue receipts and compressing expenditure. As such, debt relief measures will need to be recommended by us in the context of debt considered sustainable and with a view to eliminating the revenue deficit of the states. Apart from providing for specific debt relief, qualitative and quantitative measures also need to be prescribed to restrict the future growth of debt stock of states beyond sustainable levels. Specifically, the debt relief measures recommended in regard to central loans to states need to be substantial and need to encourage better fiscal performance. The role of the centre vis-à-vis the debt of states needs to be re-determined by prescribing a rational lending policy for the future. This should include a rational computation of interest rates for future loans to the states. In addition, the future requirements in regard to repayments, particularly on open market borrowings, needs to be catered for in a manner that bunching or bullet payments do not cause undue fiscal stress.

12.36 As debt is the aggregate of borrowings made to finance fiscal deficits over the years, higher revenue and fiscal deficits lead to larger accretions in the stock of debt. We feel that states should make efforts to eliminate their revenue deficits so that borrowings are not used to finance revenue expenditure but are utilized for generating capital assets. We note that five states, namely, Karnataka, Kerala, Punjab, Tamil Nadu and Uttar Pradesh have enacted fiscal responsibility legislations to safeguard fiscal discipline and impose a statutory limit on the size of state's debt and/or borrowings (including guarantees). A fiscal responsibility bill had also been introduced in the state assembly of Maharashtra. We find that the fiscal responsibility legislations of these six states have specified targets for the fiscal and revenue deficits. In regard to total liabilities, ceilings have been prescribed by Karnataka, Punjab and Uttar Pradesh. Maharashtra proposes to put a restriction on borrowings. Capping of guarantees is provided for in the legislation of Karnataka, Tamil Nadu, Punjab, Uttar Pradesh (ceiling to be laid down under the rules or the law) and Maharashtra. We recommend that in the first instance, as a measure of fiscal discipline, all states should enact fiscal responsibility legislations prescribing specific annual targets for reducing their revenue and fiscal deficits and providing for a ceiling alongwith a path for reduction of borrowings and guarantees. We further recommend that the legislation should provide that the revenue deficit of states be brought down to zero by 2008-09, coinciding with similar targets prescribed for the central government. Enacting the fiscal responsibility legislation on the lines indicated in chapter 4 will be a necessary pre-condition for availing of debt relief, as recommended in this chapter.

12.37 Our TOR require us to recommend corrective measures giving weightage to performance of states in the fields of human development and investment climate. We have considered the matter keeping in view the suggestions of the central and state governments and the feasibility of providing such a linkage. While some state governments have supported the inclusion of these as a criterion for debt relief, other states are not in favour of linking debt relief to progress in human development or investment climate stating that the poor performance or the relatively low ranking of states in these fields are largely attributable to fiscal imbalance including unsustainable debt burden. Such a linkage would also widen the gap between the developing and backward states. Further, preparing an index of HDI and judging the performance of a state as on a particular cut-off date may render the assessment subjective. Similarly, defining what constitutes improvement in investment climate could also prove contentious. As far as the central government is concerned, their view is that it may not be appropriate to link debt relief to improvements in HDI.

12.38 The feasibility of linking debt relief to performance of states in the fields of human development and investment climate has been examined by us. We note that our TOR do not clarify whether such performance should be given a positive or negative weight in the scheme of relief. After a careful examination of the issues involved including the methodology and the outcome of the study assigned by us, we are unable to establish any direct link between debt relief and performance in the field of either human development or investment climate. Even the central government has not favoured such a linkage, suggesting that there is merit in adhering to pure financial and fiscal indicators in the matter of debt relief. Besides, given the diverse methodologies, incomplete coverage of states and infrequent availability of data, the linkage of performance in human development with debt relief would not be appropriate. The formulation of an index of investment climate suffers from even greater constraints, as it involves considerable subjective judgement based on perception with no accepted or standard methodology for formulating the index. We have, therefore, decided not to link debt relief with performance in human development or investment climate.

