

Chapter 14

Fiscal Environment and Fiscal Consolidation Roadmap

14.1. The Terms of Reference (ToR) of this Commission requires us to "review the state of the finances, deficit and debt levels of the Union and the States, keeping in view, in particular, the fiscal consolidation roadmap recommended by the Thirteenth Finance Commission, and suggest measures for maintaining a stable and sustainable fiscal environment consistent with equitable growth including suggestions to amend the Fiscal Responsibility and Budget Management Acts currently in force and while doing so, the Commission may consider the effect of the receipts and expenditure in the form of grants for creation of capital assets on the deficits; and the Commission shall also consider and recommend incentives and disincentives for States for observing the obligations laid down in the Fiscal Responsibility Budget Management Acts".

14.2 While making its recommendations, the Commission is also required, under paragraph 6, to have regard, among other considerations, to:

- (ii) the demands on the resources of the Central government, in particular, on account of the expenditure on civil administration, defence, internal and border security, debt servicing and other committed expenditure and liabilities.
- (iii) the resources of the State governments and demands on such resources under different heads, including the impact of debt levels on resource availability in debt stressed states, for the five years commencing on 1st April 2015, on the basis of levels of taxation and non-tax revenues likely to be reached during 2014-15.
- (iv) the objective of not only balancing the receipt and expenditure on revenue account of all the states and the Union, but also generating surpluses for capital investment."

14.3 In short, the Commission has been tasked with evolving an approach, based on its review of Union and State finances, to create a fiscal environment that is sustainable and also promotes equitable growth. This would involve reviewing the functioning of the Fiscal Responsibility Budget Management Act, 2003 (FRBM Act) and suggesting amendments, if necessary, keeping in mind the effective revenue deficit (which takes into account the difference between revenue deficit and grants for creation of capital assets). The Commission is also expected to recommend incentives and disincentives for States to comply with the provisions of the FRBM Act. In making its recommendations, the Commission has to take into account resources of State Governments and the demands made on these resources, particularly how debt impacts the resources of debt-stressed states.

Views of Previous Finance Commissions

14.4 A review of the financial requirements of both the Union and State Governments, their indebtedness levels and long-term fiscal sustainability has been an important element of the

analysis of successive Finance Commissions. The FC-XII recommended the Debt Consolidation and Relief Facility (DCRF), which involved the consolidation of Central loans (excluding loans given for Centrally sponsored schemes (CSS)/Central Plan schemes through ministries other than the Ministry of Finance) to the States contracted till March 2004 and outstanding on 31 March 2005 and rescheduling them for a fresh term of twenty years, resetting the interest rate to be charged on them at 7.5 per cent along with a debt write-off. An individual State could avail the DCRF only if it enacted a fiscal responsibility legislation prescribing specific annual deficit reduction targets in order to ultimately eliminate the revenue deficit by 2008-09 and reduce the fiscal deficit to 3 per cent of gross state domestic product (GSDP).

14.5 As regards future lending policy, the FC-XII recommended discontinuing the role of the Union Government in lending to the States, and the latter being allowed to approach the market directly. Recognising that some fiscally weak States would be unable to raise funds from the market, the FC-XII recommended that the Union could borrow in order to lend to such States, but the interest rates should remain aligned to the marginal cost of borrowing of the Union. External assistance was made a pass-through to States, with the Union acting as a financial intermediary. It also recommended that all States set up a Sinking Fund for the amortisation of all loans, including loans from banks and liabilities on account of the National Small Savings Fund (NSSF). For the discharge of the State's obligation on guarantees, the FC-XII recommended setting up guarantee redemption funds through earmarked guarantee fees.

14.6 The FC-XIII recommended a fiscal consolidation roadmap which would progressively reduce and eliminate the revenue deficit of the Union and yield a revenue surplus by 2014-15. It recommended that States with zero revenue deficits or revenue surplus in 2007-08 should maintain those levels while other States should eliminate the revenue deficit by 2014-15. The Commission also recommended a fiscal deficit target of 3 per cent of GSDP for all States, but with different target dates for general category states and special category states. A consolidated fiscal deficit target of 5.4 per cent of gross domestic product (GDP) was projected, of which the target for the Union was 3 per cent and that for all States 2.4 per cent.¹ The FC-XIII set a combined debt-GDP target of 68 per cent² for the Union and the States to be achieved by 2014-15. However, individually, the Union and States had terminal year debt-GDP targets of 44.8 per cent and 24.3 per cent, respectively.

14.7 The FC-XIII also recommended aligning the NSSF to the market and resetting interest rates on these loans to States contracted up to 2006-07 and outstanding at the end of 2009-10 at 9 per cent, subject to certain conditions. Conditional write-off was recommended for loans given by the Union to the States, which were outstanding at the end of 2009-10 and were administered by ministries and departments other than the Ministry of Finance. The benefit of the DCRF was extended to West Bengal and Sikkim, which had not availed the benefit earlier, on the condition that they enact the fiscal responsibility legislation.

¹ The apparent mismatch between a 3 per cent of GSDP fiscal deficit target and a 2.4 per cent of GDP target, for all States, in relation to the consolidated fiscal deficit is due to differences in the methodology in calculating GSDP and GDP. This is also because all States do not include Union Territories.

² The FC-XIII had recommended a consolidated debt target of 68 per cent of GDP for 2014-15, which excluded loans from the Union to the States, amounting to 1.3 per cent of GDP, since these are in the nature of an inter-government transaction.

Review of Debt and Deficit

Review of Combined Finances³

14.8 The consolidated fiscal deficit of Union and State Governments declined from 7.2 per cent of GDP in 2004-05 to 4 per cent in 2007-08, its lowest level in our period of analysis which is 2004-05 to 2013-14 (BE). This was a period of high economic growth, revenue buoyancy and fiscal consolidation in line with the fiscal responsibility legislations at the Union and State levels. However, the combined fiscal deficit-GDP ratio increased sharply to 8.2 per cent in 2008-09 and reached a peak of 9.4 per cent in 2009-10 on account of the economic slowdown and the fiscal stimulus given to mitigate its effects, pay revision, debt relief measures, a high subsidy bill and increased welfare spending initiated largely by the Union Government. Subsequently, the fiscal deficit-GDP ratio declined to 7.6 per cent in 2011-12 and 6.9 per cent in 2013-14 (BE). Similarly, the combined revenue deficit-GDP ratio showed significant improvement from 3.5 per cent in 2004-05 to 0.1 per cent in 2007-08, before a sharp increase to 5.7 per cent in 2009-10. It later declined to 2.8 per cent in 2013-14 (BE).

14.9 The combined debt-GDP ratio declined from 79.5 per cent in 2004-05 to 66.4 per cent in 2013-14 (RE). The reduction was particularly significant - around 10 percentage points - in the period from 2004-05 to 2007-08 and came against the backdrop of high nominal GDP growth, moderate inflation and compressed fiscal deficit. The debt-GDP ratio deteriorated after 2007-08 primarily due to a higher fiscal deficit. It then declined to 66.5 per cent in 2010-11 and has since plateaued at that level. By the end of 2013-14 (BE), the combined fiscal deficit was 6.9 per cent, revenue deficit 2.8 per cent and adjusted outstanding liabilities (net of loans from the Union Government) was 66.4 per cent.

14.10 On a consolidated basis, the general government debt met the standard criteria of sustainability (that the nominal growth rate of the economy is higher than the nominal interest rate with no primary deficit) between 2004-05 and 2013-14 (RE). The shares of the Union and State Governments in the consolidated general government debt have largely been in the ratio of 70:30 in the same period. The proportion of loans from the Union Government to the States relative to GDP also declined from 5.9 per cent in 2004-05 to 1.4 per cent in 2013-14 (RE).

14.11 The consolidated debt-GDP ratio, at 66.4 per cent in 2013-14 (RE), was within the target of 70.8 for that year and the terminal year target of 67.8 per cent for 2014-15 prescribed by the FC-XIII. However, while the consolidated State debt on both net basis (19.8 per cent) and gross basis (21.0 per cent) for 2014-15 (BE) was within the recommended target of 24.3 per of GDP for 2014-15, the Union Government debt, at 45.4 per cent of GDP for 2014-15 (BE) marginally exceeded the recommended target of 44.8 per cent.

Review of the Fiscal Indicators of the Union

14.12 High growth in revenues from income tax and service tax from 2004-05 to 2007-08 enabled the Union Government to reduce its fiscal deficit to 2.5 per cent in 2007-08. However, the fiscal deficit increased sharply thereafter to 6.5 per cent in 2009-10 and although it later declined from 5.7 per cent in 2011-12 to 4.6 per cent in 2013-14 (RE), Union Government finances remained

³ Consolidated data on fiscal deficit and revenue deficit of the Union and States is only available till 2013-14 (BE) in Indian Public Finance Statistics.

under pressure. The revenue deficit declined to 1.1 per cent of GDP in 2007-08, but later increased. Except for two years - 2006-07 and 2007-08 - the Union Government had a primary deficit through the period from 2004-05 to 2013-14.

14.13 The total outstanding debt of the Union Government includes liabilities contracted in the Consolidated Fund and obligations secured under the Public Account. While the former consists of internal debt (dated securities and treasury bills) and external debt, the latter include liabilities on account of the NSSF and provident fund, among others. However, the outstanding debt as reported in the Union budget needs to be adjusted for certain liabilities that are not used to finance the Union Government's fiscal deficit such as Market Stabilisation Scheme (MSS) securities and borrowings by States under NSSF. In addition, this reported debt needs to be adjusted for external debt which is valued at historical book value in the Receipts Budget instead of current exchange (end of the financial year) rates.

