Chapter 9

Revised Roadmap for Fiscal Consolidation

9.1 Para 8A of the Terms of Reference (ToR) requires the Commission to undertake the following task: 'Having regard to the need to bring the liabilities of the Central Government on account of oil, food and fertilizer bonds into the fiscal accounting and the impact of various other obligations of the Central Government on the deficit targets, the Commission may review the roadmap for fiscal adjustment and suggest a suitably revised roadmap with a view to maintaining the gains of fiscal consolidation through 2010 to 2015.' In addition, the Commission has also been asked, vide Para 5 of the ToR, to 'review the state of the finances of the Union and the States, keeping in view, in particular, the operation of the States' Debt Consolidation and Relief Facility (DCRF) 2005-10 introduced by the Central Government on the basis of the recommendations of the Twelfth Finance Commission and suggest measures for maintaining a stable and sustainable fiscal environment consistent with equitable growth.' This chapter addresses these ToR.

The Overall Macro-fiscal Position: Assessment and Targets

9.2 The fiscal roadmap for 2010-15 needs to take account of the combined macro-fiscal position of the Central and State Governments and to set macro-fiscal targets with reference to the overall position. The two key indicators in this context are the combined fiscal deficit and the combined debt to GDP ratio. The latter is not a simple aggregation of the outstanding liabilities of the Central and State Governments. Inter-governmental transactions such as loans to states from the Centre need to be netted out. Table 9.1 provides a picture of the combined liabilities and combined fiscal deficit of the Central and State Governments from 2004-05 to 2008-09 (BE). Combined liabilities[1] have fallen consistently from 91.7 per cent of Gross Domestic Product (GDP) in 2004-05 to 81.9 per cent by the budget estimates for 2008-09. The combined fiscal deficit also fell from 7.3 per cent in 2004-05 to 5.0 per cent in 2008-09 (BE). Subsequent to the budget for 2008-09, there was a global slowdown which continued in the year 2009-10.

Table 9.1: Aggregate Position of Centre and States

(*per cent of GDP*)

	2004-05	2005-06	2006-07	2007-08 (RE)	2008-09 (BE)
RD	3.6	2.6	1.2	0.6	0.4
FD	7.3	6.6	5.3	5.3	5.0
Debt	91.7	91.2	88.2	86.5	81.9

Source: Indian Public Finance Statistics 2008-09

9.3 The macro-fiscal correction prescribed by the Twelfth Finance Commission targeted the combined fiscal deficit of the Centre and states, in line with the assumed availability of household savings at 10 per cent of GDP and an acceptable level for the current account deficit at 1.5 per cent of GDP. After allowing for absorption by the private sector at 4 per cent of GDP and by non-departmental public sector enterprises at 1.5 per cent of GDP, this yielded a feasible, sustainable, combined fiscal deficit of 6 per cent of GDP. However, it should be noted that this fiscal deficit was the target for the last year of FC-XII projections (2009-10) and that the combined deficit figures projected for the years

[1] These liabilities include external debt at book value.

leading up to the final year were higher. A constant fiscal deficit of 6 per cent with nominal GDP growth rate of 12 per cent for the economy, as assumed in the FC-XII projection exercise, would stabilise debt in the long term at 56 per cent. However, the economy approaches such a long term resting point, asymptotically, only at infinity. After factoring in the fiscal deficit progression assumed for the projection period of FC-XII, to the final targeted fiscal deficit of 6 per cent of GDP, their targeted debt for 2009-10 worked out to 75 per cent of GDP.

9.4 Despite the commendable fiscal correction achieved by the Centre and states, as described in Chapter 4, the closing debt to GDP ratio for 2009-10 is estimated to reach 82 per cent, well above the FC-XII target of 75 per cent, owing largely to the adverse macroeconomic circumstances in 2008-09. Given the imperative of creating an environment favourable to private investment in the Indian economy, it is necessary that the ratio of consolidated liabilities to GDP be reduced, not merely below the level presently estimated for the close of 2009-10, but also that targeted by the previous Finance Commission.

9.5 In our view, it should be possible to reduce the combined debt of Centre and states to around 68 per cent of GDP by 2014-15. This target has been arrived at as the feasible and desirable correction, based on our projections of the medium term macroeconomic situation during the award period and our assessment of the resource position of the Centre and states over this horizon. Accordingly, the fiscal deficit targets prescribed for the Centre and states are such as to secure the targeted correction in the combined debt to GDP ratio to around 68 per cent. In the sections that follow, we obtain the individual components of the Centre and states within this overall target.

9.6 The Fiscal Responsibility and Budget Management Act (FRBMA), 2003 is, in essence, a target-based framework to ensure that government finances are managed with a view to achieving equitable, long term macroeconomic stability consistent with attainment of the medium term growth target of the Indian economy. It requires the government to maintain a medium term fiscal strategy that can be monitored over a multi-year period.

9.7 It is clear that in spite of improved performance in the first three years of the FC-XII award period, the Centre will not be able to achieve the FRBM targets by the end of 2009-10. Looking ahead, the government has not set a firm time limit for fiscal performance to be brought back on its FRBM envisaged path. This, then, becomes a central task for this Commission. In addition, the impact of the recent counter-recessionary measures on the fiscal stance indicate two important priorities for the present Commission: (i) to ensure that the fiscal sustainability of the Centre is protected and improved through measures to reduce the debt to GDP ratio, which rose as a consequence of not meeting the FRBM targets and (ii) to be mindful of the need for the FRBM Act targets to be adjusted when exogenous unanticipated shocks occur.

9.8 The Commission has considered the targets prescribed in the FRBMA and has taken into account the views of the Central Government and Reserve Bank of India (RBI) on the value and utility of these targets. Our discussions and a perusal of their memoranda reinforce our belief that a target-based framework needs to be maintained for the award period of this Commission.

9.9 The enactment of Fiscal Responsibility Legislation (FRL) in 26 states has resulted in significant fiscal correction. In aggregate, these states have reached their expenditure and debt targets ahead of schedule. Revenue buoyancy, both due to improved own tax revenues of the states and due to the derived benefit of high central tax buoyancies (through share in central taxes) has mainly been responsible for the fiscal correction. Another encouraging feature is that, in the aggregate, the states have been able to reduce their debt to Gross State Domestic Product (GSDP) ratio to less than 30 per cent. An equally, noteworthy outcome of the implementation of FRL has been the welcome exit of all general category and three special category states from a post devolution non-plan revenue deficit. However, there is wide variation in performance among the states. The Commission's objectives are, therefore, to maintain the virtuous improvements in state finances, to protect state finances against exogenous shocks to the extent feasible and to incentivise those states that continue to face fiscal stress towards undertaking urgent fiscal correction.

Stakeholders' Views on Existing FRBM Framework

9.10 The states, in their individual memoranda, have raised various issues regarding the roadmap for fiscal consolidation and debt relief. On the issue of elimination of revenue deficit, the states have agreed with the approach of FC-XII and accept that, as a prudent fiscal policy, borrowings should not be used for government consumption expenditure. They have suggested that this 'golden rule' should be made an integral part of the roadmap for 2010-15. On the issue of fiscal transparency the states have criticised the practice of off-budget borrowings. Some states have represented that this should not be used as an excuse for relaxation in the fiscal targets for the Centre. In their collective memorandum the states have pointed out that all grants to local bodies and to other aided institutions are classified as revenue expenditure. Hence, a mechanical application of the revenue deficit conditionality detracts from the efforts of State Governments to decentralise development expenditure.

9.11 On the subject of fiscal targets, the states have suggested that targets should not be mechanically set, but should depend on the states' capacity to service debt. Some states have suggested that the targets should allow them to take up their development spending. A few states have pointed out that the path to fiscal correction should allow countercyclicality and in years of high revenues, restrict excessive spending. They have also suggested the setting up of a National Fiscal Stabilisation Fund. It has further been represented that GSDP is not a very reliable denominator for fixing the targets and the roadmap. Instead, they suggest that targets be set for both interest payments and debt stock in terms of total revenue receipts.

9.12 With regard to debt relief, the states have asserted that interest rates on loans from the National Small Savings Fund (NSSF) are high and sought an intervention on this front. While some states have sought reduction of interest rates to 9.5 per cent on the pre-2003-04 loans, some have sought its inclusion in the Debt Consolidation and Relief Facility (DCRF) at an interest rate of 7.5 per cent. Some states have sought a reduction in the difference between the interest rates on open market loans and NSSF loans. It has also been suggested that the interest rate should not be more than 50 basis points higher than the average cost of funds. Some states have suggested that it should be linked to the Central Government Securities (G-Sec) rate to eliminate the anomalies in interest rates for all time. The joint memorandum of the states urges us to take into account the total loan burden of the states, including NSSF loans and loans of ministries other than Finance in recommending effective debt relief measures.

9.13 On debt management, states have protested that they are saddled with high cost debt. It has been pointed out that while states take 80 per cent of the high-cost NSSF loans, the Centre takes 80 per cent of the aggregate open market loans, which are low-cost. Some states have argued that the ratio of the shares of the Centre and states should be similar for all sources of borrowings. It has also been pointed out that the repayment obligation is expected to be higher than ever before during the award period of FC-XIII due to the loans taken for debt swap and increased market borrowings due to reduction in NSSF loans. It has been suggested that this should be taken into account while recommending debt relief schemes and drawing up the revised fiscal consolidation path.

9.14 On DCRF, some states have argued that the size of relief recommended was inadequate and have asked for inclusion of NSSF loans under the DCRF scheme. Some states have suggested that the benefit of the debt waiver was not concomitant with its extremely stringent conditionalities. We have received requests for continuation of the scheme during our award period.

9.15 The Central Government, in its memorandum, has stated that the Centre has been moving towards fiscal consolidation. It has argued that debt relief schemes tend to give perverse incentives to those who have contracted high debts in the past and thus, need to be carefully designed.

