CHAPTER XII

# DEBT POSITION OF STATES

## Introduction

**12.1** We are required, under Paragraph 8 of the Presidential Order, to make 'an assessment of the debt position of States as on 31st March, 1994, and suggest such corrective measures as are deemed necessary keeping in view also the financial requirements of the Centre'. However Para 4(iii) of our terms of reference requires us to have regard to the maintenance and upkeep of capital assets as on 31st March, 1995 . Many States have also suggested that the relevant date for the assessment of their debt position should be the same. In line with our approach we shall endeavour to make an assessment of the debt position of the States as on 31st March, 1994 as well as 1995.

**12.2** Our terms of reference regarding the debt position of States would bear comparison with those of earlier Commissions in several respects. Like the Ninth Commission we have been asked to review the debt position of the States with respect to their entire debt and not merely for Central loans to States. Further, the Sixth, Seventh and Eighth Commissions were asked to consider the non-plan capital gap while considering the debt position of States, and to suggest measures to deal with those gaps. The Ninth Commission, like us, were not so asked although they did keep an assessment of the non-plan capital gap of the States in the background of their considerations (Para 9.11 of the Second Report). In the context of "corrective measures", our terms of reference differ from those of the Ninth . Whereas a specific reference was made to them to consider investments made in infrastructure projects and to provide a 'linkage with improvements in financial and managerial efficiency' in suggesting corrective measures, there is no such reference to us.

**12.3** In para 4(i) of our terms of reference, a reference has been made to 'reducing fiscal deficit'. Fuelled by rising fiscal deficits, the indebtedness of the Central and State Governments has continued to rise. While considering the indebtedness of States, the appropriate perspective is, in fact, the indebtedness of the entire fiscal system. As such, in designing a suitable policy for alleviating the debt burden of the States, the debt position of the States as well as that of the Centre has to be kept in mind.

**12.4** The Ninth Commission (Paras 9.12 and 9.29) noted with concern the state of indebtedness of the States which appeared to be sliding into a vicious cycle. Loans are advanced to States with specific maturity periods and rates of interest. Finance Commissions subsequently recommend corrective measures, often across the board, consisting of write-offs, extensions of maturity periods, and lowering of interest rates, thus converting loans effectively into grants, partially or fully. Periodically repeated debt relief exercises may induce States to overstate their demand for borrowed funds. Corrective measures should, therefore, be formulated in a manner as would provide an in-built incentive for prudent use of borrowed funds.

## Debt Position of States

**12.5** Total debt of State Governments is estimated to rise from Rs 1,83,886 crores as on 31st March, 1994 to Rs. 2,09,159 crores as on 31st March, 1995. The stock of debt and its composition at the end of these two years is placed at Annexures XII.1 and XII.2. Loans from the Central Government account for 54.31 and 53.74 per cent of the outstanding debt, for 1994 and 1995 respectively. The shares of market loans and bonds, and those of provident funds, etc. come to 13.4 and 15.7 per cent for 1994 and to 17 and 15.8 per cent in 1995.

**12.6** In assessing the overall debt position of States, previous Finance Commissions have followed the practice of excluding the short-term components of debt. In keeping with this practice, for purposes of comparison, the profile of estimated debt of State Governments, excluding ways and means advances from the Reserve Bank of India and reserve funds, is drawn in Table 1.

**12.7** Loans for State plans and small savings account for 97.6 per cent of the total central loans to States during 1989-1994 as at Table 2. The Statewise position of outstandings with respect to loans in the above period and the repayments during 1995-2000 is at Annexures XII.3 and XII.4.