12.39 We have, in paras 12.20 to 12.22 referred to the manner in which previous commissions have sought to provide debt relief to states. In formulating our scheme of debt relief, we have taken into account the schemes recommended by the tenth and eleventh finance commissions. The debt-swap scheme of the central government has provided substantial relief to the states. Our focus, as far as fiscal reforms are concerned, is on the states achieving revenue balance by 2008-09. We have, therefore, followed a two-pronged approach to debt relief- firstly, a general scheme of debt relief applicable to all states and secondly, a write-off scheme linked to fiscal performance with a view to providing an incentive for the achievement of revenue balance by 2008-09. We have, however, excluded the loans given to the states from the NSSF from 1.4.99 onwards from the scope of the debt relief as the Fund is maintained in the public account.

12.40 As already noted, the debt-swap scheme of the government of India covers central loans which have an interest rate of 13 per cent and above and is expected to close by 2004-05. States have requested for alignment of interest rates on central loans with interest rates applicable to market borrowings. It is seen from the receipts budget 2004-05 that the weighted average cost of market borrowings of the centre during 2003-04 was 5.74 per cent. As per data collected from the Ministry of Finance, the weighted average cost of the total borrowings in 2003-04 works out to 6.04 per cent as indicated in Table 12.6. The interest rate charged from the states by the centre in 2003-04 was, however, 10.5 per cent. The marginal cost of borrowing by the centre is, therefore, much lower than the interest rate charged from states. Large interest payments have been a major factor leading to increase in the outstanding debt of state governments. In our view, therefore, the reduction of interest payments is integral to attaining debt sustainability. We requested the central and state governments to provide loan-wise details containing outstanding balances as on 31.3.04 and the quantum of repayments and the interest payments due from the central loans during our award period. Data provided reveal that a large number of loans for each state are being administered by Ministry of Finance and that consolidation of these loans would lend simplicity to the management of these loans. A consolidation exercise in respect of central loans to states outstanding as on 31.3.04, except the loans given by central ministries for which data were not available, has, therefore, been carried out by us.

12.41 For the purpose of consolidation of outstanding central loans to states as on

Table 12.6

Weighted Average Interest Rate of Central Government Borrowings in 2003-04

Net Borrowings	Amount	Interest Rate (percentage)
Market borrowings	86797	5.74
NSSF	13765	7
NSSF	32602	6
NSSF	13608	5.95
Provident Funds	5000	8
Others (tax-free)	4520	6.5
Others (taxable)	1588	8
Total	157880	
Weighted Average Interest Rate		6.04 %

31.3.04, we have relied on the statement of outstanding central loans supplied to us by the Ministry of Finance for the reason that, (a) the Ministry of Finance data have taken into account the debt-swap expected to take place by the end of 2004-05 and determines the repayments accordingly and (b) the data of central loans supplied by states in many cases include loans from NSSF. The balance of outstanding central loans to states, as on 31.3.04, consolidated by us works out to Rs. 184268 crore. These loans do not include loans given by ministries/departments for central plan/centrally sponsored schemes. The break-up of these outstanding loans is shown in Table 12.7.

Table 12.7

Break-up of Outstanding Central Loans to States as on 31.03.2004

Balance of loans on 31.3.04	(Rs. in crore)
Block Loans	146198
Mid Term Loans	2431
Small Savings Loans granted upto 31.3.99	30638
Pre-1979-80 Consolidated Loans (30 years)	475
Pre-1979-80 Re-Consolidated Loans (30 years)	1441
1979-84 Consolidated Loans (20 years)	27
1979-84 Consolidated Loans (25 years)	550
1979-84 Consolidated Loans (30 years)	1562
1984-89 Consolidated Loans (15 years)	942
Others	4
GRAND TOTAL	**184268**

12.42 A debt-swap of about Rs. 44000 crore has been indicated as expected to take place in 2004-05 in the data provided. The balance of these consolidated loans, which will remain as on 31.3.05 after taking into account normal repayments in 2004-05 and the expected debt-swap, is Rs. 128795 crore. The state-wise details of the repayments due on the loans mentioned in Table 12.7 above during our award period are in annexure