9.16 In its comments, the Reserve Bank of India has maintained that the design of the post-FRBM fiscal architecture should ensure long term sustainability, inter-generational equity and ability to stabilise the fluctuations in employment and output in the economy. Deficits and debt should be contained at tolerable levels so as not to hinder monetary policy objectives. RBI has noted that due to the economic slowdown, the FRBM rules have been relaxed for fiscal years 2008-09 and 2009-10. Therefore, post-FRBM fiscal architecture should exclude these two exceptional years and begin when normalcy returns. RBI is of the opinion that there is need to maintain a balanced revenue account with a ceiling on deficits and debt. Hence, there is need for a revenue deficit target along with a cap on the fiscal deficit. According to an exercise carried out by RBI, the absorption capacity of the economy for the combined market borrowings of the Centre and the states is in the range of 5 to 6 per cent of GDP during the period 2010-11 to 2014-15. Hence, the combined fiscal deficit of 5 to 6 per cent may be apportioned equally between the Centre and the states. RBI's opinion is that off-budget liabilities must be captured in the calculation of debt. However, in the case of NSSF, the part of the fund utilised by State Governments is to be excluded before setting up any debt targets for the Centre.

9.17 The Planning Commission, in its comments, has pointed out that the entire practice of meeting the subsidy requirements through off-budget borrowings and not taking it into account in the revenue and fiscal deficits is a clear violation of the definitions under the FRBM Act. One of the important points raised by the Planning Commission is that the recommendation of elimination of the revenue deficit should be reviewed in the light of the blurring line between revenue and capital spending of governments, at both the central as well as the state level. It has argued that capital expenditure involves a 'sacrifice' of present consumption by the present generation and thus, the future generations have an obligation to repay this sacrifice. The Commission further points out that the current framework provides a straitjacketed approach to the fiscal roadmap and does not prescribe any cyclically adjusted budget balance to build in counter cyclicality in government spending. It has also pointed out that the conformity of the current classification to the distinction between expenditure on revenue account and other expenditure referred to in the Constitution should be examined. With regard to the fiscal deficit, the Planning Commission has suggested that the approach should be to set a trajectory for the debt stock instead of fixing uniform targets for fiscal deficit. It has also suggested that one aspect of debt sustainability is liquidity of government, which can be assessed as a ratio of debt servicing requirement to the revenues of the government. Putting a cap on this ratio can be an additional measure in the direction of ensuring debt sustainability.

Central Government: Roadmap and Recommendations

Fiscal Targets

9.18 A long term and permanent target for the Central Government should be to maintain, at the minimum, a zero revenue deficit. In essence, this target is based on the 'golden rule' which is simply that, in the absence of economic emergencies no economic agent should borrow to finance current consumption. Borrowing should be undertaken for investment purposes only. In the context of the public sector, this requires the government not to use national savings to finance consumption. Thus, all items of consumption expenditure need to be financed from current receipts, a practice which is widely implemented in most countries that have successfully addressed the issue of fiscal responsibility.

9.19 While some allowances may be made for revenue deficits during recessionary phases, the medium-term fiscal framework must plan for all current expenditures to be financed entirely out of current revenues. This is an essential requirement for prudent long term fiscal policy. It is salutary to note the importance that has been attached to maintaining progress towards a zero revenue deficit in the speeches of all the Finance Ministers since the passing of the FRBM Act, even in a situation where a high growth rate and a comfortable balance of payments position afforded them room to manoeuvre and where, unlike in the 1990s, the deficit situation posed no immediate threat to fiscal solvency. Thus, we are of the view that there is a general consensus on maintenance of the golden rule and on setting the associated revenue deficit target at zero, with surpluses on the revenue account as a desirable goal.

9.20 We recognise that the revenue deficit is but an approximation for the current deficit in India. It includes spending that is not consumption and does not include spending of a consumption nature. We have, in a subsequent section, recommended an urgent review of this issue. However, we do not feel that this shortcoming is of such magnitude as to render the revenue deficit inadequate as a measure of borrowing for government consumption spending. The definition of consumption spending is fairly clear and is fully captured in the economic classification of government expenditure. While definitional refinements are certainly important and desirable, they do not present a barrier to setting revenue deficit targets.

9.21 We also feel that it is important to strictly follow the accepted definition of what items are treated as current (or recurrent) expenditures in the economic classification of public expenditures. It is necessary to make this point because we have, in the course of our consultations and perusal of international literature, noted that there is an argument that outputs 'constructed by the public sector providing longer-term benefits to society over time' should be treated as capital expenditures. For example, the National Rural Health Mission (NRHM) uses labour in the form of doctors and nurses and other factors such as hospitals and buildings, to produce health services. The outcome–improved health—yields returns in the future through higher productivity from a healthier workforce as well as through improvement on the human development front. It has been argued that public expenditure on teachers' or nurses' salaries be treated as capital expenditure, given that they yield all kinds of returns in the future.

9.22 It has been further argued that since development on account of health and education gets embodied in the beneficiaries once health standards improve or educational standards are stepped up, the expenditure incurred on these is more akin to investment and hence, it would be fair to treat it as capital expenditure. Moreover, in the absence of nurses, doctors and teachers, the capital expenditure incurred on hospital buildings or school buildings is of little use.

9.23 We have considered the above argument carefully. However, we are of the view that it is not valid for the following reasons.

i) The services provided by teachers and health workers are 'exhausted' or fully delivered when their job is done (teaching children/ treating patients). A teacher paid an annual salary to educate a class of children has provided his or her human resource inputs when the payment is made across the academic year. The same is true of medicines, etc.–they are fully consumed in the process of providing the service within the financial year in which they are purchased (less any positive changes in inventories, which are carried forward as additions to capital stock). The same is not true of hospital buildings and school buildings (less depreciation, which is treated as current expenditure).

ii) The services do not, on their own, create future human capital. This is created through a combination of capital inputs (like hospitals) to which we apply current inputs (like doctors and nurses) on a continuous and recurrent basis–which is why current expenditures are sometimes referred to as 'recurrent' expenditures. Thus, a doctor needs to be paid to treat patients on a periodic basis for the time that

that s/he devotes to such treatment. The same is not true of hospital buildings.

9.24 The existing classification of revenue and capital expenditure cannot be disturbed in an *ad hoc* manner. It has to be the result of a comprehensive study. Any disturbance of this classification has wide-ranging implications for the finances of both the Union and the states. In view of this, it is not possible to accept the suggestion mentioned earlier about reclassifying some portions of revenue expenditure as capital expenditure. It would, thus, be appropriate to continue with the existing classification of expenditure as 'revenue' or 'capital'.

9.25 There are also other related issues, such as classification of grants. At present all grants to other tiers of government are classified as revenue expenditures, irrespective of purpose. Even when a grant is provided for the explicit purpose of creating a capital asset, it is classified as revenue expenditure because the capital asset so created is owned by the grant recipient and not the grant provider. No provision presently exists to define a grant for creation of assets as a capital grant. This issue is taken up further in Chapter 13.

9.26 We now turn to the fiscal deficit target for 2014-15 and the roadmap for adjustment of the fiscal deficit across the award period. The terminal year fiscal deficit target needs to be consistent with reduction in the debt to GDP ratio to a desired level, concomitantly with maintenance of a desired level of capital expenditure across the award period. Hence, it is necessary to first specify the debt to GDP ratio desired in the terminal year

9.27 For the purpose of our analysis we have adjusted the outstanding debt figures of the Central Government for the year 2009-10. We have netted out certain liabilities that have been double counted, in particular the NSSF liabilities of State Governments. We have also adopted the Ministry of Finance revaluation of external debt at current exchange rates.

9.28 Since the National Small Savings Fund is maintained in the public account of the Central Government, the total amount invested by the Fund in special securities of the Central and State Governments is accounted under 'other liabilities' within the 'total outstanding liabilities' of the Central Government. However, the amount invested in State Government securities are loans to the states from the Fund, primarily financing the fiscal deficit of the State Governments. It is shown within the outstanding liabilities of the Central Government merely for accounting purposes, but should be treated as outstanding debt of the states alone. While arriving at the outstanding debt of the Central Government, this amount has been deducted from the reported debt stock. Finally, an adjustment has been made to account for external debt at the current exchange rate This is presently accounted at book value in 'outstanding debt' as reported in the Union Budget. The adjustments made to arrive at the outstanding debt at the end of 2009-10 are as shown in Table 9.2.

9.29 In line with the above adjustments, Central Government debt is projected at 54.2 per cent of

Table 9.2: Adjusted Debt Stock of Central Government

Component	As on 31 March 2010 (Rs. crore)
1. Outstanding Liabilities (Budget Documents 2009-10)	3495152
2. Investment in Special State Government Securities	463337
3. Outstanding Liabilities of GoI Net of Amounts Invested in State Securities [1-2]	3031815
4. Off-Budget Liabilities *Of which*	201236
(a) Securities Issued to Oil Companies	*157536*
(b) Securities Issued to FCI	*16200*
(c) Securities Issued to Fertiliser Companies	*27500*
5. Adjustment on Account of Valuation of External Debt on Current Exchange Rate	142441
6. Adjusted Debt [3+5]	3174256
(*as per cent of GDP*)	(*54.2%*)

GDP at the conclusion of 2009-10. Taking into account the expected reduction in fuel and fertiliser prices, along with the expected return to the trend growth rate of over 13 per cent from 2011-12, in conjunction with other reforms including reduction of subsidies along a prescribed path, we project a feasible level for outstanding liabilities of the Centre at 45 per cent of GDP by 2014-15, while at the same time maintaining adequate resources for public investment.

9.30 The first step in constructing the fiscal correction trajectory was to prescribe the revenue deficit path, starting with the projections of revenue receipts and expenditures of the Centre provided to us by the Ministry of Finance for 2010-15 and applying normative corrections for some elements of revenue expenditure, such as explicit subsidies (refer to Chapter 6).