14.14 The adjusted Union debt-GDP ratio⁴ declined from 54.3 per cent in 2004-05 to 46.3 per cent in 2013-14 (RE) and further to 45.4 per cent in 2014-15 (BE). However, the public debt component of this increased from 79.8 per cent in 2007-08 to 87.9 per cent in 2013-14 (RE), before marginally falling to 87.2 per cent in 2014-15 (BE). This decline was largely due to an increase in the share of internal debt in total liabilities, from 70.6 per cent in 2007-08 to 80.0 per cent in 2012-13. It later increased to 80.8 per cent in 2013-14 (RE) and to 81.3 per cent in 2014-15 (BE). Currency risk is relatively low, with the share of external debt in total liabilities declining from 9.1 per cent in 2007-08 to 7.1 per cent in 2012-13. It stood at 5.9 per cent in 2014-15 (BE). The proportion of public account liabilities in Union Government debt witnessed a continuous decline from 20.7 per cent in 2006-07 to 12.8 per cent in 2014-15 (BE), with provident funds and reserve funds and deposits each accounting for around 5.4 per cent.

14.15 The dated securities of the Union Government, as on 31 March 2014, accounted for 66.8 per cent of its total outstanding liabilities. The weighted average maturity of new issues declined from a high of 14.9 years in 2007-08 to 11.2 years in 2009-10, before rising to 14.3 years in 2013-14 (RE). Around 83 per cent of the stock of dated securities would be up for redemption over the next twenty years, including 33 per cent during our award period.

Review of the Fiscal Indicators of the States⁵

14.16 At an aggregate level, fiscal indicators of States improved in the period from 2004-05 to 2013-14 (RE). The fiscal deficit-GDP ratio for all States declined from 3.3 per cent in 2004-05 to 1.4 per cent in 2007-08. Although the aggregate fiscal deficit later increased to 3 per cent in 2009-10⁶, it declined to 1.9 per cent in 2012-13, before increasing again to 2.5 per cent in 2013-14 (RE). States, taken together, moved into a revenue surplus position in 2006-07 and have maintained this since then, except for 2009-10 when the implementation of Pay Commission awards and reduced revenue buoyancy on account of the economic slowdown resulted in a revenue deficit. However, there have been some exceptions. Kerala and West Bengal incurred revenue deficits between 2004-05 and 2012-13, while Punjab had revenue deficits during these years except in 2006-07. The 2013-14 (RE) figures show that Arunachal Pradesh, Assam, Bihar, Goa, Himachal Pradesh, Jammu & Kashmir, Karnataka, Kerala, Mizoram, Nagaland, Rajasthan, Tripura, and West Bengal incurred fiscal deficit in excess of 3 per cent of GSDP.

⁴ For the purpose of this chapter, outstanding debt of the Union Government refers to the resultant debt stock after undertaking the adjustment outlined in paragraph 14.13

⁵ The assessment of State finances is based on data from 2004-05 to 2013-14 (RE).

⁶ States remained within the relaxed FRBM fiscal deficit-GSDP target of 4 per cent permitted for 2009-10.

14.17 The debt profile of States has undergone a significant change in the period from 2004-05 to 2013-14(RE). As a result of the debt write-off and interest relief offered under the DCRF by the FC-XII, along with the discontinuation of the practice of giving Central loans for State Plans from 2005-06, the share of loans from the Union in the total debt of the States witnessed a steady decline from 18.8 per cent in 2004-05 to 6.7 per cent in 2012-13 and further to 6.3 per cent in 2013-14 (RE).

14.18 Market borrowings have emerged as the major source of borrowings for State Governments, particularly after 2008, with their share in total debt rising from 23.2 per cent in 2007-08 to 42.6 per cent in 2013-14 (RE). Although NSSF securities are an important source of financing the fiscal deficit of States, their share in total debt has exhibited a secular decline from 32.8 per cent in 2006-07 to 19.2 per cent in 2013-14 (RE) because of policy changes by the Union Government. Other sources of financing for 2013-14 (RE) include liabilities in the public account like provident fund (12.6 per cent) and reserve funds and deposits (12.5 percent).

14.19 The share of State Government securities with interest rates above 10 per cent in the total outstanding liabilities of States declined from 10.1 per cent in 2008-09 to 1.5 per cent in 2010-11, and there were no such liabilities in 2011-12. A majority of the outstanding market loans (estimated at 82.6 per cent in 2012-13 RE) were contracted in the interest rate category of 7 per cent to 9 per cent; two-thirds of these were secured at annual interest rates in the range of 8 per cent to 9 per cent.

Extending the Definition of Debt

14.20 We believe that for any evaluation of public finances to be meaningful, it should consider the government's risk exposure to its public sector in the form of guarantees, off-budget borrowings and accumulated losses of financially weak public sector enterprises. In this context, we have explored the concept of extended debt, analysing different indicators, including the debt of public sector enterprises (PSEs), guarantees to PSEs, and a risk-weighted combination of guarantees. However, our analysis has been constrained by the non-availability of comprehensive audited recent data on State public sector debt.

14.21 A sizeable proportion of guarantees extended to State public sector entities is on account of short-term debt facilities which do not get reflected in the long term PSE debt. Thus, to get an approximation of the aggregate public sector borrowing of the States, we looked at the sum of public debt, State PSE debt and the ratio of guarantees to GDP as an indicative number.⁷

14.22 All long-term debt of State PSEs accounted for 4.6 per cent of GDP in 2011-12. When this was combined with the aggregate public debt of States, the extended debt of all States for that year ballooned to 26.4 per cent of GDP. Similarly, in the case of the Union Government, extended debt defined as the sum of Union public debt and the long term debt of Central public sector enterprises' (CPSEs) stood at 52.4 per cent of GDP in 2011-12.⁸

14.23 We find that the current and likely future stress on States' fiscal position could come from the exposure on account of guarantees provided to the power utilities and other PSEs,

⁷ This was done at the risk of double counting the portion of long-term debt that also has a guarantee.

⁸ CPSE Survey 2012.

including those in the transport sector. For the purpose of our analysis, we restricted the definition of extended debt to a sum total of public debt and a weighted sum of the guarantees of high risk public sector companies like those in the power and transport sectors as well as other PSEs. While analysing this extended debt, we assigned a weight of 90 percent to the power sector guarantees and 10 per cent to other guarantees, including transport sector guarantees. Under this definition, the aggregate extended debt of all States was 23.3 per cent of GDP in 2011-12. This approach cannot be used for the Union Government since there is hardly any devolvement of guarantee obligation on it, especially with regard to power and transport, unlike in the case of States.

14.24 Our analysis indicates that while the all-State aggregate extended debt for 2011-12 was below the debt target set by the FC-XIII for 2014-15, there were some States which were slipping from a position of relative comfort towards debt-stress due to significant exposure to guarantees of loss-making power sector companies. **Thus, we believe that it is important to keep such risks in mind when assessing the debt position of States while preparing fiscal management roadmaps for them, even though insufficient data prevents us from making firm policy inferences. In our view, it would be possible, and useful, to conduct a similar exercise with more contemporaneous data in the future. To this end, we recommend that both Union and State Governments adopt a template for collating, analysing and annually reporting the total extended public debt in their respective budgets as a supplement to the budget document.**

Stakeholders' Views

Views of State Governments

14.25 The States, in their memoranda, covered several issues and made suggestions regarding fiscal consolidation, fiscal sustainability, debt relief and the existing FRBM framework. One suggestion was to recommend a flexible model of fiscal consolidation that takes into account recent fiscal trends, the overall accumulated debt, and the requirements of counter-cyclical measures, with the revenue and fiscal deficit targets being adjusted in line with the growth expectations each year. Some States argued that in view of the uneven levels of economic growth and development across the country, the fiscal target-setting methodology should be modified to reflect the true fiscal situation of different States.

14.26 To overcome large deficits in social and physical infrastructure, States urged that the fiscal consolidation path be linked with the capital investment roadmap for each State separately and the current one-size-fits-all approach adopted while determining fiscal targets for States be discarded. In this context, they suggested an approach in which States would be given a medium term debt target, with the flexibility to roll over fiscal deficit and fiscal liabilities targets from year to year, provided the overall target is not breached.

14.27 Some States suggested an increase in the fiscal deficit target in the range of 3.5 per cent to 5 per cent of GSDP and raising the debt-GSDP ratio limit to 30 per cent. Andhra Pradesh (the successor State following the bifurcation of the State) urged that its fiscal deficit limit be enhanced to 7 per cent to allow it to meet its additional capital expenditure requirements following bifurcation.

14.28 The States gave several suggestions on the fiscal indicators that we should adopt in our recommendations. Some proposed the adoption of a single indicator, while others suggested a

multiple indicator approach. States argued that our recommendations could indicate alternative benchmarks in the fiscal consolidation roadmap and that their performance could be assessed on the basis of a combination of criteria. The suggestions made included dropping the revenue deficit target and anchoring the fiscal rules to a combination of ratios of fiscal deficit, debt to GSDP and interest payment to total revenue receipts ratios. Some States advocated that debt sustainability be determined by the ratio of interest payments to total revenue receipts, not exceeding 15 per cent, and the stock of debt not exceeding 200 per cent of revenue receipts. The States further urged that, as in the case of the Union Government, the use of the concept of effective revenue deficit should be extended to them and investments made in the sinking funds should be incorporated as part of the fiscal consolidation roadmap.