12.6. We observe that even after the debt-swap scheme closes, the effective interest rate on the outstanding loans would be around 11.5 per cent. In our view, a relief in interest payments is called for by way of adjustment of the difference between the marginal cost of borrowing of the central government and the effective interest rates charged by the centre on loans. Keeping in view the fact that some premium in the form of transaction costs should be available to the centre, we recommend that the central loans to states contracted till 31.3.04 and outstanding on 31.3.05 (amounting to Rs. 128795 crore) may be consolidated and rescheduled for a fresh term of 20 years (resulting in repayment in 20 equal installments), and an interest rate of 7.5 per cent be charged on them. The consolidated loans include some loans which had been consolidated by earlier commissions at interest rates lower than 7.5 per cent. We have, however, included them in the present exercise so that management of loans becomes simpler for the central government. States would get benefit in repayment on account of reschedulement of these loans. In terms of these recommendations relating to consolidation, reschedulement and lowering of interest rate, the debt relief during the award period for all states put together, works out to Rs. 21276 crore in interest payments and Rs. 11929 crore in repayments. Thus, the proposed scheme provides benefit both in terms of interest rate reduction and a reschedulement of loans which will ease the liquidity position of states. The state-wise details of debt relief are indicated in annexure 12.7. In the debt consolidation exercise, we have not taken into account the fresh loans to be granted by the centre in the year 2004-05, as state-wise details of such loans were not available. The central government has, however, lowered the rate of interest on loans to states from 10.5 per cent to 9 per cent in 2004-05. This general debt relief comprising consolidation, reschedulement and lowering of interest rate to 7.5 per cent shall be available to all states with effect from the year they enact the fiscal responsibility legislation as recommended by us at para 12.36.

12.43 In addition to providing general debt relief by consolidating and rescheduling at substantially reduced rates of interest the central loans granted to states before 31.3.04 and outstanding as on 31.3.05, we have devised a scheme of debt write-off based on fiscal performance. We have already stressed the need for each state to enact a fiscal responsibility legislation prescribing the fiscal adjustment path for reduction of the revenue deficit to zero by 2008-09. We have, in chapter 11 of our report, suggested discontinuation of the states' Fiscal Reform Facility on the ground that the present design of the facility is not conducive to achievement of its objectives. In our opinion, instead of a multiplicity of incentive schemes to reward fiscal performance, incentives for fiscal performance should be built into the debt write-off package. We feel that states will be provided a tangible incentive if a reduction of the revenue deficit also entitles them to a write-off of debt. A scheme of this nature would further the efforts at eliminating the revenue deficit of states. We, therefore, recommend the introduction of a debt write-off scheme linked to the reduction of revenue deficit of states. Under the scheme, the repayments due on central loans from 2005-06 to 2009-10 after consolidation and reschedulement as recommended in paras 12.40 to 12.42 will be eligible for write-off. The quantum of write-off of repayment will be linked to the absolute amount by which the revenue deficit is reduced in each successive year during our award period. In effect, if the revenue deficit is brought down to zero, the entire repayments during the period will be written-off. The scheme of write-off shall be available for all states from the year they have qualified for the general debt relief by enacting the fiscal responsibility legislation.

12.44 The manner in which the scheme will operate is outlined below:

(a) Fiscal performance will be measured with reference to the revenue deficit/ revenue surplus, as worked out in absolute numbers by taking an average of three years, viz., 2001-02 (Actuals), 2002-03 (Actuals), and 2003-04 (RE). This average will be taken as the base year figure for 2003-04.

(b) For states which were in revenue surplus, as per the base year figure (calculated in the manner indicated above), and continue to remain so in the subsequent years till the end of our award period, the installment of repayment due on the central loans (after consolidation and re-schedulement) may be written-off in each of the years from 2005-06 onwards so long as the revenue surplus of the states does not go below the base year level in absolute terms. In the year the revenue surplus is less than that in the base year figure, no write-off will be permitted.