9.31 The Commission recognises that making progress towards the golden rule of zero revenue deficit during the award period has to take account of the sharp increase in the revenue deficit to GDP ratio expected in 2009-10. Our analysis led us to conclude that it would be unrealistic to expect that the revenue deficit to GDP ratio would be zero across all years of the award period. Accordingly, based on our normative assessment of central revenues and expenditure, the ratio is projected to decline from 4.8 per cent of GDP as budgeted for 2009-10, to a revenue surplus of 0.5 per cent of GDP by 2014-15. These projections imply, on average, a revenue deficit to GDP ratio of 1.25 per cent across the award period. Details of the underlying GDP growth rates, other parameters and adjustments are in annexes 6.1 and 6.3.

9.32 In the initial years of our projection horizon, when the revenue deficit is expected to be high, the target for capital expenditure is held at the same percentage of GDP as budgeted in 2009-10. As per the budget estimates for 2009-10, the fiscal deficit of 6.8 per cent, in conjunction with the budgeted revenue deficit of 4.8 per cent and non-debt capital receipts at 0.1 per cent of GDP, yields a capital expenditure of 2.1 per cent of GDP. As indicated in Para 6.47, non-debt capital receipts have been projected to increase from 0.5 per cent of GDP in 2010-11 to 1 per cent in 2014-15. Capital expenditure has been increased to 3 per cent of GDP in the first and 3.1 per cent in the second year of the projection horizon. In view of the projected reduction in revenue deficit, the permissible capital expenditure has been allowed to increase to 3.8 per cent, 3.9 per cent and 4.5 per cent in the third, fourth and fifth year, respectively of our award period (see Table 9.3). Higher capital expenditure than that projected by us will be possible in all the years of the projection period if there are increased receipts from disinvestment.

9.33 Currently, with regard to government guarantees, the FRBM rules prescribe a ceiling of 0.5 per cent of GDP for the annual flow, rather than for the stock. We recommend that this be converted to a ceiling of 5 per cent of GDP for the stock of outstanding guarantees at the end of every year. In 2007-08 government guarantees amounted to 2.2 per cent of GDP, which was within the above limit. We elaborate on the guarantees covered by this rule in a later section.

Reforms to FRBM Legislation

9.34 The Commission undertook extensive consultations on the content of FRBM legislation

Table 9.3: Fiscal Consolidation Path for the Centre

(*per cent of GDP*)

	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Revenue Deficit	4.8	3.2	2.3	1.2	0.0	-0.5
Non-Debt Capital Receipts	0.1	0.5	0.6	0.8	0.9	1.0
Capital Expenditure	2.1	3.0	3.1	3.8	3.9	4.5
Fiscal Deficit	6.8	5.7	4.8	4.2	3.0	3.0
Outstanding Debt (Adjusted)	54.2	53.9	52.5	50.5	47.5	44.8

and the issues raised during its implementation over the last five years. Based on these consultations, the issues raised can be grouped into three categories:

i) Making the FRBM process more transparent and comprehensive.

ii) Ensuring that the FRBM process takes account of changes in the values of parameters exogenous to government action and is sensitive to exogenous shocks.

iii) Improving monitoring and compliance.

9.35 Before detailing the recommendations it is important to recognise that the implementation of Fiscal Responsibility Legislation cannot be fully effective when the time frame for policy making is largely annual in nature. For the FRBM legislation to work more effectively, with the flexibility required to adapt to exogenous shocks and changes in parameter values (like oil prices), what is required is an annually adjusted, medium term fiscal framework, that sets medium term targets consistent with achievement of FRBM and provides evidence-based rationale for deviations in actual out-turns from these medium term targets.

9.36 We think that the budgeting process in India needs significant reform to enhance the medium term dimensions to fiscal policy design and that far more attention needs to be devoted to this issue than has historically been the case. A beginning has, indeed, been made by the annual presentation of a medium term fiscal policy statement. However, this document is less than adequate to assess the fiscal impact of major policy decisions of the government and has a tenuous link with the annual budget which continues to be the major policy document guiding the design of the Central Government's public finances.

9.37 The transition from an annual statement of revenue and spending (such as that embodied in the annual budget) to a rolling medium term fiscal framework (of which the annual budget is but one part) has been an important reform in countries where target-based fiscal policy has proved to be effective and durable. Conversely, target-based fiscal policy has been gestural in countries where such a transition has not been made. This is because the benefits of fiscal consolidation are more likely to accrue when policy decisions are made with a view to medium term impact and where the medium term horizon allows governments to be flexible when exogenous or unanticipated events occur.

9.38 Thus, it is recommended that the Central Government revises the existing medium term fiscal policy statement with a more detailed Medium Term Fiscal Plan (MTFP) which contains three-year-forward estimates of revenues and expenditures, with detailed breakup of major items that form a part of the revenue and expenditure, together with a narrative explanation of how these estimates have been generated. In other words, the estimates of revenues and expenditures should be arrived at as the sum of their parts and should be in conformity with the broad roadmap for fiscal parameters set out under the Act. Thereafter, the government could increase the time horizon of the MTFP by one year in each subsequent year and provide fresh estimates for the other years. The estimates of the first year would be converted into budget estimates, along with a narrative explanation of such revisions. In effect, this would mean that the Central Government would provide a fiscal roadmap for three years into the future. This would ensure tighter integration of the MTFP into the budget and make the MTFP more a statement of commitment rather than merely one of intent. These changes, when implemented, will also facilitate our more effective participation in the G-20 Forum's mutual assessment mechanism.

9.39 We are of the view that this is the most significant reform that India needs to make in the context of effective design and implementation of fiscal responsibility legislation. Such legislation can be effective and its credibility enhanced when there is a medium term plan that is used by the government as an operational policy document. In the following paragraphs we recommend a number of steps that will need to be taken for progress in this direction. We have tried to ensure that these recommendations can be implemented within the existing Constitutional framework and only require incremental changes that build on the existing institutional processes and procedures.

Making the FRBM Process More Transparent and Comprehensive

9.40 The economic and functional classification of the budget is an important tool–this is what makes a budget or a MTFP an instrument of policy as distinct from an instrument of accounting and legislative compliance, which is the principal function of a line item budget. This is currently produced with a considerable time lag. We recommend that the government prepare to present a detailed economic and functional classification of the expenditure budget as part of the MTFP. The budget preparation process should be modified to enable this, so that expenditure proposals are concurrently presented in line item format as well as in the economic and functional format. This will enhance the operational value of the budgetary process and enable progress in assessing the quality of public expenditure by relating fiscal proposals to their economic and developmental impact. We recommend that this process commence from the 2011-12 fiscal year with respect to the economic classification, as the information necessary for this purpose is already being collected in the budget exercise, with the full economic and functional classification to be presented as soon as practicable.

9.41 We have noted that there is considerable difficulty in identifying the volume and incidence of central transfers to states. We recommend that all central transfers to states be set out in an independent statement including, in the case of central transfers under budget head 3601, a detailed breakup into the constituent flows, such as Finance Commission grants (separate components), other non-plan grants, normal central assistance, additional central assistance and special central assistance. The Ministry of Finance should produce this statement with retrospective effect once the format is available, in order to enable inter-temporal analysis that would facilitate the work of future Finance Commissions.

9.42 The Central Government has commenced reporting tax expenditures in a separate statement from the 2006-07 Budget, which is a laudable and useful initiative. We recommend that this be systematised in all future budgets and the basis for calculation of these expenditures be made explicit.

9.43 We recommend that the Central Government should initiate measures to report the compliance costs of major tax proposals in the MTFP. We recognise that this move would require sufficient preparatory action and hence, recommend that this should be done from the 2013-14 Budget.

9.44 In its memorandum to the Commission, the Ministry of Finance has pointed out: '... a plan expenditure proposal without reference to the ability of the state/project to finance its maintenance by user charges or by a specific future charge on the revenues of the state is essentially faulty design/planning process. There is a need to correct these upfront and to limit the provision of maintenance grants by the Commission, to the real unmet needs.' This is an important proposition requiring fiscal reform and recognises that there is a mismatch between capital expenditure programmes and maintenance allocations for such programmes. The consequence has been that Finance Commissions have sought to redress this imbalance through provision of maintenance grants.

9.45 We recommend that all capital expenditure proposals for inclusion in the Government of India Budget are accompanied by a statement of the Revenue Consequences of Capital Expenditure (RCCE) for the lifetime of the proposed projects. RCCE statements should be annually modified to take into account price and other changes. The RCCE statements should be used to calculate revenue expenditure requirements in the years covered by the MTFP such that revenue expenditure projections are consistent with the RCCE statements. This activity will need to be coordinated with the Planning Commission, which will also need to institute a process of producing RCCE statements for plan expenditure proposals, in the preparation of Annual Plans and for the Twelfth Five Year Plan. RCCE statements should begin to be provided from the 2013-14 Budget for all projects requiring Public Investment Board (PIB) approval.

9.46 Government policies are, by nature, forward looking. Many important development initiatives such as the National Rural Employment Guarantee Scheme (NREGS) and measures to implement the Right of Children to Free and Compulsry Education (RTE) Act have expenditure consequences for future years. Hence, we recommend that new policy initiatives that are known to involve future expenditure commitments should be reflected in the MTFP. In addition, the MTFP should also provide the projections for transfers to states, either in the form of plan assistance or under Centrally Sponsored Schemes (CSS). This, too, should be done from the 2013-14 Budget.

9.47 It is important that contingent liabilities be reported fully and that adequate provisioning be made for such liabilities. We have recommended modification of the fiscal rule that limits government guarantees. The public sector as a whole is vastly enhancing its use of the Public Private Partnership (PPP) mode for project financing. This frees valuable fiscal space for the provision of public goods in areas where such finance is unlikely to be forthcoming.