14.29 Punjab, Kerala and West Bengal, the three States which had been given a longer period by the FC-XIII to reach revenue balance as compared to other States, urged special consideration of their respective requirements. Punjab cited the historical legacy of accumulated debt and requested a one-time special purpose grant to restructure and retire high-cost loans, as well as waiver of the outstanding debt of the Union Government. Kerala argued that the bunching of maturity of about 60 per cent of its debt outstanding in five years beginning from 2015-16 would create enormous pressures on its finances, with little scope for raising resources for development. As the existing fiscal rules restrict borrowing beyond a limit, it urged that either all or 50 per cent of past Central loans may be waived, along with interest. West Bengal argued that its large interest burden constricted its development initiatives. It requested for a debt write-off of the outstanding loans from the Union Government, a three-year moratorium on interest obligations on open market borrowings, a special purpose grant for servicing current outstanding NSSF loans with a facility to replace NSSF loans in stages and enhanced access to Ways and Means Advance (WMA) from the Reserve Bank of India (RBI).

14.30 Some States pointed out that the high cost of NSSF loans, in comparison to market borrowings, adds to their debt-servicing burden. They also drew attention to the fact that in many States the collections under NSSF had fallen over the years and constituted an insignificant portion of their total current borrowings. In this connection, there were suggestions for write-off of these loans, granting debt waiver to the extent of 50 per cent of the annual repayment, resetting of all the outstanding NSSF loans at a common rate of interest of 7.25 per cent and giving the States an option to borrow from the NSSF fund.

14.31 Several States advocated write-off of debt and debt relief from one source or the other. The various suggestions included: (i) the grant of a one-time debt relief package by writing off all outstanding Central loans including interest; (ii) consolidation of the outstanding block loans of Ministry of Finance with interest reset at 7.5 per cent; (iii) debt waiver of 50 per cent of annual externally aided programmes (EAP) repayment obligation and (iv) transfer of exchange risk on EAP to the Union Government. As a measure to promote fiscal prudence, it was suggested that an interest subvention of 2 per cent on market borrowings be allowed for those States that adhered to revenue and fiscal deficit targets.

14.32 Most States were of the view that the rule-based fiscal framework has achieved its purpose and needs to be continued. However, they felt that the fiscal rules should apply equally to both the Union Government and State Governments. In view of the large fiscal and revenue deficits of

the Union Government, the States stressed the need for building disincentives in the FRBM Act to restrain it from breaching the numerical targets.

Views of Union Government

14.33 The Ministry of Finance pointed out that the process of fiscal consolidation had to be paused in 2008-09 in order to cushion the economy from the impact of the global economic slowdown. It said that a revised roadmap for consolidation has been adopted following the amendments to the FRBM Act in 2012 and that the Union Government is committed to abide by rule-based fiscal prudence.

14.34 The Ministry highlighted that the combined debt-GDP ratio of Union and States has shown a secular decline, barring the marginal increase in 2008-09 because of global factors, and was 65.6 per cent in 2013-14(RE). The trend in nominal growth rate in GDP, it pointed out, has been well above the average interest cost, reinforcing the sustainability of public debt. The Ministry drew attention to the fact that a bulk of Union Government debt is held domestically and denominated in domestic currency. A key feature of the country's debt profile is the declining proportion of external debt as a percentage of total borrowing and this insulates the debt portfolio from external sector shocks and currency risks.

14.35 The Ministry was of the view that the revenue surpluses of the States from 2006-07 onwards (except for 2009-10) was made possible, among other things, due to robust revenue transfers from the Union to the States, which amounted to about 40 percent of total revenue receipts of the States. On an aggregate basis, the States carried large cash balances.

14.36 The outstanding liabilities of State Governments indicate that there is a compositional shift in the outstanding debts component. The share of Central loans in the total outstanding debt of the States has declined from 57.4 percent in 1991 to 6.6 percent in 2013-14 (BE), thereby limiting any scope for restructuring or write-off of loans by the Union Government, except on outstanding non-Plan loans.

14.37 The Ministry stated that there was a need to improve the quality of fiscal consolidation at the state level by incentivising revenue generation, reducing committed liabilities and improving the quality of expenditures as measured against forward looking outcomes. To this end, it had approved multi-lateral funding through the Asian Development Bank in order to encourage West Bengal to pursue tax reforms measures, augment its resources and sustain development financing. A similar proposal is being considered for Punjab as well. The Ministry was also in favour of a uniform framework on the extent of guarantees that the States can extend to the borrowings made by PSEs, power distribution companies (discoms) and other utilities.

14.38 The Ministry categorically opposed the request by States for prepayment of NSSF, pointing out that any sudden change in the asset base of NSSF on account of draw down by the States would pose a threat to the viability of the fund. Small savings, it argued, serve a specific public policy purpose and should not be viewed as another source of debt financing by either the Union or the States.

14.39 Underlying the role of the Union Government in macro-stabilisation, the Ministry emphasised that the improvement in the finances of the States despite adverse global economic

conditions demonstrates the effectiveness of the Union's interventions. It underlined that the year on year growth of grants from the Union to the States have been in the range of 11 per cent to 13 per cent except 2012-13.

14.40 The Ministry pointed out that the FRBM Act was amended to provide for a review by the Comptroller and Auditor General (C&AG) of the observance of fiscal rules by the Union Government. On the issue of conforming to the rules set in the Act, the Ministry explained that the Union Government is answerable to Parliament, which is the highest form of accountability in a democratic setup for a sovereign government.

14.41 The Planning Commission, in its written comments to the Commission, indicated that internationally, the preferred measure of fiscal performance is primary deficit (which excludes interest payments from fiscal deficits) rather than fiscal deficit. On the use of revenue deficit as an indicator, it highlighted the fact that including the Union Government's transfers to the States for financing capital expenditure in the former's revenue expenditures conveyed a misleading picture of its revenue deficit. The Planning Commission also suggested that fiscal deficit targets should be redefined in terms of "structurally adjusted deficit", that allows flexibility from the initial deficit target to be factored in on account of unexpected changes in GDP growth. Its proposals for modification in the approach to the fiscal consolidation roadmap included revised accounting norms for equity investment as well as disinvestment and capitalisation of public sector banks under Basel III norms. Implementing these suggested changes, it pointed out, would require amendments to the FRBM Act.

Views of the Comptroller and Auditor General

14.42 The C&AG proposed measures to deepen the elements of FRBM reporting in order to enhance fiscal marksmanship. It pointed out the need for improvements in budgetary forecasts, efficient tax mobilisation and the cost of compliance. The outcome indicators on each of these could be incorporated in the FRBM Acts so as to clearly define the fiscal numerators as committed disclosures in the medium term fiscal plan.

Issues and Approach

14.43 Our ToR mandates us to look at the impact of debt levels on resource availability in debt-stressed States with the objective of not only balancing the revenue receipts and revenue expenditure of all the States and the Union, but also generating surpluses for capital investment. We have accordingly assessed the burden of public debt of States during the 2015-20 period. The assessment was made on the basis of fiscal accounts and also by adopting the extended definition of public debt in order to ensure comparability of debt stress among states.

14.44 The FC-XII defined debt sustainability in terms of debt-GDP ratio and also in terms of interest payments relative to revenue receipts. This was considered an easier target to follow, as both revenue receipts and interest payments are part of budgetary data which is readily available, as compared to GSDP data, which comes with a lag. It recommended that States should target interest payments as a proportion of revenue receipts at 15 per cent for 2009-10.

14.45 By the end of 2012-13, five States had an interest payments-revenue receipts ratio more than 15 per cent, seventeen had debt-GSDP ratio of more than 25 per cent and twelve had interest

payments-revenue receipts ratio of less than 15 per cent but with debt-GSDP ratio of more than 25 per cent. However, the debt sustainability position of States changes on extending the definition of debt, with a few States moving from a position of relative comfort to vulnerability, largely because of the drag of power sector losses. We note that there were varying degrees of fiscal stress among States and it is difficult to draw a line and categorise some as seriously debt stressed.

14.46 We have also considered the scope and feasibility of debt relief, keeping in view the nature of outstanding debt obligations of States. It was noticed that a large part of the debt of States has been through open market borrowings. Since these are in the nature of tradable bonds, they cannot be rescheduled or renegotiated in the current dispensation of financial markets. The National Small Savings is a category which, by itself, is not strictly a part of the debt obligation of the States to the Union Government. While, the debt that is owed to the Union Government is amenable to traditional measures of debt relief through rescheduling and write-offs, it needs to be noted that the outstanding debt of the States to the Union is not a very large part of the debt portfolio of State Governments. In view of this, we find that the scope for rescheduling debt is very limited, compared to the past when previous Commissions undertook such exercises.

14.47 We have also noted the view that any debt relief to debt-stressed States could be construed as penalising the States that were prudent in their fiscal management. We are of the view that the assessment of the fiscal needs of all States, including those with significant debt stress, should fully provide for interest payments to discharge their debt. Accordingly, in our forecast for our award period, we have provided in full for the interest payments to the States.