(c) As for the states which were in revenue deficit as per the base year figure, the revenue deficit is expected to be eliminated by 2008-09, i.e. over a five year period. Fiscal performance will be measured by the absolute amount by which the revenue deficit is reduced in each year compared to the deficit in the previous year starting from the base year figure. For the purpose of determining the scale at which the relief will be provided, the ratio of the repayment due by a state during the period 2005-10 (of central loans after consolidation and re-schedulement) to the base year revenue deficit figure has been worked out. This determines the amount of write-off of repayment that will be allowed to each state for the reduction of each rupee of revenue deficit. Annexure 12.8 contains the ratios which will be applicable to the states for determining the quantum of write-off.

(d) The actual reduction in the revenue deficit in each year over the immediately preceding one would determine the amount of write-off for the state in the repayment due in the immediately succeeding year. This is calculated by multiplying the above mentioned ratio by the amount of reduction of the revenue deficit. The total amount of write-off in a year will, however, be restricted to the repayments due on the consolidated loans in that year. Further, the write-off will only be admissible if the state reduces the revenue deficit to a level lower than the base year figure.

(e) It may be noted that, other things remaining the same, a reduction of revenue deficit is inherent from 2005-06 onwards as a result of the debt relief due to the lowering of the interest rate recommended in para 12.42. Reduction in revenue deficit which is at least equal to the interest rate relief shall be treated as an eligibility requirement. Each state will, therefore, be required to achieve, in each year of our award period, a reduction in the revenue deficit, which, compared to the base year figure, is cumulatively higher than the cumulative reduction attributable to the interest relief recommended by us. Details of the year-wise relief in interest payments and the cumulative reduction in revenue deficit arising out of lowering of interest rate for each state during 2005-10 are at annexure 12.9.

(f) If the reduction in revenue deficit in a year is more than the minimum required for the write-off of the entire repayment due in that year, the excess will be carried forward fully to the next year, provided the revenue deficit continued to follow a downward trend in the next year and is lower than the base year figure. On the other hand, if there is an increase in the revenue deficit in the next year, but the revenue deficit is still lower than the base year figure, the entitlement to write-off shall be determined on the basis of improvement from the minimum revenue deficit figure of the previous year that would have given full relief in the previous year.

(g) To provide an illustration of our scheme, if state A has the base year revenue deficit figure of Rs 2000 crore and the repayments due from 2005-2010 are Rs 1000 crore (or say Rs 200 crore in each year), the ratio for determining the quantum of write-off will be 0.50 i.e. the state will be eligible for write-off of debt equal to 50 per cent of the amount of reduction in revenue deficit. If the state reduces its deficit by Rs 300 crore in 2004-05, compared to the base year level, it will qualify for a debt write-off of Rs 150 crore in 2005-06. If, however, the reduction in deficit is of the order of Rs 600 crore, although the state will be eligible for a write-off of Rs 300 crore, the debt write-off in that year will be restricted to the instalment of repayment due (i.e. Rs 200 crore) in the year, the remaining amount (i.e. Rs 100 crore) qualifying for write-off in the next year subject to the state maintaining or further reducing its revenue deficit in the next year. If on the other hand, in the year 2005-06, the revenue deficit increases by say Rs.100 crore from 2004-05 level, the net improvement over the base year level would only be Rs 500 crore. In that event, since an amount of Rs 400 crore has already been utilized for debt relief in the previous year, the state will qualify for a relief in repayment amounting to fifty per cent of the balance of Rs 100 crore i.e., a relief of Rs.50 crore only in 2006-07.