9.48 We welcome this trend of private participation in the public sector. We also recognise that PPPs create explicit and implicit obligations on the part of the public entity that is party to them so that, in the final instance, they become contingent liabilities of the Government of India. The fiscal fallout of such partnerships could reflect on the health of the aggregate balance sheet of the public sector and may create demands for enhanced budgetary support to the public sector entities contracting such liabilities. Explicit contingent liabilities, which may be in the form of stipulated annuity payments over a multi-year horizon, should be spelt out. Implicit contingent liabilities in this context are obligations to compensate the private sector partners for contingencies such as changes in specifications, breach of obligations and/or early contract termination for *force majeure*. These are relatively difficult to quantify. We think that the FRBM Act should stipulate these contingent liabilities.

9.49 We, therefore, recommend that the documentation associated with each PPP should contain a short report that comprehensively details and quantifies the financial obligations of the public sector in the PPP arrangement. These should be collated for all central undertakings. The collation should form the basis of a statement in the MTFP, detailing the aggregate obligations of the Government of India and the risks involved. Simultaneously, GoI should initiate a review of the provisions regarding termination payments in existing PPP projects and report these in the MTFP prepared from the fiscal year 2011-12 onwards.

9.50 In a market economy, the government maintains a portfolio of physical and financial capital assets in order to secure its geopolitical and strategic priorities, provide national and global public goods and address market failures that impact affordable access to merit goods for the poor and disadvantaged sections of society. Historically, India's strategic priorities have included diversification of the production base, fostering of infant industries and provision of key infrastructure assets and commodities that the domestic private sector was not able to provide due to various reasons during the early stages of national economic development. With economic liberalisation, rapid economic growth, diversification of the production base, growth of captial markets and creation of the knowledge economy, there has been a transformation of the potential and capacity of the Indian private sector to deliver goods and services in a broad range of areas. Infant industries have become global players. At the same time, new strategic imperatives like environmental sustainability, human development, rapid urbanisation and expansion of a knowledge society to capitalise on the demographic dividend have emerged, as discussed in Chapter 3. A reordering of the government's public investment priorities is, therefore, both necessary and desirable.

9.51 To this end, disinvestment and privatisation serve as avenues for the government to increase fiscal space to meet these emerging strategic challenges. Disinvestment allows the government space to rebalance its public investment portfolio to meet new challenges, while at the same time maintaining fiscal prudence. It enables the Government of India to meet its overriding fiscal priority–to reduce the debt to GDP ratio to levels consistent with long term debt sustainability–and simultaneously increase the volume of public investment in key strategic areas.

9.52 Disinvestment increases non-debt capital receipts and so, *ceteris paribus,* allows the government to increase its capital expenditure without impacting the fiscal deficit. We recommend that transfer of disinvestment receipts to the public account, as has been the practice in the past, be discontinued and that all disinvestment receipts be maintained in the consolidated fund. This will enable the use of these funds to be decided as part of the medium term fiscal planning exercise. In addition, we recommend that to improve the quality and transparency of disinvestment, the government should list all public sector enterprises that yield a lower rate of return on assets than a norm to be decided by an expert committee set up for the purpose. This disclosure should be made annually and placed before Parliament along with the budget documentation.

9.53 We further recommend that the Government of India direct all its administrative departments as well as departmental and non-departmental undertakings to prepare an inventory of vacant land and buildings valued at market prices. When this is ready, a consolidated list should be prepared in a statement, also to be placed before Parliament along with budget documentation. Such an exercise will contribute to better protection of these public assets against the threat of encroachment. It would also enable effective utilisation of land for projects and minimise the need for fresh land acquisitions.

9.54 We recognise that the actions recommended in paras 9.52 and 9.53 will require considerable preparation and therefore, recommend that the above disclosures commence from fiscal year 2013-14 onwards.

Sensitivity to Shocks and Countercyclical Changes

9.55 The path of fiscal correction laid down in the FRBM Act has been halted since 2008-09 on account of unanticipated changes in the prices of key commodities, especially fuel and fertiliser and thereafter in 2009-10, in view of the impact of the global economic recession on the Indian economy. The subsidy bill shot up from Rs. 70,926 crore in 2007-08 to Rs. 1,29,243 crore in 2008-09 (RE), an increase of 82.2 per cent.

9.56 Gross tax receipts of the Centre grew by 25.3 per cent in 2007-08 over the 2006-07 level. This rate of increase came down to 5.9 per cent in 2008-09 (RE) over the 2007-08 level. The expected growth in 2009-10 (BE) over the 2008-09 levels is only 2.1 per cent. While the fall in direct taxes was mainly due to shrinking economic activity, the fall in excise and customs receipts was primarily due to counter-recessionary concessions given to boost economic activity. As per the Statement of Revenue Foregone by the government, the revenue loss from tax concessions aggregated to 58.0 per cent in 2007-08 and 76.3 per cent of gross tax collections in 2008-09. The basis of assessment of the tax foregone, however, is not clearly spelt out.

9.57 On the expenditure side the major increase was on subsidies and plan expenditure. The total amount of bonds issued to petroleum companies in these two years amounted to Rs. 96,496 crore while that for fertiliser companies amounted to Rs. 27,500 crore.

9.58 Increased plan expenditure, especially on schemes like NREGS and expenditure on recession hit sectors, led to a spurt in expenditure since the second half of fiscal year 2008-09. As a result, plan expenditure grew by 38 per cent in 2008-09 over the 2007-08 level. The corresponding increase in 2007-08 over 2006-07 was 20.7 per cent and is expected to be 14.9 per cent for 2009-10 over the 2008-09 level. Over and above this, the government also announced a scheme of agricultural debt waiver and debt relief with the total value of overdue loans being waived estimated at Rs. 50,000 crore. The amounts budgeted for this purpose in 2008-09 and

2009-10 are Rs. 10,000 crore and Rs. 15,000 crore respectively.

9.59 The fiscal correction path of the economy was thus reversed. The revenue deficit increased from 1.11 per cent of GDP in 2007-08, to 4.53 per cent in 2008-09 (RE). In 2009-10 (BE) it is estimated to be even higher at 4.83 per cent. The fiscal deficit also shot up from 2.69 per cent in 2007-08 to 6.14 per cent in 2008-09 (RE) and is projected at 6.85 per cent in 2009-10 (BE).

9.60 An important lesson from the implementation of the FRBMA during 2005-10 is, therefore, the need to allow the fiscal system to adapt to exogenous shocks and/or changes in exogenous parameter values. This is a core objective of the stabilisation function of public finance which no roadmap can afford to ignore. We, therefore, recommend three changes in the design of the existing fiscal responsibility legislation to address this challenge.

9.61 First, we recommend that the MTFP make explicit the values of the parameters underlying expenditure and revenue projections and the band within which these parameters can vary while remaining consistent with FRBMA targets. This will enable the government to make an evidence-based case for relaxation of these targets, should such circumstances arise. Recent history indicates that some of the important parameters that are likely to impact the path of FRBM achievement are the prices of key commodities (like oil), the exchange rate and the interest rate.

9.62 Second, we recommend that the FRBMA specify the nature of shocks that would require a relaxation of FRBM targets. These would include agro-climatic events of a national (rather than regional or state-specific) dimension, global recessions impacting the country's exports and shocks caused by domestic or external events like asset price bubbles or systemic crises in important sectors like the financial markets. It is clear that these shocks would affect some targets more than others. Thus, shocks requiring a boost to aggregate demand, or sharp increases in global oil prices would require a temporary relaxation of the revenue deficit target. Shocks addressed through expanding public investment would impact the debt-to-GDP ratio and, therefore, the fiscal deficit target.

9.63 Finally, macroeconomic stabilisation and counter-recessionary actions are the primary responsibility of the Central Government. It is true that the implementation of counter-recessionary measures has, to some extent, been customised, requiring measures which the State Governments are best placed to implement. However, the associated fiscal costs should be borne nationally and hence, be financed by the Centre. This is because the desired outcomes–macroeconomic stability and maintenance of the highest possible growth rate–are targets that need to be secured nationally. Hence, we recommend that rather than raising the borrowing limits for states when such shocks occur, the Central Government should assume the entire additional resource mobilisation responsibility and pass on the resources so mobilised to the states in the form of increased devolution. The *inter se* distribution of these resources should be determined in accordance with the horizontal devolution formula recommended by the Finance Commission. This formula would serve as the most pertinent estimate of the differential requirements of the states, having been designed specifically with reference to fiscal capacity and fiscal need. Such a policy would also maintain the integrity and improve the expenditure predictability of the state budgets as well as the medium term fiscal plans, with only the Centre needing to initiate 'pauses' or seek postponements in achievement of its FRBM targets.

9.64 Other than exogenous shocks and parametric changes, there are also policy processes which create macroeconomic shocks and distortions, but are within the control of the Central Government. Pay Commission recommendations are an important example of this. In our discussions with State Governments a significant portion of the memoranda presented and the discussions on the future fiscal roadmap centred around the impact of this award on state finances. For the Centre, arrears alone amounted to Rs. 28,160 crore on a salary base of Rs. 44,360 crore. While many reforms can and should be, contemplated to end this self-inflicted distortion, one action that could be taken immediately is that of making the pay award commence from the date on which the recommendations of future Pay Commissions are accepted by the government. In effect, this would do away with the need for arrears. Since State Governments' awards typically follow those of the Central Government, this would allow states to time their awards such that the need for arrears does not arise. In our view, if Finance Commissions are able to present their inter-governmental recommendations without any need for retrospective fiscal transactions, then the same should be possible in the case of Pay Commissions as well.

Monitoring and Compliance

9.65 Previous Finance Commissions have sought to incentivise State Governments to undertake fiscal reforms by providing conditionality-linked incentives such as debt relief. These incentives have been remarkably successful in delivering improved fiscal health in state finances. However, many state FRBM legislations also provided for an independent review of implementation of the respective FRBMAs. These reviews were critical in improving the credibility and transparency of actions taken by the State Governments for implementation of fiscal responsibility legislation. In our opinion, they have been a major contributor to the success of fiscal reform initiatives at the state level. We recommend that the Centre institute a similar process of independent review and monitoring of the implementation of its own FRBM process. This could initially be done by setting up a committee to conduct an annual independent and public review of FRBM compliance, including a review of the fiscal impact of policy decisions on the FRBM roadmap. This review should present its findings concurrently with the annual budget and the medium term strategy.