### Table 1

**Outstanding Long Term Debt of State Governments**

*(Amount in Rs.Crores)*

| | 1989 | | 1994 | | 1995 Estimates | |
|---|---|---|---|---|---|---|
| | Amount | % | Amount | % | Amount | % |
| 1. Internal Debt | | | | | | |
| a) Market Loans | 10839 | 13.43 | 24629 | 15.69 | 35585 | 19.66 |
| b) Loans from Banks | 1759 | 2.18 | 3774 | 2.40 | (*) | (*) |
| 2. Loans from Centre | 55648 | 68.93 | 99867 | 63.58 | 112395 | 62.09 |
| 3. Provident Funds etc. | 12487 | 15.46 | 28791 | 18.33 | 33029 | 18.25 |
| **Total** | **80733** | **100.00** | **157061** | **100.00** | **181009** | **100.00** |

### Table 2

**Outstanding Central Loans Advanced to States during 1989-94 and Repayments in 1995-96 to 1999-2000**

*(Rs. crores)*

| Items | Outstandings as on 31.3.1994 | Repayments due during 1995-2000 |
|---|---|---|
| 1. Plan Loans | | |
| (i) State Plan | 28786.89 | 6481.00 |
| (ii) Drought Loans | 14.35 | 6.28 |
| (iii) Others | 141.49 | 61.71 |
| (iv) Central Sector | 162.97 | 43.97 |
| (v) Centrally Sponsored schemes | 659.59 | 256.63 |
| **Total Plan Loans** | **29765.29** | **6849.59** |
| 2. Small Savings Loan | 26462.56 | 4392.20 |
| 3. Modernisation of Police | 29.93 | 6.75 |
| 4. Housing for All India Services | 23.84 | 13.99 |
| 5. Others | 305.28 | 55.80 |
| **Total (2 to 5)** | **26821.61** | **4468.74** |
| ***Grand Total*** | ***56586.90*** | ***11318.33*** |

* *Details not available*

**12.8** The share of Central loans in the total debt of State Governments has been steadily declining as may be seen at Annexure XII.5. In 1979 the share of Central loans was 71.7 per cent of the total long-term debt of the States. By 1995, this share is estimated to decline to about 62 per cent, which is reflected in the increasing share of internal debt and that of provident funds, the relative increase of the latter category being somewhat higher. On the whole, therefore, for their long-term debt State Governments have been gradually shifting towards higher-cost sources.

**12.9** The high income States (Punjab, Maharashtra, Gujarat, Haryana and Goa) currently account for slightly more than a quarter of the outstanding debt for all States as shown at Annexure XII.6. Their share has been increasing steadily over time. The share of low income States has held steady at just above 38 per cent. As such, the increase in the share of debt of the high income States is reflected basically in decreases in the shares of middle income States and special category States. Looking at the movements of the shares of individual States in each category, four out of five in the high income group, Haryana being the exception, have increased while among the low income States, the share of four has declined , Uttar Pradesh being the exception.

**12.10** Financing plan outlays continues to constitute the core of the borrowing requirements of States, although in recent years many States have been forced to borrow even to meet part of their revenue expenditure. To the extent borrowed funds are not utilised for productive investments, a future stream of income cannot ensue from them, enabling the States to meet servicing liabilities arising from the debt. States have resorted to loans in order to finance investments in social and economic infrastructure, where the returns are not necessarily direct or immediate and are characterised by considerable externalities. The disturbing features of the debt profile of States and its management appear to be the following :

i) diversion of borrowed funds for meeting revenue expenditure;

ii) use of loans in unproductive enterprises, or enterprises which are potentially productive but are beset by poor performance, and currently yielding low or even negative returns;

iii) non-provision for depreciation or amortisation funds in respect of government owned assets, leading to repayments out of fresh borrowing.

**12.11** With growing repayment obligations, the ratio of fresh loans taken on a gross basis, and funds that actually become available net of repayments, is bound to move adversely with smaller and smaller amounts being available as net borrowed funds. Central loans, whether for plan assistance or otherwise, are determined on a gross basis, leading to a gradual decline in the net amounts on account of the heavy repayment burden, because other sources for these repayments are not generally available. On the other hand, gross market borrowing by a State has been so managed by the Reserve Bank of India as to ensure availability of predetermined amounts for the States net of repayments.

