Fiscal Discipline at the State Level: Perverse Incentives and Paths to Reform

I. INTRODUCTION

Fiscal imbalance at the State level has assumed alarming proportions in India in recent years. In 1998-99 fiscal deficit (FD) of all States taken together measured 4.2 percent of Gross Domestic Produc-1Xime high and rose further to 4.9 percent in 1999-00 (RBI, 2000). While the intensity of the stress varies across States, none has remained unaffected. In 1998-99, in as many as 8 out of the then 25 States, FD exceeded 7 percent of their Gross State Domestic Product (GSDP).[1] A particularly worrisome feature of the fiscal scene is the emergence of deficit on current account (revenue deficits or RD), accounting for over 50 per cent of the aggregate fiscal deficit of the States. Primary (i.e., non-interest) deficits (PD) also are not small – in fact after remaining subdued in the first half of the 1990s, PD in State budgets has surged, exceeding 2 per cent of GDP in both 1998-99 and 1999-00.

Reflecting the consequence of heavy reliance on borrowing to meet their expenditures, the ratio of States' outstanding debt to GDP has risen from about 16 percent in mid-seventies to 21.5 percent at the end of the nineties (Table 1). In several States, outstanding debt exceeds 30 percent of their respective GSDP. Debt liabilities as a proportion of revenue receipts exceed 200 percent in many States (Table 2). The debt figures on which these ratios are based do not include contingent liabilities, like unfunded pensions or the loans of the public sector enterprises (PSEs) guaranteed by State governments. The States' indebtedness would be much higher if the burden likely to arise from these liabilities is taken into account. As debt stock kept growing, with rates of interest payable on incremental debt getting aligned to the market, interest burden on State budgets has risen sharply in the nineties. For example, in Punjab, interest payments rose from 17.9 percent of revenue receipts to 37.75 percent

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On the face of it, the emergence of large fiscal deficits at the State level seems a little baffling because, under the Indian Constitution, borrowing by States already in debt to the Center requires the consent of the Central government (Article 293). The Constitution also gives the Center an upper hand in many other related matters (Dandekar, 1987). What then went wrong? . What enabled the States to incur deficits of such magnitudes when the Constitution explicitly provides the Center with powers to exercise control over their borrowing? Equally important, what drove or encouraged the States to borrow to an extent that encumbered their budgets with the burden of debt that they cannot bear on their own?

Several factors are believed to be responsible for the emergence of unsustainable fiscal imbalance in the States.[4] On the 'demand side', fiscal problems of both the Center and the States would appear to have been the product of 'populism' and deficit bias of unstable governments in a democracy. On the 'supply side', budget problems of the States seem to reflect a softening of the hard budget constraint implicit in the constitutional restrictions on their borrowing and inadequate oversight on the part of the Center.

In this context, the weaknesses of the system of intergovernmental fiscal relations have been cited as a prime source of perverse incentives leading to fiscal indiscipline among States, calling for corrective measures. Hence, re-examination of the system of federal finance, with a view to restoring vertical balance and paving the way to fiscal responsibility at the subnational level is considered an urgent, though challenging, task for policy makers (Kopits, 2001). Faced with this challenge, the authorities at the Center are now seeking to strengthen their supervision of State finances through bilateral agreements (Memorandum of Understanding or MOUs), coupled with inducements to implement fiscal reform programs designed to bring the States to the path of fiscal rectitude. The compatibility of such an approach in the context of a federal structure, however, remains to be examined carefully.

Decentralization traditionally derives its rationale from the theory of fiscal federalism that emphasizes the efficiency benefits arising from informational advantages of governments functioning at lower levels. Decentralization promotes efficiency in the public sector also through competitive governmental systems. Proponents of a second generation theory of federalism draw attention also to the growth promoting properties of governmental systems in which local governments are given "primary authority" over their economy (Qian and Weingast, 1997). Experience however, shows that decentralization also has its costs that can outweigh the potential benefits. Externalities between jurisdictions – arising from tax competition, tax exporting and opportunistic behavior of lower level governments – if allowed to go uncorrected, may inhibit growth. One manifestation of such externalities is the soft budget constraint of the subnational governments (SNGs) and the resulting fiscal indiscipline with all its ramifications for stability and growth (Qian and Roland, 1998).