Fiscal Consolidation: Assessment and Issues

14.48 Our review shows that, at an aggregate level, States made significant improvements in complying with the FRBM targets prescribed by the FC-XII and FC-XIII. In the pre-crisis period, fiscal consolidation at the State level was aided by a number of factors, including implementation of state-level fiscal responsibility acts, debt waiver and restructuring recommended by Finance Commissions, and improvement in revenues on account of buoyancy of Central taxes and introduction of value-added tax (VAT) at the state level. Despite States experiencing pressure on their fiscal balances in the post-crisis period due to lower buoyancy of Central taxes and increased expenditure commitment due to the implementation of the recommendations of Pay Commissions, they largely continued to comply with the FRBM targets.

14.49 The aggregate debt and deficit indicators of all States are well within the target thresholds suggested by the FC-XIII. We, however, note that there are variations among States in fiscal consolidation when the debt sustainability is measured on a multiple indicator approach like debt as percentage of GSDP and interest payments relative to revenue receipts.

14.50 The weak combined fiscal position of the Union and States at present, in our view, is primarily due to the large fiscal deficit of the Union Government. The fiscal consolidation path for the Union Government that the FC-XIII laid down envisaged a reduction in the debt-GDP ratio from 54.2 per cent in 2009-10 to 44.8 per cent of GDP, bringing the fiscal deficit down to 3 per cent and eliminating the revenue deficit, all by the end of 2014-15. However, the Union Government amended the FRBM Act in 2012. Under the revised roadmap, it is to achieve a revenue deficit target of not more than 2 per cent of GDP by 31 March 2015 and a fiscal deficit

target of 3 per cent by 2017. The Union Government also introduced the concept of effective revenue deficit in 2012.

Quality of Fiscal Consolidation

14.51 Our ToR mandates us to recommend measures for "maintaining a stable and sustainable fiscal environment consistent with equitable growth", which makes it important to critically assess the fiscal adjustment process thus far, not just on the basis of achievement of quantitative fiscal targets, but also on the quality of consolidation. We note that the excessive focus on containing fiscal deficits by some States has resulted in constraining capital expenditures. In this context, we have considered the under-utilisation of borrowing headroom by most States and its impact on development spending, especially capital expenditure. At the same time, we are conscious that it is also important to consider the role of fiscal rules in ensuring fiscal stability and not encouraging over-borrowing given the challenging structural headwinds being faced by a few States.

14.52 An analysis of the budget documents of the Union and State Governments reveals imbalance between the budgetary allocations and the accumulated liabilities of incomplete and ongoing capital projects. Ministries at both the Union and State level routinely overreach themselves while making investment proposals. The delays in implementation and poor project management lead to cost and time overruns, impacting likely benefits accruing from capital investments in the form of higher per capita income and increased revenues to the governments. We are of the view that there is a need to curb the scope for perverse allocation of available funds among competing projects and to ensure that the economy benefits from investments in capital works by putting a statutory ceiling on the sanction of new capital works. This can be done by amending the FRBM Acts. We have noted that some States have already initiated action in this regard. **We recommend that the Union and the State Governments provide a statutory ceiling on the sanction of new capital works to an appropriate multiple of the annual budget provision.**

Approach to Fiscal Consolidation

14.53 The fiscal consolidation path drawn up by the FC-XIII envisaged a steady reduction in the augmented debt stock of the Union Government to 45 per cent of GDP by 2014-15 and that of the States to less than 25 per cent of GDP by the same period. The revenue deficit of the Union Government was to be progressively reduced and eliminated, followed by an emergence of revenue surplus by 2014-15. The State Governments were to bring down the fiscal deficit from 2.8 per cent in 2009-10 to 2.4 per cent of GDP in 2014-15 while the Union Government had to reduce its fiscal deficit from 6.8 per cent to 3 per cent. The consolidated fiscal deficit target was set at 5.4 per cent in 2014-15.

14.54 In our view, a uniform and rigid fiscal rule not only undermines the fiscal autonomy of the States, but also results in undesirable cuts in development expenditure in order to comply with numerical targets. The structural issues relating to fiscal imbalances in the Union Government as well as in some of the States do not get addressed through these rules alone. Acknowledging the asymmetry in the fiscal consolidation path at the Union and the State levels so far, we are proposing different rules and roadmaps and targets for the Union and State Governments. Keeping in view the fiscal position of the States and the need to provide headroom for the fiscally prudent ones, we have developed a multiple-indicator approach to fiscal consolidation.

14.55 We have also analysed the demand of the States for raising the limits on fiscal deficit by linking the fiscal consolidation path with the capital requirements and investment roadmap for each State. We recognise that there could be inter-state variations in the ability to utilise available resources due to a combination of a number of state-specific factors, including governance and administrative priorities, structural aspects of the implementation machinery and the characteristics of the intra-state resource transfer mechanisms. Investments for capital expenditure come through both borrowings and from revenue surpluses. Our tax devolution supplemented, where necessary, by grants-in-aid to cover any deficit, ensures that there will be no revenue deficit in any State while some will have surplus for investment so long as they follow a prudent fiscal policy. The States which have a revenue balance are well advised to make additional efforts to generate surpluses through better returns on investments made and through rationalising and reducing revenue expenditure. States which have a revenue surplus will, according to our assessment, have the additional headroom for investment along with the borrowing limit that is prescribed.

14.56 We have noted the suggestion of some States for a model which takes into consideration recent trends in fiscal consolidation and the overall accumulated debt and then adjust the fiscal deficit targets in line with the growth expectations each year. Keeping in view the parameters of debt sustainability and the medium term requirements of equitable and sustainable growth, we are of the opinion that the rigid application of uniform fiscal targets needs correction in our award period.

14.57 In our assessment, the basic parameters of fiscal consolidation adopted by the FC-XIII were reasonable and appropriate to our conditions. They have worked well as far as the States are concerned, though some operational flexibility has been desired by the States. They would have worked well for the Union Government also, but for the unforeseen external developments and, possibly, certain domestic policies. We, therefore, adopted an approach that is based on the parameters of the FC-XIII, but also builds on the experience gained.

14.58 We are aware that the FC-XIII had noted that macro-economic stabilisation and counter-recessionary actions are the primary responsibility of the Union Government, the core objective of which is 'the need to allow the fiscal system to adapt to exogenous shocks and/or changes in exogenous parameter values'. In this regard, the FC-XIII had made certain recommendations in respect of the FRBM Act and we note that some aspects were acted upon by the Union Government. We suggest that the Union Government take a comprehensive view on the above taking into account the global experience of legislation in this regard, Indian experience in the past, and the data and operational requirements for the purpose.

14.59 We consider the existing ceiling on the fiscal deficit of the Union Government at 3 per cent of GDP appropriate, but it may be able to achieve this by the end of 2016-17. The debt-GDP ratio of 45 per cent desired by the FC-XIII at the end of 2014-15 is also treated as an appropriate ceiling to start with. Given the FRBM target for the Union Government, the debt-GDP ratio should remain below this level. A realistic fiscal consolidation roadmap has to recognise that the desirable goal of eliminating the revenue deficit by 2019-20 may be difficult, but not impossible.

14.60 In respect of States, we have adopted the fiscal deficit threshold limit of 3 per cent of GSDP as fixed by the FC-XIII. We have treated the aggregate debt-GDP ratio of States and its

equivalent to GSDP, as determined by the FC-XIII, at 25⁹ per cent at the end of 2014-15 as a ceiling for all States in aggregate at end of 2019-20. Further, we are providing a year-to-year flexibility for additional borrowing to States. If the fiscal deficit of a State in a year falls short of the normal yearly limit of 3 per cent of GSDP, that State can borrow to the extent of the shortfall in the given year,¹⁰ provided it fulfils the eligibility conditions recommended. Similarly, if, for any reason, the fiscal deficit exceeds the normal 3 per cent in any given year, a downward adjustment needs to be done in the following year, except in cases where the State is otherwise eligible for the additional fiscal limit as per our recommendation. Finally, taking into account the development needs and the current macro- economic requirement, we are providing additional headroom to a maximum of 0.5 per cent over and above the normal limit of 3 per cent in any given year to the States that have a favourable debt-GSDP ratio and interest payments-revenue receipts ratio.

14.61 Thus, our approach to fiscal consolidation spells out the need for equitable growth and improvements in the quality of fiscal adjustment, with scope for headroom, where appropriate, for States to take recourse to fresh borrowings to finance developmental expenditures. For making the fiscal rules operational for the States, we have not proposed any conditionality in regard to adherence to the fiscal roadmap. We expect the Union Government to enforce the fiscal roadmap through the powers it has to approve any borrowing by the States during our award period under Article 293(3) of the Constitution.

Fiscal Rules

14.62 In the light of our approach to fiscal consolidation and the fiscal roadmap as developed through our assessment of Union and State finances, we recommend the following rules for the Union and the States.

14.63 For the Union Government, the ceiling on fiscal deficit will be 3 per cent of GDP from the year 2016-17 onwards up to the end of our award period. We expect that an improvement in the macroeconomic conditions and revival of growth as well as tax reforms (rationalisation of the tax structure on the direct taxes side and implementation of goods and services tax (GST) on the indirect taxes side) should enhance the total tax revenues of the Union Government, enabling it to eliminate the revenue deficit completely much earlier than 2019-20.