(h) If the performance of a state deteriorates in a year, with the revenue deficit registering a higher level over the previous year for which relief in repayment has been availed of, any improvement in the succeeding year will be measured, not with reference to that year, but the performance level in the previous year up to which relief has been availed of. If the revenue deficit reduction in that previous year was more than the minimum reduction required to qualify for 100 per cent write-off of repayment, the revenue deficit in that year may be re-determined notionally keeping in view the minimum revenue deficit reduction that would have qualified the state for 100 per cent relief in repayment. To illustrate in continuation of sub para (g) above, if the revenue deficit of state A goes up to Rs.1800 crore in 2005-06 after being reduced to Rs 1400 crore in 2004-05, it will not qualify for relief in repayment in 2006-07. Also, its performance in 2006-07 for relief in 2007-08 will be measured from the notional level of 2004-05. The notional level in this case would be Rs 2000 crore minus Rs.400 crore i.e. Rs 1600 crore. This would ensure that no state will be able to avail of relief more than once for the same level of improvement over the base. Nor would any state stand penalized for performing better than the minimum required level in any year.

(i) One criticism against the debt relief scheme of the Tenth and Eleventh Commissions has been the time lag involved in granting the benefit. We, therefore, recommend that for the purpose of determining the write-off, the revenue deficit indicated in the revised estimates of the preceding year may be used provisionally, so that the relief in respect of a year is available in the immediately succeeding year. Necessary adjustment may be carried out subsequently once the finance accounts become available.

(j) Looking at the necessity of containing the fiscal deficit, we further recommend that the benefit of write-off would be available only if the fiscal deficit of the state is contained to the level of 2004-05. If, in any year, the fiscal deficit exceeds this level, the benefit of write-off, even if eligible otherwise, would not be given.

12.45 In terms of our debt write-off package, if a state achieves through a consistent performance, a zero revenue deficit by 2008-09, it will have the facility of having all the repayments due from 2005-10 on central loans contracted upto 31.3.04 and consolidated by us written-off. The total amount which would be written-off if all states achieve revenue balance by 2008-09 is approximately Rs 32200 crore in a period of five years.

Future lending policy

12.46 In the context of the debt burden of states, the direction in which future lending policy of the centre should move was considered by us. While there might have been some justification for the centre to act as a banker to states when market rates of interest were high and in the process of on-lending to states, an indirect subsidy was granted to states by way of concessional interest, this is no longer valid in a low interest rates regime. In some ways, central lending to states, which is done at much higher rates of interest than the marginal cost of borrowing, results in a reverse subsidy from the states to the centre. In most federal countries, the federal government's loan intermediation role has been discontinued over the years, subjecting the states to market discipline. Such a dispensation allows the constituent units to borrow on terms that reflect their credit risk. While fiscally prudent states manage to borrow at rates lower than those offered by the federal government, the fiscally imprudent states would find their access to loan finance curtailed. We feel that it would be appropriate for states to take advantage of the market rates and avoid the spread charged by the centre. We, therefore, recommend that, in future, the central government should not act as an intermediary and allow the states to approach the market directly. If, however, some fiscally weak states are unable to raise funds from the market, the centre could resort to lending, but the interest rates should remain aligned to the marginal cost of borrowing for the centre.

External Assistance Loans

12.47 A large number of states have suggested that external loans should be passed on to states on the same terms and conditions as granted by the lending agency. External assistance to India is project based, except for structural adjustment assistance. The financing terms for externally aided projects and programmes vary according to projects and lending agencies. There are grants, soft loans and non-concessional loans, provided by lending agencies, depending upon the nature, the financial viability of the project and the revenue earning potential of a project. The external assistance received for states' projects is, however, passed on as 70 per cent loan and 30 per cent grant (10 per cent and 90 per cent respectively in case of special category states). Interest rates applied are those applicable to block loans.

12.48 While the external assistance from some sources and for some projects is highly concessional, in other cases it may be expensive. In the process of pooling and fixing a uniform interest rate in rupee terms, an element of cross-subsidization occurs at two levels : between centre and all states, and among the states. In the case of cross-subsidization between the centre and the states, the gain/loss to one side vis-à-vis another depends on the rate of depreciation of the Indian rupee against major foreign currencies. In the case of states, the cross-subsidization takes place, when states having a relatively larger share of grants and soft loans (which may offer relief to social welfare and long gestation, low return type of projects) in their assistance portfolio, are required to pay a higher rate of interest to help sustain the relatively larger share of high cost loans, which may often relate to commercial projects, used by some states.