The possibility of subnational borrowing creating problems in macro economic management in federations has of late received considerable attention among fiscal economists (Hommes, 1996, Tanzi, 1996, Prud'homme, 1995). Fiscal indiscipline among SNGs has come into sharp focus particularly in the context of the experience of Latin American countries (LAC) and several studies have analyzed the causes and suggested remedies.[5] The problems are believed to arise essentially from weaknesses of the fiscal and political institutions of federations creating incompatible incentives for fiscal discipline, and softening the budget constraint of SNGs. However, to what extent the institutions of intergovernmental relations operating in India have generated perverse incentives and encouraged fiscal indiscipline among the States, and what are the corrective measures require more careful examination than has taken place so far. This paper is a modest attempt to address these questions in general and the issue of soft budget constraints in particular.

The rest of the paper is organized as follows: Section II reviews the structure and role of institutions underpinning intergovernmental fiscal relations that influence subnational fiscal behavior and their operation in India. Section III tries to identify the factors that may have been responsible for softening the States' budget constraints. Section IV discusses the

relative merits of alternative paths to reform, focussing on hierarchical mechanisms as against market-based discipline. Section V explores directions of reform for India and Section VI summarizes the suggestions made.

II. INTER-GOVERNMENTAL FISCAL RELATIONS IN INDIA - STRUCTURE AND ROLE OF INSTITUTIONS

While the character of intergovernmental relations in a federation and the way it functions depend greatly on its history and politics, studies based on theory and experience show that the outcome of the fiscal operations of SNGs in federal countries is shaped ultimately by its fiscal and political institutions and their interaction (Dillinger *et al*, 2000, Rodden *et al*, forthcoming).

Fiscal institutions that determine the budget performance of SNGs broadly are: (i) adequacy of the revenue raising powers assigned to them relative to their expenditure responsibilities; (ii) the system of intergovernmental transfers and signals emanating therefrom influencing fiscal behavior of recipient governments, and (iii) the States' room for maneuver when under stress. Fiscal institutions however do not operate in a vacuum. They necessarily work within a given socio-political milieu and it is the political institutions that exert a decisive influence on the functioning of the fiscal institutions. Even a sound set of fiscal institutions may fail to provide the right environ or incentives for prudent conduct of SNGs if the political institutions are not supportive. Hence, in investigating the source of fiscal indiscipline among the States in India, it may be useful to start by looking at the nature of the fiscal and political institutions that underpin the federal financial relations in the polity.

a. The Fiscal Institutions and their Working

i. Assignment of Functions and Fiscal Powers

Under the Constitution of India, as in most federations, division of powers and functions among different levels of government are asymmetrical, with a pronounced concentration of revenue raising powers in the Center while the States are entrusted with functional responsibilities that entail larger expenditures than they can meet out of their own resources.

Matters concerning the nation as a whole such as defense, foreign affairs, currency and coinage, and communication networks are responsibilities of the Center, while the States bear the main responsibility to deliver public services that are of more immediate concern to the people, like public order, public health and sanitation, agriculture, water supply and irrigation. The States also have concurrent jurisdiction in several areas like education, electricity, economic and social planning, population control and family planning. Powers to levy broad based taxes (income tax, corporation tax, customs and excise) are on other hand vested in the Center, the only major exception being sales tax. While the States can also levy a few other taxes with good revenue potential like duties of excise on liquor, motor vehicle tax and taxes on agricultural land and income, the revenue from their own sources meet on an average only about fifty to sixty percent of their current expenditure (Table 3), necessitating transfers from the Center on a large scale, thereby weakening the Wicksellian connection between spending and taxing decisions and raising the possibility of opportunistic fiscal behavior among recipient governments.[6]

Anticipating the inadequacy of the States' own revenues to meet their expenditure requirements, and the need for substantial financial transfers from the Center, the Constitution provided for the creation of an independent panel – the Finance Commission. Its function is to ensure orderly and judicious devolution deemed necessary, while avoiding fiscal imbalances at the Center and in the States, simultaneously maintaining a measure of autonomy for the States in the discharge of their responsibilities. The States can also augment their resources by borrowing, but from the domestic sources only. Moreover, as already noted, the Constitution gives the Center authority to restrict imprudent borrowing by the States, implying thereby the Center's power to impose a hard budget constraint on the States.

three decades after independence. Despite shortcomings, by and large, the transfers recommended by the FC have been rule-based and transparent – the two important characteristics of a good transfer system – and helped to meet the vertical imbalance while also reducing the horizontal disparities of the States in their capacity to provide public services at least partially. Although substantial amounts were transferred also through other channels, particularly the Planning Commission (PC) in the form of grants and loans by way of central assistance to State plans, these too have been largely formula based (at least since 1969). Market access of the States to domestic savings mediated by financial institutions has also been controlled by the Center through the Reserve Bank of India (RBI), so that all States get an equitable share in the nation's investible resources.