14.64 The fiscal deficit targets and annual borrowing limits for the States during our award period are enunciated as follows:

- i. Fiscal deficit of all States will be anchored to an annual limit of 3 per cent of GSDP. The States will be eligible for flexibility of 0.25 per cent over and above this for any given year for which the borrowing limits are to be fixed if their debt-GSDP ratio is less than or equal to 25 per cent in the preceding year.**
- ii. States will be further eligible for an additional borrowing limit of 0.25 per cent of GSDP in a given year for which the borrowing limits are to be fixed if the interest payments are less than or equal to 10 per cent of the revenue receipts in the preceding year.**

⁹ FC-XIII had recommended debt-GDP target of less than 25 per cent for the States by 2014-15.

¹⁰ 'given year' for the purpose of this Chapter is the year 't', for which the borrowing limits are to be fixed .

- iii. **The two options under these flexibility provisions can be availed of by a State either separately, if any of the above criteria is fulfilled, or simultaneously if both the above stated criteria are fulfilled. Thus, a State can have a maximum fiscal deficit-GSDP limit of 3.5 per cent in any given year.**
- iv. **The flexibility in availing the additional limit under either of the two options or both will be available to a State only if there is no revenue deficit in the year in which borrowing limits are to be fixed and the immediately preceding year.**

If a State is not able to fully utilise its sanctioned borrowing limit of 3 per cent of GSDP in any particular year during the first four years of our award period (2015-16 to 2018-19), it will have the option of availing this un-utilised borrowing amount (calculated in rupees) only in the following year but within our award period.

14.65 In this regard, some States wanted the current methodology for fixing borrowing limits, relying on the Finance Commission's assessment of GSDP, to be modified, as these limits are fixed in advance and may be subject to either favourable or adverse correction due to macro-economic developments. According to these States, this practice of determination of borrowing limit by the Union Government denies the States their rightful share of annual borrowing. We have examined the matter. While there is merit in this argument, we also recognise that there are difficulties in obtaining up-to-date GSDP data at the time that the annual borrowing programme of States is being determined, which is done in the year preceding the given year. The Central Statistical Office (CSO) publishes GSDP data series on a bi-annual basis on 1 March and 1 August of each calendar year, which provides actual estimates of GSDP for the year, $t - 2$, where t is the given year for which the borrowing limit is going to be fixed and $t - 1$ is the year in which decision is taken for fixing the borrowing limits.

14.66 In our view, the difficulties in obtaining up-to-date GSDP data can be overcome by adopting a practical and reasonable methodology that factors in the trends of recent years to arrive at a close proximate of the likely GSDP for arriving at the borrowing limit. **We recommend that for the purpose of assigning state-specific borrowing limits as a percentage of GSDP for a given fiscal year (t), GSDP should be estimated on the basis of the annual average growth rate of the actual GSDP observed during the previous three years or the average growth rate of GSDP observed during the previous three years for which actual GSDP data are available. This growth should be applied on the GSDP of the year $t - 2$. Specifically, GSDP for the year ($t-1$) and the given fiscal year (t) should be estimated by applying the annual average growth rate of GSDP in $t - 2$, $t - 3$ and $t - 4$ years on the base GSDP (at current prices) of $t - 2$. We recommend that State estimates of GSDP published by the CSO should be used for this purpose.**

14.67 In the case of the interest payments-revenue receipts ratio required for determining additional borrowing limits, we recommend that figures for both should be based solely on the Finance Accounts data for the year $t - 2$. The same procedure should be followed in estimating the debt-GSDP ratio. The Ministry of Finance should adhere to the above rules and methodology while determining the annual borrowing ceiling for individual States.

(To clarify matters and to remove ambiguity, illustrative working of the Rules is given through hypothetical examples in Volume II) (Annex 14.2)

Fiscal Roadmap

14.68 Adopting the approach to fiscal consolidation laid out in the preceding paragraphs and the assessment of revenues and expenditure of the Union Government in Chapter 6, we restrict its fiscal deficit to 3 per cent of the GDP from 2016-17 onwards. The consolidation path conforms to the FRBM Act of the Union Government and the Medium Term Fiscal Policy (MTFP) statement of 2014-15. In terms of our roadmap (Table 14.1), the debt stock of the Union Government should decline from 43.6 per cent for 2015-16 to 36.3 per cent of GDP in 2019-20. Based on our projections, the roadmap leaves a revenue deficit of 0.9 per cent in 2019-20 for the Union Government. Thus, the revenue deficit of the Union Government will decline but will not be eliminated by the terminal year.

14.69 We have observed that States, at an aggregate level, have not fully utilised the fiscal space (corresponding to 3 percent of GSDP for each State) available to them in the past. If States maintain a fiscal deficit of this level in each year of our award period,¹¹ according to our projections their debt-GSDP ratio would decline from 25.6 per cent in 2015-16 to 25.4 per cent in 2019-20. As a percentage of GDP, the debt of all States would decline from 21.7 per cent in 2015-16 to 21.6 percent in 2019-20.

14.70 Based on our approach, we have projected the roadmap for the States after factoring in the additional fiscal space they could avail during the 2015-20 period. Under the fiscal roadmap we have drawn for the States (Annex 14.1), at the aggregate level, the State's debt-GSDP ratio would increase from 25.9 per cent in 2015-16 to 26.3 per cent in 2019-20. As a percentage of GDP, debt stock would increase marginally from 21.9 per cent in 2015-16 to 22.4 per cent in 2019-20. Nevertheless, this would still remain well below the debt-GDP target of 24.3 per cent for States recommended by the FC-XIII for 2014-15. The combined fiscal deficit of States in our roadmap would reduce from 2.76 per cent of GDP in 2015-16 to 2.74 per cent of GDP in 2019-20. Thus, the aggregate fiscal deficit in our road map is marginally higher than the target of 2.4 per cent that the FC-XIII recommended. However, keeping in view the needs of the States and the macro-economic situation, the additional fiscal space will not affect the sustainability of debt during our award period. The ceilings under the fiscal flexibility recommendations are unlikely to be reached, as many States have, in the past, kept well below the statutorily set fiscal deficit target of 3 per cent of GSDP.

Table 14.1: Consolidated fiscal roadmap (2015-16 to 2019-20)

| | <i>(surplus (-) and deficit (+) (per cent of GDP)</i> | | | | |
|----------------------------------|---|----------------|----------------|----------------|----------------|
| | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20 |
| Revenue Deficit - Union | 2.56 | 2.25 | 1.79 | 1.36 | 0.93 |
| Revenue Deficit - States | -1.07 | -1.32 | -1.60 | -1.84 | -1.88 |
| Consolidated Revenue Deficit | 1.49 | 0.92 | 0.19 | -0.48 | -0.95 |
| Fiscal Deficit- Union | 3.60 | 3.00 | 3.00 | 3.00 | 3.00 |
| Fiscal Deficit - States | 2.76 | 2.77 | 2.77 | 2.73 | 2.74 |
| Consolidated Fiscal Deficit | 6.36 | 5.77 | 5.77 | 5.73 | 5.74 |
| Debt Stock - Union | 43.60 | 41.41 | 39.49 | 37.79 | 36.30 |
| Debt Stock - States | 21.90 | 22.06 | 22.21 | 22.30 | 22.38 |
| Outstanding Union Loan to States | 0.97 | 0.81 | 0.66 | 0.54 | 0.44 |
| Consolidated Outstanding Debt | 64.53 | 62.67 | 61.03 | 59.55 | 58.24 |

¹¹Corresponding to an aggregate fiscal deficit-GDP ratio of 2.5 percent in each year.

14.71 As per the assessment of the Union and State finances discussed in Chapters 6 and 7 respectively, the consolidated revenue surplus in 2019-20 would be 0.95 per cent. The consolidated fiscal deficit would decline from 6.4 per cent in 2015-16 to 5.7 per cent in 2019-20. The total consolidated outstanding debt would decline from 64.5 per cent to 58.2 per cent in 2019-20.

Implicit Capital Outlay

14.72 Our ToR requires us to make recommendations for generating surpluses for capital investment. On the basis of the fiscal road map we have drawn up, the capital outlay of the Union Government should increase from 1.6 per cent of GDP in 2015-16 to 2.9 per cent in 2019-20. If the Union Government eliminates the revenue deficit, the capital outlay in the terminal year of our projection should reach 3.8 per cent of GDP. Considering the aggregate revenue surplus of the states and assuming that the States would not have non-debt capital receipts, and adding the implicit capital outlay receipts of Union Government, the combined capital outlay should, at the minimum, be 7.5 per cent of GDP 2019-20.

14.73 All States taken together moved from a revenue deficit of 1.2 per cent in 2004-05 to a revenue surplus in 2013-14 (RE). Our assessment of State finances shows that eighteen states will have a revenue surplus from the start of our award period. Some States will get into revenue surplus during the award period and the remaining will be in revenue balance.