**12.12** With the outstanding internal and external debt and other liabilities of the Government of India estimated at Rs.5,32,753.22 crores at the end of 1994-95, which by itself represents a 12.96 per cent increase over the revised estimates for the previous year , the debt/gdp ratio for the Centre and the States works out to nearly 69 per cent.

## Views of States on Debt Relief

**12.13** With respect to the existing liabilities, States have generally been asking for write-off of their debt, extension of maturity periods and reduction in interest rates. In relation to fresh borrowing, they have advocated a larger ratio of grants in the Central plan assistance, changing the grant to loan ratio from 30:70 to 50:50 for non-special category States and from 90:10 to 100:0 for the special category States.

**12.14** States have also reiterated their long-standing demand that loans based on small savings be converted into loans in perpetuity and that 90 to 100 per cent of the net collections of small savings be given to the States as loans. It is also suggested that States be allowed to raise small savings and retain them. Treating loans from Central financial institutions as loans in perpetuity, has also been asked for.

**12.15** Among the other suggestions of the States, the following may be highlighted:

- that the grant component for externally aided projects be 70 per cent ;
- that Central loans used directly for non-productive purposes (e.g. public works, roads, bridges, education) be written off;
- that loans used for semi-productive purposes like housing, multi-purpose river schemes, power projects, be made repayable in 30 years;
- that loans for natural calamity and socially desirable but financially unremunerative schemes be written-off;
- that differential rates of interest be charged according to the purpose of the loan and the economic backwardness of a State;
- that previous loans be consolidated as on 31st March, 95 and then 50 per cent of these be written-off, and a fresh interest rate of 8 per cent be charged on the remaining balance after determining a new maturity period allowing for an initial grace period; and
- that relief be especially provided for the backward States.

**12.16** The issue that there exists now a reverse flow of funds from the States to the Centre, and that this should be stopped has also been raised. In this context, it has been urged that the non-plan capital gap be considered while making an assessment of the debt position, and that a ceiling be fixed so that repayment of principal and interest does not exceed 20 per cent of own revenues.

**12.17** States which have been formed more recently, i.e. Goa, Mizoram, and Arunachal Pradesh, have urged that their pre-Statehood loans be written off entirely. Many of the special category States want all of their outstanding loans written off. States have asked for greater latitude in raising loans. In particular, it is suggested that like the Centre, States should be allowed to issue tax-free bonds .

## Views of the Central Government

**12.18** Considering the fiscal system as a whole any debt relief measures for the States would automatically affect the Centre. In its memorandum , the Central Government has stated that re-scheduling of debt and write-offs of interest recommended by the earlier Commissions have at least partly been responsible for the rise in Central debt and consequently the burden of increased interest payments. In our meeting with the Ministry of

Finance, it was pointed out that the burden of interest payments must be appreciated with reference to i) the difference in the rates at which the Centre borrows and lends, ii) administrative expenses and iii) implicit costs of tax incentives.

**12.19** The memorandum notes that the resources of States have grown on both the revenue and capital account. Revenues accruing to the States have gone up from 8.2 per cent of GDP to 12.7 per cent over the period 1974-75 to 1991-92. A large part of the increase in the combined Central and State revenues over this period has accrued to the States. Their gross capital receipts as well as fiscal deficit have grown fairly fast. It calls for a plan to bring down the ratio of debt of State Governments to GDP which includes reduction of fiscal deficit, retirement of debt out of the proceeds of loan recoveries, and sale of equity holdings of States in public enterprises.

**12.20** The Central Government has urged us not to reschedule the debts of State Governments as it is no longer in a position to bear any additional burden and rescheduling would inevitably lead to a reduction in future lending by the Centre.