12.49 We have examined the recommendations of the EFC in this regard and the policy enunciated in the medium term fiscal policy strategy statement of the government of India. Since the transfer of external assistance on back-to-back basis will enable states to participate on an equal footing in concessional external assistance, we recommend that external assistance be transferred to states on the same terms and conditions as attached to such assistance by external funding agencies, thereby making government of India a financial intermediary without any gain or loss. States would get the same maturity, moratorium and amortization schedule, as the government of India gets from the external lender. As per our information, no loan from the external agency is for less than 20 years, and as such the states would get the benefit of higher maturity (35 years in case of International Development Association (IDA) loans, 25 years in case of Asian Development Bank (ADB) loans and 20 years for International Bank for Reconstruction and Development (IBRD) loans). The states would also get a longer moratorium of 10 years in case of IDA credits. Although the states would gain on interest payments, they would be subject to the risk of foreign exchange fluctuations. We further feel that it would be easier to operate the external assistance outside the Consolidated Fund of India and it will result in faster disbursement of external assistance to the states. We, therefore, recommend that the external assistance pass through to states should be managed through a separate fund in the public account. The Fund could also be utilized for taking care of the foreign exchange risk.

Special Term Loans of Punjab

12.50 Special term loans amounting to Rs. 5799.92 crore were given to Punjab by the government of India during 1984-85 to 1988-89 for combating insurgency and militancy. The Ninth Finance Commission had granted a moratorium of two years (1990-92) on the repayment of principal and payment of interest in respect of these special term loans. The Tenth Finance Commission had recommended that one-third of the repayment of principal, amounting to Rs. 490.63 crore falling due during the period 1995-2000, be waived in view of the special circumstances prevailing when these loans were advanced, and also keeping in view the need for the state to reinvigorate its developmental efforts. The EFC recommended a moratorium on payment of installments of debt and interest during the period 2000-05 on the outstanding special term loans amounting to Rs. 3772 crore, stating that the expenditure incurred on security be worked out by Ministry of Home Affairs in consultation with the Punjab government and Ministry of Finance and relief of debt to the extent the state is entitled to reimbursement on account of security related expenditure be given after the period of moratorium is over and after taking into account waiver already given.

12.51 In its submissions to us, the state government has requested that the outstanding special term loan of Rs. 3772 crore as on 31st March, 2000 plus the interest thereon may be waived by the government of India. The state has cited article 355 of the Constitution, the assurance by the then Prime Minister of India and the poor financial condition of the state in support of its request. We understand that the quantum of the security related expenditure out of the special term loans and, the consequent debt relief to be given after the moratorium period (2000-05) has not yet been worked out. An account of the security related expenditure has now been submitted by the government of Punjab to the Ministry of Home Affairs. This is still to be examined by the Ministries of Home Affairs and Finance. Pending finalization of the amount in respect of which debt relief is to be allowed in terms of the recommendations of the EFC, we recommend that the moratorium on repayments and interest payments on these loans may continue for another two years i.e. upto 2006-07, by which time the central government must finalize the quantum of debt relief to be allowed.

Relief and Rehabilitation Loan for Gujarat Earthquake

12.52 Government of Gujarat had taken a loan of Rs. 5478 crore from ADB and World Bank through the central government for relief, rehabilitation and reconstruction work in the wake of the earthquake of 2001. This amount was passed on by the central government on the pattern of normal central assistance, namely 30 per cent grant and 70 per cent loan. The request of the government of Gujarat is that the entire amount may be treated as a grant.