Table 14.2: Implicit Capital Outlay

(surplus (-) and deficit (+)
(per cent of GDP)

| | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20 |
|---|-------------|-------------|-------------|-------------|-------------|
| Union | | | | | |
| Revenue Deficit | 2.56 | 2.25 | 1.79 | 1.36 | 0.93 |
| Fiscal Deficit | 3.60 | 3.00 | 3.00 | 3.00 | 3.00 |
| Non-debt Capital Receipts | 0.61 | 0.65 | 0.70 | 0.76 | 0.82 |
| Implicit Capital Outlay | 1.64 | 1.40 | 1.90 | 2.40 | 2.90 |
| States | | | | | |
| Revenue Deficit | -1.07 | -1.32 | -1.60 | -1.84 | -1.88 |
| Fiscal Deficit | 2.76 | 2.77 | 2.77 | 2.73 | 2.74 |
| Implicit Capital Outlay | 3.83 | 4.09 | 4.37 | 4.57 | 4.61 |
| Consolidated Implicit Capital Outlay | 5.47 | 5.50 | 6.27 | 6.97 | 7.51 |

National Small Savings Fund

14.74 The FC-XIII recommended that loans to States from the NSSF contracted till 2006-07 and outstanding at the end of 2009-10 be reset at 9 per cent rate of interest and that the NSSF be reformed into a market-aligned scheme. However, the benefit of interest relief on NSSF to States was subject to necessary amendments/enactments carried out in the FRBM Acts, as recommended by the Commission. Consequent to the recommendations of the FC-XIII, the Union Government set up a "Committee on Comprehensive Review of National Small Savings Fund (NSSF)" in 2010. Based on the report of the Committee, the Union Government decided, among other things, that the mandatory component of investment of net small savings collections in State Government

securities be reduced from 80 per cent to 50 per cent and that the tenure of the loans be reduced from twenty-five years, including moratorium of five years, to ten years.

14.75 As we have noted earlier, States expressed concern regarding the rising liabilities on account of the NSSF and the involuntary nature of such borrowings. The suggestions they made in this regard included write-off of borrowings under NSSF or interest resetting. A study that we commissioned concluded that there is a serious mismatch between the income and expenses of the NSSF, with the interest earnings from the scheme being significantly lower than the liabilities.¹²

14.76 The study also observes that before the NSSF was constituted, the small savings receipts mobilised by the Union Government and on-lent to the States were treated as its capital expenditure and, accordingly, calculated in its gross fiscal deficit. Shortfalls in returns from loans to the Union Government out of small savings proceeds and the interest paid on small savings were calculated under its revenue deficit. After the constitution of the NSSF, however, the income deficit is not being reflected as a part of the Union Government's revenue deficit. This is because the NSSF operations are being accounted for within the Public Account, with outstanding balances under the NSSF being included under public account liabilities, instead of being accounted for as internal debt. The operational deficit, therefore, represents a defacto liability of the Union Government which remains unrecognised in the budget documents and for which the budget does not make any provision. This 'off-budget' nature of the NSSF operations renders them outside the regulatory framework of the FRBM Act, raising concerns of fiscal transparency and comprehensiveness.

14.77 It is note worthy that, according to the study, the NSSF operations combine several functions. These are: (a) sovereign debt management, involving financing through involuntary borrowings by States, (b) banking, outside the prudential norms applicable to commercial banking, (c) financial intermediation by the sovereign outside the fiscal accounts, (d) inter-governmental transfers, preventing full exposure of States to the market and (e) savings promotion. These operations are carried out in the absence of oversight by a financial sector regulator. Further, the study pointed out that direct public financing of public or private sector entities, such as lending to the India Infrastructure Finance Company Ltd. (IIFCL) from NSSF is also extraordinary. The study has also observed that the NSSF itself would need further review if post offices are allowed to function as payments banks, reducing the need for a separate NSSF outside the Consolidated Fund.

14.78 We note that the NSSF, in its present form, is characterised by several infirmities and has been under review by the Union Government. More recent developments in the financial sector, including licensing of payment banks in the private sector, make the future of the NSSF, in its present form, uncertain. The States have expressed several reservations about the scheme and are less than enthusiastic about their continued participation in it.

14.79 The FC-XII had recommended that the system of on-lending by the Union to the States should be phased out, thereby establishing the principle that it is normally not desirable for the Union Government to act as an intermediary for fulfilling any part of the borrowing requirements of the States. In substance, the NSSF model is essentially one in which the Union Government

¹² Liabilities include expenditure incurred on account of interest due to depositors; commissions due to the banks/agents; and remuneration due to the Department of Posts.

undertakes borrowings to further lend to the States. There is considerable merit in adopting the principle established by the FC-XII. We have, therefore, examined the future of NSSF in the light of concerns expressed by the States, the uncertain future of the NSSF and the implications of NSSF for sound federal fiscal relations.

14.80 We have noted the concerns expressed by the States and the suggestions they have made which amount to seeking either a virtual resetting of the existing debt obligations on this account or getting grants from the Union Government for offsetting a part of this burden. We, however, have not considered it appropriate to accept the suggestions made by some States for relief from the debt burden as any assessment of the burden, on account of this scheme, has to be viewed in the overall context of the debt burden of States with respect to all debtors.

14.81 We are, therefore, of the opinion that it would be appropriate to exclude the States from the operations of the scheme in future, even as they should honour the obligations already entered into insofar as servicing and repayment of outstanding debt is concerned. Accordingly, we recommend that State Governments be excluded from the operations of the NSSF, with effect from 1 April, 2015. This exclusion will not hamper the overall borrowing programme of the States in any manner, as they will continue to have access to open market borrowings. This arrangement would provide the Union Government greater flexibility in taking operational decisions on the future of the scheme, as well as freedom to manage it in the manner that it feels most appropriate. **As for the fiscal burden incurred in the course of the operations of the NSSF, prior to 1 April, 2015, since the scheme has been administered almost in its entirety by the Union Government, no part of this fiscal burden, incurred till that date, should be passed on to the States. We recommend that the involvement of the States in the NSSF scheme with effect from 1 April 2015, therefore, may be limited solely to discharging the debt obligations already incurred by them until that date.**

Consolidated Sinking Fund

14.82 The FC-X observed that the establishment of a sinking fund was desirable as a part of overall fiscal discipline and that the constitution of Consolidated Sinking Fund (CSF) for the amortisation of debt was relevant both for States and the Union. The logic of constituting a CSF for States was to enable them to tide over the roll-over risks due to their weak cash management practices and also State Development Loans being under-subscribed.

14.83 The CSF scheme was launched for State Governments in 1999-2000 to meet the redemption of market loans of States by contributing between 1 per cent and 3 per cent per annum of the outstanding open market loans as at the end of the previous financial year. A revised CSF scheme has come into effect since 2006-07. So far, twenty-one State Governments have constituted the CSF and the outstanding corpus stood at about Rs 60,000 crore in February 2014. The Union Government is yet to constitute a sinking fund.

14.84 In our view, CSF is an integral part of prudent fiscal management. The CSF creates a cushion to meet repayment obligations in times of fiscal/market stress, as it boosts investor confidence and thereby facilitates borrowing in the primary market at a reasonable cost even in normal times. Though there could be a trade-off between CSF investment and development expenditure in the very short-term, there is also a trade-off between roll-over risk and debt sustainability and development.

14.85 While the constitution of a CSF for the Union Government, as in the case of the States, could have a favourable impact on investor sentiments, we are conscious of the fact that it may not be viable when fiscal deficit is persisting, as the Union Government will have to borrow more to invest in the Fund, which would further push up fiscal deficit. **Keeping in view the experience of the States in this regard, we recommend the Union Government should examine the desirability of setting up of CSF at this stage.**

Fiscal Environment for Equitable Growth: A Shared Responsibility

14.86 We believe that fiscal management consistent with the fiscal roadmap we have set out would address the important issues relating to growth, equity and overall stability, particularly price stability and external sector stability. To discharge their obligations both the Union and the States should be fiscally empowered, separately and jointly. Such empowerment may warrant fiscal consolidation and improvement in the quality of fiscal management. Thus, the medium term framework for fiscal environment that we envisage is not mere consolidation, but prudent fiscal empowerment and the framework provides only quantitative, but binding, guidelines. The impact of growth equity and stability will depend significantly on the quality of fiscal transparency and fiscal management. **Recognising that the fiscal environment should be conducive to equitable growth, we recommend that the Union and all the States should target improving the quality of fiscal management encompassing receipts and expenditures while adhering to the roadmap we have outlined.**

14.87 Both the Union and the State Governments contribute to the country's fiscal environment, but the former has a greater role and responsibility in this area. The Union Government accounts for almost two-thirds of the consolidated revenues and debt. Its financial position is critical for external sector stability and the stability of the financial sector. Its fiscal management has significant implications for monetary and macroeconomic management. **We urge that all stakeholders recognise the predominant role of the Union in fiscal management, while considering our roadmap for the Union and the States that treats a conducive fiscal environment as the joint responsibility of both.**

14.88 We recognise that the FRBM framework at the Union and State level has brought about an improvement in the level of fiscal transparency, with a greater degree of publicly available information about government finances and budgetary processes. However, the measures taken thus far have to be further strengthened in order to ensure that the data available to the public is detailed, comprehensive, and accurate. In any case, we believe that it is critical to improve the quality, level and frequency of public data on the status of the debt of the Union and the States. At present, the Union Government publishes public debt management reports on different aspects of Union debt on a quarterly basis, and detailed reports on India's external debt thrice a year. Since 2010-11, it has also been bringing out an annual status paper on debt, covering different facets of debt of the Union and the States on a combined and disaggregated basis. More recently, the Union Government has started publishing an annual 'Handbook of Statistics on Central Government Debt'. We also note that the RBI puts out data on debt of State Governments and also reports on the debt of the Union Government, though there are some variations in the methodology of compilation between the Union government and the RBI. **To enable wider dissemination of the manner in which this shared responsibility for a conducive fiscal**

environment is being discharged by the Union and State Governments, we recommend that the Union Government and the RBI bring out a bi-annual report on the public debt of the Union and State Governments on a regular and comparable basis and place it in public domain.