**12.21** There is merit in the argument that with both tiers of government under considerable fiscal strain, the transfer of burden from one channel of the fiscal flows would sooner or later be adjusted through another. It is futile merely to shift the debt from one to the other since it will make no dent on the aggregate fiscal deficit of the system. Any relief given to the States should thus be so formulated as to make an impression on the basic fiscal malaise of revenue expenditures persistently exceeding revenue receipts.

## Corrective Measures

**12.22** The constraints on the fiscal system put limits on the extent of debt relief that can be organised in the medium-term perspective. In the long run there is no escape from the rule that the rate of return on borrowed funds must be greater than the rate of interest at which they are held. The appropriation of a part of borrowing for consumption makes the need for earning an adquate return on investments in productive enterprises that much greater.

**12.23** At the same time, States which are under severe fiscal pressure, need to be helped. Similarly, several specific problems relating to debt management and relief need to be addressed. In general, we have considered relief measures keeping in view the following objectives viz.

i) that the quantum of relief is limited ;

ii) that priority is given to States under severe fiscal strain ; and,

iii) that incentives are given for better fiscal management.

**12.24** We now consider the following :

Plan Loans;

Small Savings Loans; and

Amortisation Funds.

**12.25** Loans advanced by the Centre by way of assistance to finance State plans constitute the bulk of Central loans to States. The burden of debt servicing of States on this account has gone up with the progressive increase in plan outlays and the rise in interest rates as indicated in Annexure XII.7

**12.26** States have reiterated their demand that loans against small savings be treated as loans in perpetuity. The present arrangements entitle States to a 75 per cent share of the net collections under various small savings schemes, to be given to them by the Central Government as a loan for use for development purposes. A State may also get an additional 2.5 per cent share provided the net collections in the State as a percentage of gross collections exceed the corresponding percentage for the country by more than 5 per cent. States are also entitled to a 50 per cent share of the net collections under the deposit scheme for retiring employees of Government and Public Sector Undertakings. The repayment period for small savings loans advanced to the States is 25 years inclusive of an initial moratorium period of five years towards repayment of the principal. The current rate of interest on the small savings loans is 14.5 per cent. We note that the rate of interest on small savings loans to the States has been increasing steadily over time, as indicated in Annexure XII.8

**12.27** States argue that since their entitlement to a loan against small savings is worked out on the basis of net collections under the small savings scheme, the Union government should not insist on repayments. The loan should be treated as a loan in perpetuity, as the Central Government is able to make the repayments from the gross collections. It is argued that the small savings actually belong to States and the role of the Centre is only to ensure economies of scale through Central management.

**12.28** On the other hand, the Central Government has argued that :

i) while State Governments make the repayment in 25 years, the Central Government repays to the investor in 5 to 6 years;

ii) while the Central Government services the repayments out of gross fresh borrowings, it does so at increasing costs; and

iii) the effective interest costs to the Centre are much higher when administrative costs and tax losses due to incentives for small savings provided in the tax statutes are also taken into account.

**12.29** According to the Sixth Commission, these loans have been given to the States largely as inducement to join the Centre in a cooperative effort to mobilise small savings, and that treating them as loans in perpetuity would confer disproportionately larger benefits on some of the advanced States and defeat the crucial objective of any properly designed scheme of debt relief.

**12.30** The Seventh Commission had recommended that the small savings loans outstanding against each State at the end of 1978-79 may be consolidated into one loan and treated as a loan in perpetuity. This recommendation was not accepted by the Government of India although it did concede that the States would not be required to make any repayment during 1979-84 on account of small savings loans outstanding at the end of 1978-79. Apart from waiving repayments for 1984-85, the Eighth Commission did not recommend any further relief or change in the arrangements with respect to the small savings loans. The Ninth Commission also did not recommend any change in the terms and conditions relating to these loans.

**12.31** We have examined this question afresh. We find that net amounts available under small savings schemes have been falling in recent years. From a peak of 50 percent, net collections as a percentage of gross collections have fallen to about 25 per cent. The amounts retained by the Centre net of interest payments and administrative charges indicate that this source contributes only marginally to its funds.