9.66 It is to be hoped that this Committee would, over time, evolve into a full-fledged Fiscal Council. We are of the view that given India's legislative and executive structure, the Council should act as an autonomous body reporting to the Ministry of Finance, which should report to Parliament on matters dealt with by the Council in accordance with current Constitutional provisions. As the size and complexity of the Indian economy expands, it is imperative that such an institution be developed to assist the government in addressing its fiscal tasks in a professional, transparent and effective manner. Fiscal Council like institutional arrangments exist in many countries such as Brazil, Japan, Korea, Mexico, Sweden and these have been found to add considerable value to the integrity and effectiveness of medium term fiscal policy and design.

State Finances: Roadmap and Recommendations

9.67 In Para 9.5 we specified the medium term combined debt to GDP ratio target for 2014-15 at 68 per cent. With the target Central Government debt at 45 per cent of GDP in 2014-15, this implies a target debt to GDP ratio of 25 per cent for all states in the same year (the state and central ratios do not add up to the combined ratio because central loans to the states have to be netted out).

9.68 This is a feasible target from the perspective of the states. In the 2005-09 period, the states have undertaken considerable fiscal correction and their aggregate debt to GDP ratio is not expected to be higher than 30 per cent in 2009-10. Given that the ratio was 27 per cent in 2008-09, we consider any increase from this ratio to be temporary, in the sense that it reflects the allowance for debt financed counter-recessionary expenditures by State Governments. Recognising the need for such expenditures, the Government of India has relaxed the borrowing limits for the states to 3.5 per cent and 4 per cent of GSDP for all the states for the years 2008-09 and 2009-10 respectively, as opposed to the 3 per cent target set out in the roadmap of the Government of India for states, following the action taken on the recommendation of FC-XII.

9.69 It should, therefore, be feasible to undertake a small reduction in the aggregate debt to GDP ratio of the states from about 27 per cent of GDP in 2007-08 to 25 per cent by 2014-15, especially if, as we recommend above, the Central Government assumes responsibility for all borrowings due to unanticipated shocks and/or parameter changes of a global or national dimension. However, the adjustment path will have to allow for temporary increases in revenue and fiscal deficits in 2008-09 and 2009-10, given the need for counter-recessionary expenditure.

9.70 A long term and permanent target for the states should be to maintain a zero revenue deficit. The arguments advanced in favour of the application of the 'golden rule' to the Centre also apply in the case of the states. It is encouraging that most states in the Union are already following this rule. In essence, all that the future fiscal roadmap requires is that they continue to do so and the few states that have not yet reduced revenue deficits to zero, endeavour to do so, by 2014-15.

9.71 We recognise that the exceptional circumstances of 2009-10 may increase the fiscal pressure on all states. We are unable to provide a quantified assessment of the extent to which this is likely to be the case in individual states in 2009-10 on account of data lags. However, given our growth assumptions, we are of the view that all states that incurred zero revenue deficit or achieved a revenue surplus in 2007-08 should be able to undertake fiscal corrections to return to a zero revenue deficit by 2011-12. Thus, we recommend that the zero revenue deficit target be attained by all such states from 2011-12 onwards.

General Category States

9.72 Three of the general category states incurred a revenue deficit in 2007-08. For these we recommend an adjustment path commencing 2011-12, to eliminate the revenue deficit by 2014-15. This is shown in Table 9.4

Table 9.4: RD Path for General Category States with RD in 2007-08

(*per cent of GSDP*)

	State	2007-08	2011-12	2012-13	2013-14	2014-15
1	Kerala	2.3	1.4	0.9	0.5	0.0
2	Punjab	2.9	1.8	1.2	0.6	0.0
3	West Bengal	2.7	1.6	1.1	0.5	0.0

9.73 In order to attain a target aggregate debt-to-GDP ratio of 25 per cent, it will be necessary that the aggregate fiscal deficit/GDP ratio of the states be maintained at 3 per cent of GDP. This is an aggregate indicator and does not take into account the individual circumstances of states. For the purpose of striking a balance between the virtues of customisation and the need to adopt the same procedure for determining targets for all states in similar circumstances, we recommend the differentiated adjustment paths detailed in the subsequent paras.

9.74 All states having a revenue surplus in 2007-08 had fiscal deficits of less than 3 per cent of GSDP, except Uttar Pradesh, which had a fiscal deficit of 3.9 per cent. A state should have adequate room for capital expenditure by using its revenue surplus and a deficit not exceeding 3 per cent of GSDP. Any state that has a revenue surplus along with a higher fiscal deficit should compress its capital expenditure, or alternately, increase its surplus on the revenue account. We, therefore, expect that Uttar Pradesh too will be able to come back to the 3 per cent level of fiscal deficit by 2011-12.

9.75 We recommend that in the case of all states that attained a zero revenue deficit or a revenue surplus in 2007-08, a fiscal deficit of 3 per cent of GSDP be achieved by 2011-12 and maintained thereafter. We expect that the maximum fiscal deficit that these states would incur in 2009-10 is 4 per cent of GSDP, which corresponds to the maximum allowable net borrowing ceiling for that year. The reform path sets targets from the year 2011-12 onwards. The methodology to be adopted for 2010-11 is given in Para 9.86.

9.76 In the case of states having revenue deficit in 2007-08, we recognise that the process of adjustment in the revenue deficit would have a concomitant virtuous impact on the fiscal deficit. Since we have recommended an achievable correction path for revenue deficit, an abrupt reduction in fiscal deficit would lead to compression of capital expenditure, which is not desirable. Thus, it is required that a fiscal deficit higher than 3 per cent is allowed till the revenue deficit comes down to a certain level, so as to prevent any undesirable compression of capital expenditure. We have noted in these states' memoranda their willingness to attempt a fiscal correction exercise that would allow them to maintain and even increase their fiscal space for capital expenditure. Thus, in the case of these states, the fiscal adjustment path requires them to have capital expenditure less than the states that have already carried out fiscal correction, but with a slightly relaxed fiscal deficit target in the years 2011-12 and 2012-13, so that capital expenditure is not compressed to undesirable levels. Moreover, additional reduction in the revenue deficit will allow these states greater fiscal space on the capital account. The fiscal adjustment path is indicated in Table 9.5.

Table 9.5: FD Path for General Category States with RD in 2007-08

(*per cent of GSDP*)

	State	2007-08	2011-12	2012-13	2013-14	2014-15
1	Kerala	3.6	3.5	3.5	3.0	3.0
2	Punjab	3.5	3.5	3.5	3.0	3.0
3	West Bengal	3.8	3.5	3.5	3.0	3.0

Special Category States

9.77 Unlike in general category states where the fiscal adjustment path has been fixed on the basis of 2007-08, in the case of special category states the deficit parameters are highly volatile and, thus, the fiscal adjustment path cannot be fixed depending only on 2007-08 levels. For this purpose we have taken the average of three years, viz. 2005-06, 2006-07 and 2007-08 to determine the base fiscal parameters on which the future adjustment path can be decided.

9.78 While the revenue deficit is the primary driver of the fiscal deficit amongst the general category states, this is not the case with special category states. All the special category states have had an average revenue surplus over the 2005-08 period, while six states have an average fiscal deficit higher than 3 per cent of GSDP over the same period. The reason is that these states are highly dependent on central grants and although all grants from the Central Government are classified as revenue receipts, capital expenditure incurred out of these grants is not accounted in the revenue deficit. Thus, for special category states, the revenue balance is not of much significance for purposes of fiscal adjustment.

9.79 Depending upon the base figure for the fiscal deficit, special category states can be divided into three groups. Four states viz Manipur, Nagaland, Sikkim and Uttarakhand have a base level fiscal deficit of more than 3 per cent but less than 6 per cent. These states will need to make a relatively higher effort in terms of achieving a 3 per cent fiscal deficit and thus, we require that they achieve this level by 2013-14, following the same path prescribed for the three general category states in Table 9.5.

9.80 Jammu & Kashmir and Mizoram have even higher levels of base fiscal deficits, at 7.8 per cent and 10.3 per cent of GSDP respectively. We recognise that these states require more customised fiscal correction paths, which require reforms at their end, but are achievable, nevertheless. Jammu & Kashmir had a fiscal deficit of 7.8 per cent in 2007-08 that included Rs. 606 crore interest payment on NSSF loans of past years due in the previous year. Thus, the fiscal deficit of Jammu & Kashmir for 2007-08 is overstated by this amount. Correcting for this one-time expenditure, the fiscal deficit adjustment path of Jammu & Kashmir can start from 5.9 per cent to reach 3 per cent in 2014-15, with equi-proportional adjustments each year (for J&K please also refer to Para 12.177). Mizoram had a fiscal deficit of 6 per cent in 2006-07 and 11 per cent in 2007-08. The primary reason for this has been the grant received in 2006-07, a considerable portion of which got spent only by 2007-08. Thus, a better point to start the fiscal adjustment path of Mizoram would be the average of the two, i.e., 8.5 per cent, to be reduced to 3 per cent by 2014-15, with equi-proportional annual adjustments. The fiscal adjustment path of the six states with a base level fiscal deficit of more than 3 per cent is as shown in Table 9.6.

Table 9.6: FD Path for Special Category States with High Base FD

(*per cent of GSDP*)

	State	Base	2011-12	2012-13	2013-14	2014-15
1	Jammu & Kashmir	5.9	4.7	4.2	3.6	3.0
2	Manipur	4.1	3.5	3.5	3.0	3.0
3	Mizoram	8.5	6.4	5.2	4.1	3.0
4	Nagaland	4.8	3.5	3.5	3.0	3.0
5	Sikkim	5.2	3.5	3.5	3.0	3.0
6	Uttarakhand	5.2	3.5	3.5	3.0	3.0

Note: The base in the case of each state is explained in paras 9.77 and 9.80.