A Review of FRBM Acts

14.89 Our review of Union and State finances in the period following the introduction of the FRBM framework indicates that rule-based fiscal legislation has been effective in enabling fiscal consolidation and improvement of fiscal management, particularly at the State level. However, as mentioned earlier, some challenges remain for the Union Government in adhering to the FRBM provisions.

14.90 We also see the point in the assertion by most States that the fiscal rules should apply equally to the Union Government and the States and the need for building disincentives in the FRBM Act for restraining the former from violating the fiscal rules. At the Union Government level, the challenges in achieving fiscal correction and adherence to rule-bound fiscal framework persist. The Union Government's FRBM Act came into effect in August 2003. It was amended in July 2004. Rules were modified twice over the years and were breached in practice. The conventional rule, as understood, of financing current expenditure by current revenue was discarded and an artificial concept of effective revenue deficit was introduced in the statute in 2012. We note that FRBM Rules in conducting the stated fiscal policy correction or fiscal adjustment path, as recommended by the FC-XIII, have not been effective, in the absence of hard budget constraints and any cost of non-compliance for the Union Government except for a threat of downgrade by sovereign rating agencies.

14.91 In the light of the experience gained so far, we conclude that the challenge is to design a basic incentive-compatible framework for the Union and State Governments to hold each other accountable over agreed fiscal targets. Accordingly, we stress the need for stronger mechanisms for ensuring compliance with fiscal targets and enhancing the quality of fiscal adjustment, particularly for the Union Government.

Effective Revenue Deficit

14.92 The ToR requires the Commission to consider the effect of receipts and expenditure in the form of grants for the creation of capital assets on the deficit, while making suggestions to amend the FRBM Acts currently in force. The Union Government amended the FRBM Act in 2012 by including the definition of an effective revenue deficit. The effective revenue deficit, as defined in the Act, is the difference between the revenue deficit and grants for the creation of capital assets. There is a further definition of grants for creation of capital assets to mean the grants-in-aid given by the Union Government to State Governments, Constitutional authorities or bodies, autonomous bodies, local bodies and other agencies implementing schemes for the creation of capital assets which are owned by the said entities. The amendment mandates the Union Government to take appropriate measures to reduce the fiscal deficit, revenue deficit and effective revenue deficit, in order to eliminate the effective revenue deficit by 31 March 2015 and thereafter build up adequate effective revenue surplus.

14.93 Under the Constitution, there are only two categories of expenditure- expenditure on the revenue account and other expenditure which is broadly expressed as capital expenditure. These

are shown separately in the budget for approval of legislatures. The artificial carving out of the revenue account deficit into effective revenue deficit to bring out that portion of grants which is intended to create capital asset at the recipient level leads to an accounting problem and raises the moral hazard issue of creative budgeting.

14.94 The FC-XIII examined in detail the existing classification of revenue and capital expenditure and, while recognising the revenue deficit as an approximation of current deficit, they considered it important to strictly follow the accepted definition of all the items that are to be treated as current (recurrent expenditure) in the economic classification of public expenditure. The Commission also stated that the existing classification of revenue and capital expenditure cannot be disturbed in an ad-hoc manner and has to be the result of a comprehensive study. Any disturbances of this classification, it was pointed out, would have wide-ranging implications for the finances of both the Union and the States.

14.95 In our view, the current definition of effective revenue deficit is unique and does not fit within international practices of classification of accounts/expenditure. A few State Governments, in their memorandum, argued that the States also be allowed to incorporate the concept of effective revenue deficit. We are not in favour of the continuance of the treatment of effective revenue deficit as a distinct concept. **We recommend that the Union Government should consider making an amendment to the FRBM Act to omit the definition of effective revenue deficit from 1 April 2015. We also recommend that the objective of balancing revenues and expenditure on the revenue account enunciated in the FRBM Acts should be pursued.**

Independent Fiscal Institution

14.96 The FC-XIII had recommended that the Union Government should institute a process of independent review and monitoring of the implementation of its own FRBM process, initially 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. It hoped that this committee would, over time, evolve into a full-fledged Fiscal Council and act as an autonomous body reporting to the Ministry of Finance, which would, in turn, report to Parliament on matters dealt with by the Council in accordance with current Constitutional provisions.

14.97 There is increasing recognition globally that the conduct of sustainable fiscal policy by governments and imparting greater realism to the forecasts (including testing their consistency with the fiscal rules) calls for the establishment of an independent fiscal institution which could undertake ex-ante assessment of the impact of fiscal policy and the fiscal implications of budget proposals. A number of countries have constituted fiscal councils to monitor fiscal policy calibration, particularly since 2005. These include the United States of America, Australia, Canada, the United Kingdom and Brazil. While the common agenda of these institutions is to promote sound fiscal policies as watchdogs, there is considerable diversity in their structure and the functions they are assigned to perform.

14.98 A common objective of these fiscal councils is to assist the national legislatures to monitor and evaluate the fiscal adjustment process and impart greater transparency to this process by objectively estimating the costs of various policies and programmes. The fiscal councils also enhance accountability to Parliament/Legislatures and the public at large in calibrating fiscal

policies. In addition, these institutions are also mandated to undertake objective and independent evaluation of budget forecasts in order to impart greater realism to budget formulation. Experience shows that such independent institutions may undertake ex-ante analysis and ex-post evaluation.

14.99 We have examined the status and potential usefulness of an independent fiscal council in India. While the Union Government has been generally able to enforce fiscal rules on the States, its own record of adherence to fiscal rules has not been impressive. Prima facie, recent experience invites our attention to the need for a fiscal council at the Union Government level. In an amendment to FRBM Act in 2012, a new Section 7A was inserted which requires the C&AG to conduct a periodic review of the compliance of the provisions of the FRBM Act by the Union Government. The Ministry of Finance, in its memoranda submitted to the Commission, has stated that the periodicity and scope of the C&AG review needs to be deliberated, keeping in mind the impact of fiscal policy on key macro-economic parameters as well as the efficacy of periodic review in the context of the economic growth cycle. The term 'review' appearing in Section 7A has not been defined. In this context, the 'review' that the C&AG can be entrusted with would only be an ex-post review.

14.100 We are of the view that it is important to have an ex-ante evaluation of the fiscal implications of the budget proposals and, therefore, believe that it is essential to establish an independent fiscal institution for this purpose. This could be done through the establishment of a fiscal council by an amendment to the FRBM Act, similar to the one that enables the ex-post assessment by the C&AG. The mission of the fiscal council would be to undertake ex-ante assessment of the fiscal policy implications of budget proposals and their consistency with fiscal policy and Rules. This institution should have the benefit of appropriate expertise, including getting its work done through outsourcing to reputed institutions. Similar to the provision under Section 7A of the FRBM Act, the newly-inserted section should provide that the assessment made by the fiscal council be tabled in both Houses of Parliament.

14.101 In the light of the above, we recommend an amendment to the FRBM Act inserting a new section mandating the establishment of an independent fiscal council on the lines indicated above to undertake ex-ante assessment of the fiscal policy implications of budget proposals and their consistency with fiscal policy and Rules. In addition, we urge that the Union Government take expeditious action to bring into effect Section 7A of the FRBM Act for the purposes of ex-post assessment.

Amendments to FRBM Acts and New Legislation

14.102 The fiscal roadmap we have drawn requires appropriate changes in the existing FRBM legislations in order to incorporate both flexibility and statutory binding commitments for the Union and the States, which have a shared responsibility for facilitating a fiscal environment for equitable growth, adherence to fiscal prudence and transparency in fiscal management for long term sustainability. **Our approach outlined and recommendations made warrant amendments to the FRBM Acts. To this end, we recommend that the State Governments may amend their FRBM Acts to provide for the statutory flexible limits on fiscal deficit. The Union Government may amend its FRBM Act to reflect the fiscal roadmap, omit the definition of effective revenue deficit and mandate the establishment of an independent fiscal council.**

Further, the Union and State Governments may also amend their respective FRBM Acts to provide a statutory ceiling on the sanction of new capital works to an appropriate multiple of the annual budget provision.

14.103 We were alerted to the possibility that, in future, no State may have debt outstanding to the Union Government, due to discontinuance of intermediation of loans as recommended by FC-XII. It was further pointed out that, in such an event, the Union would be deprived of its ability to enforce fiscal rules on the States under Article 293 (3) of the Constitution. We examined the relevant facts and observed that, as of now, this contingency will not arise up to 2030, except in respect of two States where it will arise by 2025. It is, thus, clear that this issue will not become relevant during our award period.

14.104 In light of the above and the experience gained in recent years, we urge the Union Government to continue to exercise its powers under Article 293 (3), in an effective but transparent and fair manner, enforcing the fiscal rules consistent with the fiscal consolidation road map suggested by us for the award period.

14.105 We deliberated on the advisability of a new legislation being enacted by the Union to replace the existing FRBM Act. We noted that Article 292¹³ of the Constitution envisages¹⁴ such fiscal responsibility in the form of enactment of a legislation imposing a ceiling on debt. We also note that the C&AG¹⁵ referred to the suggestions made in several reports of the Public Accounts Committee and the Estimates Committee of the Parliament in this regard, and commented that the Union Government had not acted on the recommendations.