**12.32** Small savings schemes have to be run jointly by the Centre and the States in order that the benefits of economies of scale are reaped, that all States are able to participate and that investors feel protected. It follows that the liability of repayment ought to be shared. Further, if the small savings loans were to be treated as loans in perpetuity, it may mean a rising burden of interest on States in perpetuity. For all these reasons, we do not favour these loans being treated as loans in perpetuity.

**12.33** The burden of repayments can be much better borne if amortisation funds at the State level are set up in respect of investments in the government sector. Otherwise the present situation of borrowing to meet repayment obligations would continue since recoveries of loans and advances and net miscellaneous capital receipts of the State Governments can contribute only marginally towards repayments.

**12.34** The Ninth Commission had recommended an arrangement for amortisation in respect of market borrowings, and the Reserve Bank of India was asked to work out the modalities. While no final decision has been taken on the recommendation, in its Annual Report for 1992-93 (page 115), the Reserve Bank of India observed that : "Consideration could be given to setting up a States' Funding Corporation which would raise funds at market related rates of interest and pass on the funds at fixed rates to the states..." and further, "....with the shortening of the maturity structure of Governmental borrowing, the repayment schedules can give discomfort and, therefore, the restoration of the erstwhile system of a consolidated sinking fund for redeeming the debt has been long overdue...". Although, the context in which the Reserve Bank of India has considered this issue is that of market loans to the States, a similar situation would appear to have arisen about Central loans . Establishment of sinking funds now appears to be desirable as a part of overall fiscal discipline. Such funds would, however, not be able to serve their purpose unless the amounts appropriated to them are held separately by the Reserve Bank of India, and are not available as a Ways and Means resource to the State. We recommend that the modalities should be worked out by the Reserve Bank of India expeditiously.

## Quantum and Forms of Debt Relief

**12.35** Debt-related relief to States may be provided in many forms, e.g., write-off of the loan or of repayments falling due during a specified period, rescheduling of the loans with a view to shifting the timing of repayments, consolidation of past loans on common terms and reduction of interest rate The Eighth Commission had recommended a debt relief of Rs.2,285 crores for the period 1984-89 . The Ninth Commission recommended a relief of Rs.494 crores for the period 1990-95. The Commission argued that since they were not dealing with the non-plan capital gap, their focus was narrower than that of the Eighth Commission. Also, their overall approach was to discourage the periodic write-off of debt. For all debt relief measures taken together, the quantum of relief recommended by the Ninth Commission was Rs.975.62 crores. In view of the fact that many of the relief measures recommended by the previous Finance Commissions continue to be operative, any further relief should be viewed as only incremental in nature, and the amounts involved would necessarily be limited.

## Relief and Corrective Measures

**12.36** Our scheme for debt relief, has two parts :

i) a scheme for general debt relief for all States linked to fiscal performance ; and

ii) specific relief for States with high fiscal stress, special category States and States with debt problems warranting special attention.

**12.37** This is in addition to a scheme for encouraging retirment of debt from the proceeds of disinvestment of equity holdings of State Governments (Chapter III para 3.20 ). Relief, in this scheme, is linked to the use of funds for the reduction of outstanding debt. We believe that this would make a tangible impression on the debt burden of the States.

**12.38** As an incentive to better fiscal management, we have designed a scheme which links debt relief to the fiscal performance of a State. We measure improvement of fiscal performance by comparing the ratio of revenue receipts (including devolution and grants from the Centre) to total revenue expenditures in a given year (r) with the average of corresponding ratios (r*) in the three immediately preceding years. Thus each State would be considered against its performance in the past. We suggest that generalised debt relief may take the form of a certain percentage of repayment falling due in each year of the period of our recommendations being written off. Only those repayments as pertain to fresh central loans to the States during 1989-95 and as outstanding on 31st March, 1995 would be covered. This percentage (R) should be twice the excess of (r) over (r*) as defined above. The details of this scheme are given in Appendix 6.