9.81 The remaining five states, viz. Arunachal Pradesh, Assam, Himachal Pradesh, Meghalaya and Tripura, have a base level fiscal deficit of less than 3 per cent and thus, we require that these states attain a fiscal deficit of 3 per cent of GSDP or less by 2011-12 while maintaining their revenue balance in the same way as general category states with revenue surplus in 2007-08. All special category states are required to remain in surplus on revenue account during the period. The path for debt, fiscal deficit and revenue deficit is given at Annex 9.1, 9.2 and 9.3 respectively.

Monitoring and Compliance

9.82 To facilitate implementation of the above roadmap we recommend that the states' enactment/amendment of their FRLs incorporating the above targets should be a conditionality for release of all state-specific grants.

9.83 Some of the structural reforms recommended for the Centre in this chapter need to be replicated at the state level as well. The most important of these is the structure of the MTFP, which, as explained earlier, should be more comprehensive, giving details of all significant items on receipts and expenditure along with the underlying assumptions made for projection purposes. MTFP should become an iterative process where the receipts and expenditure are arrived at as the sum of the building blocks thereof and conform to the overall fiscal targets.

9.84 Independent review/monitoring is a feature that is desirable in the FRBM Act and some states already have such a system in place. It is recomended that all states introduce this feature in their Acts. The states should also attempt to incorporate statements on RCCE, PPP and related liabilities, physical and financial assets and vacant public land and buildings.

9.85 We recommend that the Central Government set net borrowing limits for states based on the fiscal deficit path outlined above for each state. While determining the net borrowing limits for any state for any year *t*, the only possible way by which to generate a GSDP estimate for year *t* is by applying our projected nominal growth rate for year *t* to the best estimate of GSDP for year *t*-1. Advance Estimates (AE) of the GSDP at factor cost for the previous fiscal year *t*-1 are issued only just before the close of the year *t*-1, in the month of January at the earliest. This, unfortunately comes a little too late for the exercise of setting state borrowing limits, which is completed by November of year *t*-1. However, by November, the Provisional Estimate (PE) for the year preceding, *t*-2, should be available for all states (a Final Estimate for year *t*-2 is issued some months before the close of year *t*-1, which is usually very close to the PE for *t*-2). Therefore, the estimate of GSDP for year t can be obtained by application of our projected nominal growth rates for years *t* and *t*-1 to the PE of GSDP for year *t*-2, thus:

$$B_t = f_t^*(1+g_t^*)(1+g_{t-1}^*)PE_{t-2}$$

Where

B_t : Net borrowing limit for year *t*

f_t^* : Prescribed fiscal deficit for year *t* as a ratio to GSDP

g_t^*, g_{t-1}^* : Projected nominal GSDP growth rates for years *t* and *t-1*, respectively

PE_{t-2} : Provisional estimate of GSDP for year *t-2*

9.86 The equation in Para 9.85 has to be independently estimated for each state, with the parameter values specific to each. An index for the state identifier is not included in the equation so as not to complicate what is in essence a simple formulation. The procedure allows continual updating of the GSDP base for determination of the net borrowing limits of the state, albeit with a time lag of two years. Without updating of this kind, borrowing limits get prescribed in advance through application of projected nominal growth rates to the estimated GSDP in the base year, leading to the kind of excessive fiscal compression observed in high-growth states during the period of FC-XII. Our procedure, through the continuous updating of GSDP estimates for the estimation of net borrowing limits, offers a growth incentive to states. It should be noted at the same time that since these limits are set with respect to projections of GSDP, any departures of fiscal deficits normalised with respect to final estimates of GSDP could well depart from the projected ratios, for reasons beyond the control of the state in question.

9.87 Since the above mentioned reform path does not include projections for the year 2010-11, the borrowing limits for that year for each state should be fixed in such a manner that the fiscal deficit does not exceed the lower of 3.5 per cent or the fiscal deficit percentage in 2008-09 as a per cent of GSDP of 2010-11, calculated by applying the projected growth rates for 2010-11 to the AE of GSDP for the year 2009-10. Likewise, for Jammu & Kashmir and Mizoram, it may be fixed with a fiscal deficit not exceeding the lower of 2008-09 fiscal deficit (in per cent terms) or 5.3 per cent and 7.5 per cent respectively, applied to the GSDP of 2010-11. In case, this amount is less than 3 per cent of the GSDP for 2010-11 projected as stated above, a figure equal to 3 per cent of GSDP for 2010-11 may be taken.

Consolidated Fiscal Roadmap

9.88 Based on the fiscal reform path prescribed for the Centre and states, the consolidated position during the award period will be as per Table 9.7. Average lending from the Centre to states on account of external aid for the period 2006-09 has been Rs. 6050 core. The stock of central loans consolidated as per the recommendation of FC-XII and loans of those states whose loans have not yet been consolidated, put together, amount to Rs. 1.23 lakh crore. Assuming that these have to be paid in twenty equal instalments, the recovery from these loans would be Rs. 6175 crore, which is almost equal to the average disbursement of loans. Thus, we have assumed that there would be no net disbursement of loans from the Centre to states during the projection period.

9.89 It is important to recognise that for successful fiscal consolidation, the key lies in maintaining the growth dynamism of our economy. There is a two-way relationship between growth and fiscal consolidation; or what is called the 'strategy of expansionary fiscal consolidation', where fiscal consolidation leads to higher growth due to higher levels of public and private investments, which in turn, further facilitates maintenance of fiscal stability.

9.90 However, in order to sustain such a virtuous circle, the proposed fiscal strategy will need to be augmented by reform measures or structural measures in areas such as widening and deepening of markets — particularly factor markets, improving productivity of public expenditure, implementation of competition policy covering both private and public sector enterprises and above all, better governance at all levels of government through increased transparency and accountability.

Debt Relief for States

9.91 Our Terms of Reference require us to: '... review the state of the finances of the Union and the States, keeping in view, in particular, the operation of the States' Debt Consolidation and Relief Facility 2005-10 introduced by the Central Government on the basis of the recommendations of the Twelfth Finance Commission and suggest measures for maintaining a stable and sustainable fiscal environment consistent with equitable growth.'

Table 9.7: Consolidated Fiscal Reform Path of Centre and States

(*per cent of GDP*)

	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Fiscal Deficit – States	2.8	2.6	2.5	2.5	2.4	2.4
Fiscal Deficit – Centre	6.8	5.7	4.8	4.2	3.0	3.0
Net Central Loans to States	0.1	0.0	0.0	0.0	0.0	0.0
Fiscal Deficit – Consolidated	9.5	8.3	7.3	6.7	5.4	5.4
Debt Stock – States	27.1	26.6	26.1	25.5	24.8	24.3
Debt Stock – Centre	54.2	53.9	52.5	50.5	47.5	44.8
Outstanding Central Loans to States	2.5	2.2	2.0	1.7	1.5	1.3
Consolidated Debt	78.8	78.3	76.6	74.3	70.8	67.8

Debt Consolidation and Relief Facility of FC-XII

9.92 With regard to the broad approach to the issue of debt sustainability, FC-XII was of the view that debt relief measures were required as a pre-requisite for achievement of revenue balance. FC-XII observed that, apart from providing for specific debt relief, qualitative and quantitative measures were also to be prescribed to restrict the future growth of debt stock of states beyond sustainable levels. FC-XII was of the view that the debt relief measures recommended with regard to central loans to states needed to be substantial so as to encourage better fiscal performance on the part of states. FC-XII also recommended disintermediation and accordingly, central lending to states was discontinued, except in the case of fiscally weak states that are not able to raise loans from the market, or in case of external loans. In case of such states, FC-XII recommended that computation of interest rates for future loans to the states be placed on a rational footing. In addition, future repayments, particularly on open market borrowings, needed to be catered to in a manner that would preclude undue fiscal stress in the event of bunching or bullet payments.

9.93 FC-XII also observed that states should make efforts to eliminate their revenue deficits so that borrowings are utilised for generating capital assets, rather than for financing revenue expenditure. It recommended that in the first instance, as a measure of fiscal discipline, all states should enact fiscal responsibility legislation prescribing specific annual targets for reduction of revenue and fiscal deficits as well as providing a ceiling for borrowings. It unambiguously recommended that the fiscal responsibility legislation should provide for revenue deficits of states being brought down to zero by 2008-09.

9.94 FC-XII examined the debt position of the states and recommended debt relief (referred to as DCRF), which had two separate components of relief in the form of debt consolidation and debt write-off. The debt consolidation component provided for consolidation of central loans to states amounting to Rs. 1,28,795 crore, contracted till 31 March 2004 and outstanding on 31 March 2005, along with rescheduling for a fresh term of 20 years, to be repaid in 20 equal instalments. Interest at the rate of 7.5 per cent was to be charged on the consolidated rescheduled central loans and the repayments due from states during the period 2005-06 to 2009-10 on these were eligible for write-off. The quantum of write-off was linked to the absolute amount by which the revenue deficit was reduced in each successive year during the award period. The DCRF envisaged that if a state was able to bring down its revenue deficit down to zero by the targeted year 2008-09, the entire repayments due from the state during the FC-XII award period would be written off. Enacting the fiscal responsibility legislation, as stated above, was to be a necessary pre-condition for availing of debt relief. For debt write-off, there was an additional pre-condition stipulating that the fiscal deficit of the states should be contained at the level of 2004-05.