14.106 We further note that the FRBM Act currently in force is implicitly consistent with Article 292 of the Constitution. An explicit invoking of Article 292 may, in our view, accord greater sanctity and legitimacy to fiscal management legislation. **We, therefore, urge the Union Government to replace the existing FRBM Act with a Debt Ceiling and Fiscal Responsibility Legislation, specifically invoking Article 292 in its preamble. This could be an alternative to amending the existing FRBM Act as proposed by us. We urge the State Governments also to consider similar enactments under Article 293(1)¹⁶.**

¹³Art. 292 - The executive power of the Union extends to borrowing upon the security of the Consolidated Fund of India within such limits, if any, as may from time to time be fixed by Parliament by law and to the giving of guarantees within such limits, if any, as may be so fixed.

¹⁴ 'I therefore think that from all points of view this article 268 as it stands is sufficient to cover all contingencies and I have no doubt about it that, as my friend Mr. Ananthasayanam Ayyangar said, we hope that Parliament will take this matter seriously and keep on enacting laws so as to limit the borrowing authority of the Union. I go further and say that I not only hope but I expect that Parliament will discharge its duties under this article.' (Dr. Ambedkar in the Constituent Assembly - 10-8-1949). It may be noted that Article 268 in his remarks corresponds to Article 292 of the Constitution.

¹⁵ Report on Union Government accounts 2000-01, paragraph 5.5.

¹⁶Articles 293(1), 293(2) and 293(3) contain similar provisions in regard to the States, as below:

293. (1) Subject to the provisions of this article, the executive power of a State extends to borrowing within the territory of India upon the security of the Consolidated Fund of the State within such limits, if any, as may from time to time be fixed by the Legislature of such State by law and to the giving of guarantees within such limits, if any, as may be so fixed.

(2) The Government of India may, subject to such conditions as may be laid down by or under any law made by Parliament, make loans to any State or, so long as any limits fixed under article 292 are not exceeded, give guarantees in respect of loans raised by any State, and any sums required for the purpose of making such loans shall be charged on the Consolidated Fund of India.

(3) A State may not without the consent of the Government of India raise any loan if there is still outstanding any part of a loan which has been made to the State by the Government of India or by its predecessor Government, or in respect of which a guarantee has been given by the Government of India or by its predecessor Government.

Recommendations

- i. Keeping in mind the importance of risks arising from guarantees, off-budget borrowings and accumulated losses of financially weak public sector enterprises when assessing the debt position of States, we recommend that both Union and State Governments adopt a template for collating, analysing and annually reporting the total extended public debt in their respective budgets as a supplement to the budget document. (para 14.24)
- ii. To curb the scope for perverse allocation of available funds among competing projects and to ensure that the economy benefits from investments in capital works, we recommend that the Union and the State Governments provide a statutory ceiling on the sanction of new capital works to an appropriate multiple of the annual budget provision. (para 14.52)
- iii. In the light of our approach to fiscal consolidation and the fiscal roadmap as developed through our assessment of Union and State finances, we recommend a set of rules for the Union and the States. (para 14.62)
- iv. For the Union Government, the ceiling on fiscal deficit will be 3 per cent of GDP from the year 2016-17 onwards up to the end of our award period. We expect that an improvement in the macroeconomic conditions and revival of growth as well as tax reforms (rationalisation of the tax structure on the direct taxes side and implementation of goods and services tax (GST) on the indirect taxes side) should enhance the total tax revenues of the Union Government, enabling it to eliminate the revenue deficit completely much earlier than 2019-20. (para 14.63)
- v. The fiscal deficit targets and annual borrowing limits for the States during our award period are enunciated as follows:
 - i. Fiscal deficit of all States will be anchored to an annual limit of 3 per cent of GSDP. The States will be eligible for flexibility of 0.25 per cent over and above this for any given year for which the borrowing limits are to be fixed if their debt-GSDP ratio is less than or equal to 25 per cent in the preceding year.
 - ii. States will be further eligible for an additional borrowing limit of 0.25 per cent of GSDP in a given year for which the borrowing limits are to be fixed if the interest payments are less than or equal to 10 per cent of the revenue receipts in the preceding year.
 - iii. The two options under these flexibility provisions can be availed of by a State either separately, if any of the above criteria is fulfilled, or simultaneously if both the above stated criteria are fulfilled. Thus, a State can have a maximum fiscal deficit-GSDP limit of 3.5 per cent in any given year.
 - iv. The flexibility in availing the additional limit under either of the two options or both will be available to a State only if there is no revenue deficit in the year in which borrowing limits are to be fixed and the immediately preceding year.

If a State is not able to fully utilise its sanctioned borrowing limit of 3 per cent of GSDP in any particular year during the first four years of our award period (2015-16 to 2018-19), it will have the option of availing this un-utilised borrowing amount (calculated in rupees) only in the following year but within our award period. (para 14.64)

- vi. We recommend that for the purpose of assigning state-specific borrowing limits as a percentage of GSDP for a given fiscal year (t), GSDP should be estimated on the basis of the annual average growth rate of the actual GSDP observed during the previous three years or the average growth rate of GSDP observed during the previous three years for which actual GSDP data are available. This growth should be applied on the GSDP of the year $t - 2$. Specifically, GSDP for the year ($t - 1$) and the given fiscal year (t) should be estimated by applying the annual average growth rate of GSDP in $t - 2$, $t - 3$ and $t - 4$ years on the base GSDP (at current prices) of $t - 2$. We recommend that State estimates of GSDP published by the CSO should be used for this purpose. (para 14.66)
- vii. In the case of the interest payments-revenue receipts ratio required for determining additional borrowing limits, we recommend that figures for both should be based solely on the Finance Accounts data for the year $t - 2$. The same procedure should be followed in estimating the debt-GSDP ratio. The Ministry of Finance should adhere to the above rules and methodology while determining the annual borrowing ceiling for individual States. (para 14.67)
- viii. We are of the opinion that it would be appropriate to exclude the States from the operations of the NSSF scheme in future, even as they should honour the obligations already entered into insofar as servicing and repayment of outstanding debt is concerned. We recommend that State Governments be excluded from the operations of the NSSF, with effect from 1 April, 2015. As for the fiscal burden incurred in the course of the operations of the NSSF, prior to 1 April, 2015, since the scheme has been administered almost in its entirety by the Union Government, no part of this fiscal burden, incurred till that date, should be passed on to the States. We recommend that the involvement of the States in the NSSF scheme with effect from 1 April 2015, therefore, may be limited solely to discharging the debt obligations already incurred by them until that date. (para 14.81)
- ix. Keeping in view the experience of the States in this regard, we recommend the Union Government should examine the desirability of setting up of Consolidated Sinking Fund at this stage. (para 14.85)
- x. Recognising that the fiscal environment should be conducive to equitable growth, we recommend that the Union and all the States should target improving the quality of fiscal management encompassing receipts and expenditures while adhering to the roadmap we have outlined. (para 14.86)
- xi. We urge that all stakeholders recognise the predominant role of the Union in fiscal management, while considering our roadmap for the Union and the States that treats a conducive fiscal environment as the joint responsibility of both. (para 14.87)

- xii. To enable wider dissemination of the manner in which this shared responsibility for a conducive fiscal environment is being discharged by the Union and State Governments, we recommend that the Union Government and the RBI bring out a bi-annual report on the public debt of the Union and State Governments on a regular and comparable basis and place it in public domain. (para 14.88)
- xiii. In the light of the experience gained so far and considering the challenge in designing a basic incentive-compatible framework for achieving fiscal correction and adherence to rule-bound fiscal framework for the Union and State Governments to hold each other accountable over agreed fiscal targets, we stress the need for stronger mechanisms for ensuring compliance with fiscal targets and enhancing the quality of fiscal adjustment, particularly for the Union Government. (para 14.91)
- xiv. We recommend that the Union Government should consider making an amendment to the FRBM Act to omit the definition of effective revenue deficit from 1 April 2015. We also recommend that the objective of balancing revenues and expenditure on the revenue account enunciated in the FRBM Acts should be pursued. (para 14.95)
- xv. We recommend an amendment to the FRBM Act inserting a new section mandating the establishment of an independent fiscal council to undertake ex-ante assessment of the fiscal policy implications of budget proposals and their consistency with fiscal policy and Rules. In addition, we urge that the Union Government take expeditious action to bring into effect Section 7A of the FRBM Act for the purposes of ex-post assessment. (para 14.101)
- xvi. Our approach outlined and recommendations made warrant amendments to the FRBM Acts. To this end, we recommend that the State Governments may amend their FRBM Acts to provide for the statutory flexible limits on fiscal deficit. The Union Government may amend its FRBM Act to reflect the fiscal roadmap, omit the definition of effective revenue deficit and mandate the establishment of an independent fiscal council. Further, the Union and State Governments may also amend their respective FRBM Acts to provide a statutory ceiling on the sanction of new capital works to an appropriate multiple of the annual budget provision. (para 14.102)
- xvii. We urge the Union Government to continue to exercise its powers under Article 293 (3), in an effective but transparent and fair manner, enforcing the fiscal rules consistent with the fiscal consolidation roadmap suggested by us for the award period. (para 14.104)
- xviii. In order to accord greater sanctity and legitimacy to fiscal management legislation, we urge the Union Government to replace the existing FRBM Act with a Debt Ceiling and Fiscal Responsibility Legislation, specifically invoking Article 292 in its preamble. This could be an alternative to amending the existing FRBM Act as proposed by us. We urge the State Governments also to consider similar enactments under Article 293(1). (para 14.106)