**12.39** We now come to specific relief for all special category States, and three other States, viz. Orissa, Bihar and Uttar Pradesh, which are characterised by high fiscal stress as indicated by an average ratio of interest payments to revenue expenditure exceeding 17 per cent during 1989-90 to 1993-94. For these States we recommend writing-off of 5 per cent of repayment due with respect to fresh central loans given during 1989-95 and outstanding on 31st March, 1995.

## Special Loans to Punjab

**12.40** An amount of Rs. 1471.90 crores is due for repayment during 1995-2000 by the Punjab Government on account of special term loans which were advanced to it to fight militancy and insurgency. These repayment liabilities refer to an outstanding amount of Rs.5522 crores as on 31st March,1994 as indicated to us by the State Government. In view of the special circumstances when these loans were advanced, and the need for the State to re-invigorate its development efforts, it is recommended that one third of the repayment of principal falling due during 1995-2000 on these special term loans be waived. The estimated amount of relief would be Rs. 490.63 crores.

## Loan Liabilities of Union Territories Graduating to Statehood

**12.41** The Union Territories of Arunachal Pradesh, Mizoram and Goa graduated to the status of Statehood in 1987. As Union Territories they received loans to cover their capital gap and grants for their revenue gap. Arunachal Pradesh and Mizoram are special category States receiving plan assistance by way of grants and loans in the ratio 90 : 10. In their case, the Ninth Commission had recommended that the excess of the central loans received by each of these three States for its plans, upto 1986-87 as Union Territories (and outstanding as on 31st March,1990) over what it would have received had it been a full-fledged State be written off. Outstanding loans remaining after this write-off, as on 31st March 1990, of each State were then to be consolidated into one loan. These States have requested for further specific relief on loans given to them as Union Territories. We recommend that the scheme of special relief in Para 12.39 should cover the consolidated loans as well.

**12.42** Arunachal Pradesh has requested that loan for payment in respect of helicopters purchased under special arrangement be written off. The Rangarajan Committee set up by the Planning Commision in 1991 to suggest durable solutions for the financial problems of special category States has recommended this earlier. We also recommend that this be done.

**12.43** The Government of Goa has stated that the loan liability of the erstwhile Union Territory of Goa, Daman and Diu has been placed entirely on Goa when it became a State. The State Government pleaded that the loan liability of Daman and Diu should be separated from the accounts of the State. We recommend that this matter may be examined and settled by the Government of India as quickly as possible.

**12.44** Our estimates of debt relief relate to fresh central loans during 1989-94 and as outstanding on 31st March, 1994 . However, central loans given to the States given in 1994-95 should also be covered by the schemes of debt relief recommended by us. We suggest that before granting debt relief, the Ministry of Finance may ascertain the exact amount due for repayments in the period 1995-2000 with respect to fresh central loans given during 1989-95 and outstanding as on 31st March , 1995.

**12.45** We have estimated the quantum of relief on account of special debt relief schemes suggested by us as in Table 3. The quantum of relief with respect to the incentive scheme suggested by us cannot be estimated at this juncture, as it depends on the future performance of the States. Should the States improve their performance by, say, 2.5 percentage points, the relief would come to Rs.565.51 crores, as explained in Appendix 6. Further relief could accrue to the States from the scheme relating to disinvestment of equity as stated earlier in Para 12.37. However, this would depend on the action taken by States and is not amenable to precise estimation by us.

## Table 3

**Summary of Special Debt Relief to States**

*(Rs. crores)*

| | | Relief for 1995-2000 |
|---|---|---|
| 1. | High Fiscal Stress States | |
| | (i) Bihar | 44.54 |
| | (ii) Orissa | 17.50 |
| | (iii) Uttar Pradesh | 104.33 |
| | (iv) Special Category States | 44.14 |
| 2. | Punjab | 490.63 |
| | **Total** | **701.14** |