9.95 The performance of states in aggregate under DCRF is given in Table 9.8. Twenty-six states have availed of debt consolidation till October 2009. This has resulted in interest relief amounting to Rs. 15,689 crore to these states as against Rs. 21,276 crore estimated by FC-XII. Sikkim and West Bengal have failed to receive the benefit of debt consolidation, not having met the conditionality of enacting fiscal responsibility legislation. Cumulatively, central loans amounting to Rs. 1,13,601 crore have been consolidated, which is lower than the FC-XII estimates by Rs. 15,194 crore. Out of the said differential, Rs. 9893 crore is accounted for by West Bengal (Rs. 9700 crore) and Sikkim (Rs. 192 crore). The balance is attributable to disparity in the actual base year stock of debt and delays in enactment of FRLs by some states. As regards the debt waiver component, waiver benefit of Rs. 18,717 crore has accrued to the states by the end of 2008-09,

Table 9.8: Summary of Performance under DCRF

(*Rs. crore*)

	Estimated by FC-XII for 2005-10	Availed of by States till 2008-09
Debt Consolidation	1,28,795	1,13,601
Interest Relief	21,276	15,689
Debt Waiver	32,199	18,717

Box 9.1: National Small Savings Fund

The National Small Savings Funds (NSSF) was created in the Public Account of India with effect from April 1999 with the Central Government taking on the responsibility of servicing the small savings deposits outstanding as on the date of creation of NSSF. The modality was that the Central Government issued special securities to NSSF for Rs. 1,76,221 crore equal to the face value of the outstanding deposits as on April 1999. These special securities against outstanding deposits carried interest rate of 11.5 per cent per annum on the date of issue and did not have any specific term. Since loans against the deposits outstanding on April 1999 had been extended to State Governments from the Consolidated Fund of India (CFI) prior to creation of NSSF, interest from states on these loans was also credited to CFI and accounted as a non-tax receipt of GoI. These loans were included in the corpus of high-coupon loans pre-paid by the states under the Debt Swap Scheme as well as in the subsequent debt relief awarded by the Twelfth Finance Commission.

Till 2001-02, the net small savings collections in a state (gross collections minus repayments to depositors) were being shared between the Central and State Governments, with the share of the State Government being progressively increased from 66.66 per cent to 75 per cent from 1 April 1987 and to 80 per cent from April 2000. From 1 April 2002 to 31 March 2007, the entire net collections in a state were being invested in special securities issued by the concerned State Government. However, with effect from 2007-08, the mandatory share of State Governments has been reduced to 80 per cent with the option to go upto 100 per cent.

The sums received in NSSF on redemption of special securities are re-invested in special Central Government securities. The special securities issued by the Central Government against such redemption amounts carry a tenure of 20 years with bullet repayment on maturity and coupon rates benchmarked to average secondary market yields on Central Government securities (G-sec) of comparable maturity.

With effect from 2007-08, an enabling provision has been made through amendment to the NSSF (Custody and Investment) Rules, 2001 to allow for investment in other instruments. A sum of Rs. 1500 crore has been given as loan @ 9 per cent per annum (payable annually), to India Infrastructure Finance Company Limited (IIFCL) in 2007-08 for financing infrastructure development. The loan carries a bullet repayment after a period of 15 years.

The interest paid to depositors plus the management cost is expenditure of the Fund while the interest received from the Central Government and State/UT Government with legislature on investment of the collections in their long term securities is income of the Fund. The management cost comprises remuneration to post offices/banks for operating the schemes, commission to agents for mobilising deposits and cost of printing of certificates.

as against the estimate of Rs.32,199 crore by FC-XII for the five year award period.

9.96 The scope of FC-XII recommendations excluded two categories of loans, viz. loans given to the states from NSSF and central loans given to State Governments for centrally sponsored schemes/ central plan schemes through central ministries/ departments other than Ministry of Finance. NSSF loans were excluded from the scope of debt relief on the grounds that NSSF is maintained in the public account of the Government of India and central loans not administered by MoF were excluded on the grounds that data for the same were not available.

Loans from National Small Savings Fund

9.97 NSSF was created in the public account of India with effect from 1 April 1999 with the objective of de-linking small savings transactions from the Consolidated Fund of India and ensuring their operation in a transparent and self-sustaining manner. Since NSSF operates in the public account, its transactions do not impact the fiscal deficit of the Centre. Box 9.1 provides details of the scheme.

9.98 All deposits under small savings schemes are credited to NSSF and all withdrawals by the depositors are made out of accumulations in the Fund. The balance is invested in special securities issued by Central and State/UT Governments as per their respective shares. These securities are issued for a period of 25 years, including a moratorium of five years on the principal amount. The special securities carry a rate of interest as fixed by the Government of India from time to time. The current rate of interest is 9.5 per cent per annum.

9.99 During the period 1999-00 to 2008-09, the states had issued special securities to NSSF amounting to Rs. 4,48,857 crore, of which an amount of Rs. 16,919 crore has been redeemed, leaving a balance of Rs. 4,31,938 crore outstanding as on 31 March 2009. Four states, viz. Maharashtra, West Bengal, Gujarat and Uttar Pradesh, account for 52 per cent of the total outstanding NSSF debt of states as on 31 March 2009.

9.100 Even though the interest rates have come down over this period, the states have had various issues with the overall scheme regarding the inflexibility of having to borrow based on availability rather than requirement, asymmetry between effective interest rates to the states and the Centre and the difference between cost to the NSSF and interest rates.

9.101 In 2005, a sub-committee of the National Development Council was set up to examine the various issues raised by the states. Based on its recommendations, the following changes were made in the scheme:

i) The states were not compelled to take 100 per cent of the net collections under small savings and were permitted to go down to 80 per cent, with the remainder being taken by the Centre.

ii) The rate of interest payable on NSSF securities issued during the years 1999-2000 to 2001-02 was reduced from 13.5 per cent, 12.5 per cent and 11 per cent per annum respectively, to 10.5 per cent per annum with effect from 1 April 2007 as shown in Table 9.9.

Table 9.9 : Interest Rates Applicable on Loans from NSSF

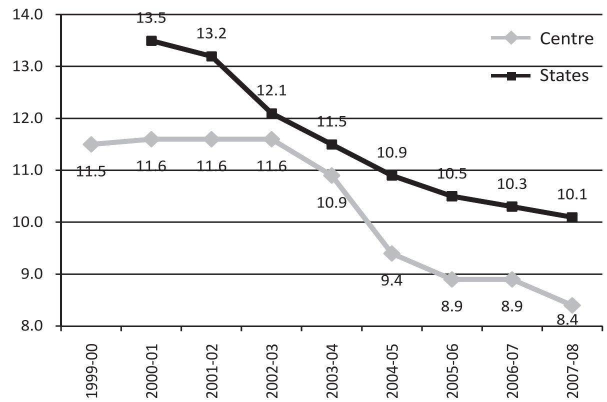
(*per cent*)

Year	Original Interest Rates	Interest Rates post NDC sub-committee recommendations
1999-2000	13.5	10.5
2000-01	12.5	10.5
2001-02	11.0	10.5
2002-03	10.5	10.5
2003-04 onwards	9.5	9.5

iii) The states were allowed to pre-pay a part of their liabilities to NSSF (this was availed of only by Tamil Nadu and Orissa with pre-paid sums of Rs. 1126 crore and Rs. 200 crore respectively during 2007-08).

9.102 Despite this relief, there is a difference between the effective rate of interest payable by the Centre and that by the states. Figure 9.1 shows the effective interest rates on NSSF loans to the Centre and states and their difference since inception of the Fund.

Fig 9.1: Effective Rate of Interest of NSSF Loans to Centre and States



9.103 Both the Centre and the states have seen the interest cost of their respective NSSF debts decline over the years. However, the average interest rate paid by the states has been higher than that of the Centre from the commencement of NSSF in 1999-2000. This is primarily because the states have been paying interest only on securities issued against collections on current small savings from 1 April 1999, whereas the Centre is also paying interest on securities against the deposits outstanding on that date, which, at 11.5 per cent, was lower than the rate of interest on transfers during 1999-2000 and 2000-01. The gap between the average interest paid by the states and the Centre on their respective NSSF debt had narrowed from 1.9 percentage points in 2000-01 to 0.5 percentage points in 2002-03, but thereafter, increased to 1.7 percentage points in 2007-08.

9.104 This widening after 2002-03 has arisen due to the following decisions taken by the Centre:

i) Reduction in interest rate on central special securities issued against outstanding balances on central liabilities from 11.5 per cent to 10.5 per cent with effect from 1 March 2003, in line with general softening of market interest rates.

ii) Use of debt swap receipts from states to partly redeem the central special securities issued against the initial outstanding balances and to replace them with fresh securities at lower market rates of interest. The total amount redeemed between 2002-03 and 2004-05 was Rs. 92,652 crore.

iii) Further redemption of high-interest central special securities against outstanding balances for a sum of Rs. 10,000 crore in 2007-08 in order to infuse cash into the NSSF consequent upon negative cash balance in the Fund due to a drastic decline in net small savings collections.

9.105 Consequent to the NDC sub-committee recommendations, the interest rate on pre-2002-03 loans was reset to 10.5 per cent and the collections from NSSF are being shared by Centre to the extent of 20 per cent. However, the asymmetry has continued in favour of the Centre even after the implementation of the recommendations of the National Development Council sub-committee. Therefore, we feel that there is a case for relief to the states on loans advanced from the NSSF.

9.106 Since the collections, from 2007-08 onwards, have been flowing to the Centre as well, we have decided to consider relief on loans contracted till 2006-07. The state-wise position of loans contracted till 2006-07 and outstanding estimated as at the end of 2009-10 can be seen in Annex 9.4. Keeping in view the existing effective rate of interest for the Centre, the fact that now the Centre too is using 20 per cent of the collections and the recent trends in flows to NSSF, we recommend that the loans contracted till 2006-07 and outstanding at the end of 2009-10 be reset at a common interest rate of 9 per cent per annum in place of 10.5 per cent or 9.5 per cent. The repayment schedule, however, should remain unchanged.