12.53 In order to consider the request, we called for detailed information from the Ministry of Finance on this loan. We have been informed that the IDA credit was passed on to the state on the standard terms applicable to additional central assistance with 1 per cent reduction in interest rate on the undisbursed amount of the loan with effect from 27.05.2003. The disbursement under the project till September, 2004 was

US$ 200 million, while the outstanding loan amount is US$ 242.8 million. As per the amortization schedule, repayment by the central government starts from 15th October, 2012 i.e. no payment needs to be made during the award period of the Commission. The interest charges due from 31.3.04 to 15.4.2010 are US$ 6984432.39 and the commitment charges paid till now are US$ 1.779 million.

12.54 The government of Gujarat has informed us that the total estimated cost of earthquake rehabilitation and reconstruction was Rs. 8087 crore of which Rs. 2244 crore was to be received as grant and Rs. 5843 crore was to be raised as loan from all sources including external aid from World Bank and ADB. The government of India approved external aid of US$ 699.80 million (Rs. 3219 crore at an exchange rate of Rs. 46 per US dollar) from World Bank and US$ 350 million (Rs. 1610 crore at Rs. 46 per US$) from ADB. Out of this, the Gujarat government has received Rs. 2920.94 crore. These loans have been treated as loan for externally aided projects by government of India. Repayments to the extent of Rs. 621.03 crore and interest payment as Rs. 1158.67 crore are to be made to the central government during our award period.

12.55 We have examined the request of the Gujarat government keeping in view the terms on which the external agencies have extended the loans and those on which the loans have been passed on to Gujarat. While we are unable to recommend a write-off or a conversion of these loans into grants, we feel that considerable relief will be available to Gujarat, if the loan is passed on to the state on the same terms and conditions as agreed to between the government of India and the external agencies. We, therefore, recommend that if the government of Gujarat so desires, the central government may alter the terms and conditions of these loans so that these are available to Gujarat on a back-to-back basis.

12.56 Apart from Punjab and Gujarat, some of the other states have also suggested a write-off or waiver of specific loans. We have examined these demands but are unable to recommend further write-off over and above the debt relief package already recommended by us.

Setting up of Sinking Funds

12.57 Some of the states have recommended setting up of sinking funds for amortization of debt. We have recommended earlier that in future, the role of the central government as intermediary should be re-defined and the centre should not lend to states. Instead, states should be allowed to access the market directly. In this context, we have noted that the Ninth Finance Commission had observed that loans should be repaid out of amortization/ sinking funds. The Tenth Finance Commission had recommended the establishment of sinking funds as being desirable for overall fiscal discipline. The EFC had also emphasized the need for setting up of a sinking fund in each state for amortization of debt.

12.58 We further understand that a consolidated sinking fund has been set up in 1999-2000 by the Reserve Bank of India to meet redemption of market loans of states. So far, eleven states, viz. Andhra Pradesh, Arunachal Pradesh, Assam, Chhattisgarh, Goa, Maharashtra, Meghalaya, Mizoram, Tripura, Uttaranchal and West Bengal have set up sinking funds.

12.59 In the context of the debt-swap scheme, we have been informed that the old debts had a residual life of less than 20 to 25 years (block loans/small savings loans). The additional open market borrowings used for the purpose of swap are bullet payments, with maturity of ten years/twelve years for some tranches raised in 2003-04. This maturity structure requires the states to make less principal repayments in first ten years and would leave the states with higher cash. As per the Ministry of Finance, there would be bunching of payments in the period 2013-2015 when all the additional open market borrowings (expected to be over Rs. 45000 crore) would mature in a short span of three to five years. The states would experience lumps in their servicing profile. This necessitates the constitution of a fund for repayment of debt. This would improve the credit rating of states when they apply for loans. We, therefore, recommend that all states should set up sinking funds for amortization of all loans including loans from banks, liabilities on account of NSSF etc. The fund should be maintained outside the consolidated fund of the states and the public account and should not be used for any other purpose, except for redemption of loans.