9.107 The total benefit that would accrue to states, estimated on the basis of outstanding at the end of 2009-10, is Rs. 13,517 crore during our award period. State-wise details of estimates of the benefit are given in Annex 9.4. The benefit shall continue to accrue even beyond the award period and is estimated to reach Rs. 28,360 crore by the maturity of the last loan coming under purview.

9.108 While the relief recommended above only addresses the interest asymmetry between the Centre and states, the structural problems in the existing arrangement need to be reviewed. The issue of high interest rate on these instruments arises because of the administrative mechanism presently in place.

9.109 A rise in the difference between the interest rates paid on small savings instruments and the market rate causes an increase in subscription to these instruments, thereby increasing flows of NSSF loans to states. With overall borrowings capped by FRBM targets, the states cannot take recourse to open market borrowings. This has already been witnessed during 2003-04 and 2004-05. Thus, states may not be able to benefit from the lower interest rates, even when market rates go down, as they are saddled with high inflows from high-cost NSSF loans. Conversely, when market interest rates increase, the subscriptions to small savings instruments dip and flows from NSSF dry up. This has been witnessed in 2006-07 and 2007-08 when net flows for many states even became negative.

9.110 States have also raised issues about the tenor of this loan, extending to 25 years, which has been used to justify the high interest rate and has led to a situation where states are locked with fixed interest debt for a long time with no option of reset and pre-payment. There is a significant mismatch between the maturity period of five to seven years for most small savings instruments and the term of the loan extended from NSSF.

9.111 These issues highlight the need for more comprehensive reforms in the overall administration of the National Small Savings Fund. Various committees constituted in the past to look into these issues have made far-reaching recommendations.

One of the important recommendations has been linking of interest rate on small savings instruments to the prevailing G-sec rates, which we endorse. We recommend, against this background, that all aspects of the design and administration of the scheme be examined with the aim of bringing transparency, market linked rates and other, much needed reforms to the scheme.

9.112 Some reforms are also required at the state level. In the past there has been a practice of giving various incentives such as cash awards to officials and other similar measures to promote subscription to small savings instruments. These measures also interfere with normal market dynamics. While most of these incentives, like awards to officials, have outlived their utility, all such incentives that either add to the cost of administration or affect normal market linked subscription, should be proactively withdrawn by the states.

Loans not Consolidated in 2005-10

9.113 As pointed out earlier, FC-XII did not consider central loans given to State Governments for Centrally Sponsored Schemes/central plan schemes through ministries other than Ministry of Finance, under DCRF, primarily because they did not have the requisite data. The balance outstanding in this regard stands at Rs. 4506 crore as at the end of 2007-08. The state-wise position for these is shown in Annex 9.5.

9.114 We feel that continuation of these loans is not consistent with the policy of disintermediation recommended by FC-XII, which is being followed today. Therefore, we recommend that these loans, as outstanding at the end of 2009-10, be written off. It is also recommended that any further lending from Centre to states, under any Centrally Sponsored Scheme, should be completely avoided. However, as per the recommendations of FC-XII, a window for borrowing from the Central Government should be available for the fiscally weak states that are unable to raise loans from the market.

9.115 While 26 states have availed of debt consolidation, two states, viz. West Bengal and Sikkim, have not legislated FRBM Acts and, thus, did not get the benefit of consolidation. We recommend that this facility be extended to these states during our award period, on the condition that they put in place an FRBM Act as stipulated in this chapter. On meeting this condition, the loans contracted by these states till 31 March 2004 and outstanding as at the end of the year preceding the year in which the Act is put in place, shall be consolidated as per the same terms and conditions as recommended by FC-XII. However, the benefit of waiver, as recommended by FC-XII, need not be continued any further to any state.

Implementation and Compliance

9.116 The relief measures recommended by us in this chapter are all in the nature of one-step actions leading to relief over the long term. The above relief should be given to states only if the states with FRBM Acts already in place amend the same as indicated in Para 9.82 and those not having an FRBM Act legislate their FRBM Acts. For interest relief on NSSF loans, the loans contracted till 2006-07 and outstanding till the end of the year preceding the year in which this condition is met should be considered for reset. We have set no conditionalities with regard to compliance with the targets since we believe that the mechanism mentioned in Para 9.85 for setting borrowing limits and allowing open market borrowings to states can act as an effective tool.

9.117 The debt waiver, as recommended by FC-XII, was booked in the finance accounts of the states as non-tax revenues under 0075– 'miscellaneous general receipts'. We feel that this is not desirable as it artificially overstates the non-tax revenues of the states. Second, since it is accounted as non-tax revenue, it allows states to spend more within the same fiscal deficit cap, reducing the intended impact on the debt stock of states. Ideally, if it were not treated as notional repayment of debt, it would have ensured that, given a fiscal deficit target, the gross borrowing of states would have to go down, thereby having a dampening impact on debt stock, which was the primary purpose of FC-XII in granting the relief. We recommend that the debt write-off recommended by us is accounted in a manner such that it does not artificially affect the revenue or fiscal deficit of the states.

Summary of Recommendations

9.118 To summarise, our recommendations are as follows:

i) Revenue deficit of the Centre needs to be progressively reduced and eliminated, followed by emergence of a revenue surplus by 2014-15 (paras 9.18 and 9.31).

ii) Target of 68 per cent of GDP for combined debt of Centre and states to be achieved by 2014-15. Fiscal consolidation path embodies the steady reduction in augmented debt stock of Centre to 45 per cent of GDP by 2014-15 and for the states to less than 25 per cent of GDP by 2014-15 (paras 9.29 and 9.69, Table 9.7).

iii) MTFP to be reformed and made a statement of commitment rather than a statement of intent. Tighter integration between the multi-year framework provided by MTFP and annual budget exercise (Para 9.38).

iv) The following disclosures to be made along with the annual Central budget/MTFP:

   a) Detailed breakup of grants to states under the overall category of non-plan and plan grants (Para 9.41).

   b) Statement on tax expenditure to be systematised and the methodology to be made explicit (Para 9.42).

   c) Compliance costs of major tax proposal to be reported (Para 9.43).

   d) Revenue Consequences of Capital Expenditure to be projected in MTFP (Para 9.45).

   e) Fiscal impact of major policy changes to be incorporated in MTFP (Para 9.46).

   f) PPP liabilities to be reported along with MTFP (paras 9.48 and 9.49).

   g) MTFP to make explicit the values of parameters underlying projections for receipts and expenditure and the band within which they can vary while remaining consistent with targets (Para 9.61).

v) Transfer of disinvestment receipts to the public account to be discontinued and all disinvestment receipts be maintained in the consolidated fund (Para 9.52).

vi) GoI should list all public sector enterprises that yield a lower rate of return on assets than a norm to be decided by an expert committee (Para 9.52).

vii) The FRBM Act specify the nature of shocks that would require a relaxation of FRBM targets (Para 9.62).

viii) In case of macroeconomic shocks, instead of relaxing states' borrowing limits and letting states borrow more, the Centre to borrow and devolve the resources using the Finance Commission tax devolution formula for *inter-se* distribution among states (Para 9.63).

ix) Structural shocks such as arrears arising out of Pay Commission awards to be avoided by, in the case of arrears, by making the pay award commence from the date on which it is accepted (Para 9.64).

x) Independent review mechanism to be set-up by the Centre to evaluate its fiscal reform process. The independent review mechanism to evolve into a Fiscal Council with legislative backing over time (paras 9.65 and 9.66).

xi) Given the exceptional circumstances of 2008-09 and 2009-10, the fiscal consolidation process of the states was disrupted. It is expected that states would be able to get back to their fiscal correction path by 2011-12, allowing for a year of adjustment in 2010-11.

a) States that incurred zero revenue deficit or achieved revenue surplus in 2007-08 should eliminate revenue deficit by 2011-12 and maintain revenue balance or attain a surplus thereafter. Other states to eliminate revenue deficit by 2014-15 (paras 9.69 to 9.72).

b) The general category states that attained a zero revenue deficit or a revenue surplus in 2007-08 should achieve a fiscal deficit of 3 per cent of GSDP by 2011-12 and maintain such thereafter. Other general category states to achieve 3 per cent fiscal deficit by 2013-14 (paras 9.74 to 9.76, Table 9.5)

c) All special category states with base fiscal deficit of less than 3 per cent of GSDP in 2007-08 could incur a fiscal deficit of 3 per cent in 2011-12 and maintain thereafter. Manipur, Nagaland, Sikkim and Uttarakhand to reduce their fiscal deficit to 3 per cent of GSDP by 2013-14 (paras 9.79 and 9.81).

d) Jammu & Kashmir and Mizoram should limit their fiscal deficit to 3 per cent of GSDP by 2014-15 (Para 9.80).

xii) States to amend/enact FRBM Acts to build in the fiscal reform path worked out. State specific grants recommended for a state to be released upon compliance (Para 9.82).

xiii) Independent review/monitoring mechanism under the FRBM Acts to be set up by all states (Para 9.84).

xiv) Borrowing limits for states to be worked out by MoF using the fiscal reform path, thus acting as an enforcement mechanism for the fiscal correction by states (Para 9.85).

xv) Loans to states from National Small Savings Fund contracted till 2006-07 and outstanding at the end of 2009-10 to be reset at 9 per cent rate of interest subject to conditions prescribed (Para 9.106).

xvi) National Small Savings Scheme to be reformed into a market-aligned scheme. State Governments also required to undertake relvant reforms at their level (paras 9.111 and 9.112).

xvii) Loans from GoI to states and administered by ministries/departments other than MoF, outstanding as at the end of 2009-10, to be written off subject to conditions prescribed (Para 9.114).

xviii) A window for borrowing from the Central Government to be available for the fiscally weak states that are unable to raise loans from market (Para 9.114).

xix) For states that have not availed the benefit of consolidation under DCRF, the facility, limited to consolidation and interest rate reduction, to be extended subject to enactment of FRBM Act (Para 9.115).

xx) Benefit of interest relief on NSSF and write-off available to states only if they bring about the necessary amendments/ enactments of FRBM (Para 9.116).