Guarantee Redemption Fund

12.60 The outstanding guarantees of state governments have shown a rising trend during the 1990s. Although contingent liabilities do not directly form a part of the debt burden of the states, the states will be required to meet the debt service obligations in the event of default by the borrowing agency. The outstanding guarantees of state governments increased from Rs. 132029 crore (6.8 per cent of GDP) as at the end of March, 2000 to Rs. 168712 crore (8.1 per cent of GDP) as at the end of March, 2001. These are estimated to be lower at Rs. 166116 crore at the end of March, 2002 (7.2 per cent of GDP). In view of the fiscal implication of rising level of guarantees, many states have taken initiative to place a ceilings on guarantees. While statutory ceilings on guarantees have been imposed by Goa, Gujarat, Karnataka, Sikkim and West Bengal, some other states viz., Assam, Orissa and Rajasthan have imposed ceilings through administrative orders. It is also understood that Andhra Pradesh, Orissa, Haryana and Gujarat have set up guarantee redemption funds. We have recommended elsewhere that all states should impose a ceiling on guarantees through the mechanism of their fiscal responsibility legislation. In order to provide for sudden discharge of the states' obligations on guarantees, we further recommend that states should set up guarantee redemption funds through earmarked guarantee fees. This should be preceded by risk weighting of guarantees. The quantum of contribution to the fund should be decided accordingly.

Recommendations

12.61 To sum up, our recommendations are as follows:

(i) Each state must enact a fiscal responsibility legislation prescribing specific annual targets with a view to eliminating the revenue deficit by 2008-09 and reducing fiscal deficits based on a path for reduction of borrowings and guarantees. Enacting the fiscal responsibility legislation on the lines indicated in chapter 4 will be a necessary pre-condition for availing of debt relief.

(ii) Debt relief may not be linked with performance in human development or investment climate.

(iii) The central loans to states contracted till 31.3.04 and outstanding on 31.3.05 (amounting to Rs. 128795 crore) may be consolidated and rescheduled for a fresh term of 20 years (resulting in repayment in 20 equal installments), and an interest rate of 7.5 per cent be charged on them. This is, however, subject to the state enacting the fiscal responsibility legislation and will take effect prospectively from the year in which such legislation is enacted.

(iv) A debt write-off scheme linked to the reduction of revenue deficit of states may be introduced. Under the scheme, the repayments due from 2005-06 to 2009-10 on central loans contracted upto 31.3.04 and recommended to be consolidated will be eligible for write off. The quantum of write off of repayment will be linked to the absolute amount by which the revenue deficit is reduced in each successive year during our award period. In effect, if the revenue deficit is brought down to zero, the entire repayments during the period will be written-off. The enactment of the fiscal responsibility legislation would be a necessary pre-condition for availing the debt relief under this scheme also with the benefit accruing prospectively. Details of the scheme have been outlined in para 12.44.

(v) As regards the future lending policy, the central government should not act as an intermediary and allow the states to approach the market directly. If, however, some fiscally weak states are unable to raise funds from the market, the centre could borrow for the purpose of on-lending to such states, but the interest rates should remain aligned to the marginal cost of borrowing for the centre.

(vi) External assistance may be transferred to states on the same terms and conditions as attached to such assistance by external funding agencies, thereby making government of India a financial intermediary without any gain or loss. The external assistance pass through to states should be managed through a separate fund in the public account.

(vii) The moratorium on repayments and interest payments on the outstanding special term loan amounting to Rs. 3772 crore as on 31.3.2000 given to Punjab may continue for another two years i.e. upto 2006-07, by which time the central government must finalize the quantum of debt relief to be allowed in terms of the recommendations of the EFC.

(viii) In respect of relief and rehabilitation loans given to Gujarat from ADB and World Bank through the central government, if the government of Gujarat so desires, the central government may alter the terms and conditions of these loans so that these are available to Gujarat on the same terms on which the external agencies have extended these loans.

(ix) All states should set up sinking funds for amortization of all loans including loans from banks, liabilities on account of NSSF etc. The fund should be maintained outside the consolidated fund of the states and the public account and should not be used for any other purpose, except for redemption of loans.

(x) States should set up guarantee redemption funds through earmarked guarantee fees. This should be preceded by risk weighting of guarantees. The quantum of contribution to the fund should be decided accordingly.

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