Testifying to the strength of these institutions neither the Center nor the States suffered from any large imbalance in their budgets in the fifties, sixties and seventies, although the size of the public sector in terms of proportion of government expenditure to GDP had nearly doubled during the period.[7] The budgets then did run into deficits in some years but their order was relatively small. This was true both of the Center and the States.

During almost three decades upto 1978-79, the Center did not have any RD except on two occasions, and its FD also stayed below 4 percent of GDP. The budgets of the States taken as a group turned in some revenue deficits from time to time but rarely did they exceed 0.5 percent of GDP. Their FD also remained mostly below 2 percent. Even in the first half of the eighties, their revenue budgets taken together yielded a surplus, though small (Table 4). It was only in the latter half of the eighties that the States started incurring RD regularly, but the deficits remained below 1 percent of GDP till as late as 1995-96. The States' RD went beyond 1 percent in 1996-97 and moved up to 2.29 percent in 1998-99, driving up their FD to over 4 percent. Could it then be said that the institutions of federal financial relations were essentially sound and free from the drawbacks that give rise to perverse incentives for discipline among SNGs?

In an insightful article on the issue of the recent fiscal crisis of the States in India, McCarten (forthcoming) argues that one reason why the State finances remained relatively stable prior to the nineties is that from 1950 until 1991, that is, until liberalization took place, the Center was in a position to exercise strong influence over the States through the system of fiscal transfers, together with other instruments of central planning like exchange control, investment licensing and tight control over lending policies of financial institutions. These instruments and a commitment to planning had discouraged the States and local governments from pursuing economic policies of their own and nurtured a culture of dependence on the Center. Policy priorities of the States were harmonized with national development strategy through the mechanism of annual approval of State Plans and centrally sponsored schemes, supported by assistance for State plans. The States were also allowed and even encouraged to borrow to implement the Plans and draw upon the savings generated in the household sector (particularly the farm sector) which proved difficult to tap through taxation, – but all under the mediation of the Center.

The system of fiscal relations described above worked adequately, according to McCarten, as long as interest rates were repressed permitting borrowing to finance budget deficits at low cost, the supply of highly subsidized services like power to agricultural users was limited and the flow of private investment to the States was controlled through 'license raj'. With liberalization these underwent a profound change. "Once key supports for the old planning system such as the low interest rates and the license raj vanished, the internal logic of the system began to collapse." (McCarten, forthcoming).

While providing some plausible clues as to what led to the deterioration of the States' finances in the nineties, the above prognostication overlooks the fact that the slide down of the States' budgets had started before liberalization had taken place. As noted by the Tenth FC, the first turning point came in 1987-88, as the revenue account of the States' budgets went

into the red. Things took a turn for the worse in 1990-91 as deficits appeared even in the non-Plan revenue accounts of three States (Kerala, Punjab and West Bengal), joined by other States subsequently. The genesis of the fiscal crisis of the States dates back earlier.

The fact of the matter is that there were structural imbalances in the system right from the beginning. While the turning points can be related to some proximate causes like pay revision of employees or sluggish revenue growth because of a slowdown in the economy, the imbalances in the State budgets have their origin in factors that are structural in character.[8] Structural imbalance was inherent in the asymmetrical assignment of powers and functions, while the transfer system that was meant to alleviate the asymmetry turned out to be a source of imbalance by generating incompatible incentives. Shortcomings of the transfer system weakened the incentives of the States to tap their revenue potential fully and exercise restraint in spending. They had, on the other hand, limited elbow room for adjusting to shocks. Given this background and in the absence of a truly hard budget constraint that could put an effective cap on their debt, the States found it expedient to rely on borrowed funds even to meet their current expenditures.

ii. Shortcomings of the Transfer System

Although the Finance Commission has earned appreciation as a useful fiscal institution for a federation, the transfer system that has been operating on the ground is marked by features that are widely perceived to be not very conducive to fiscal discipline among States. A full-fledged appraisal of the transfer system is beyond the scope of this paper. However, a few observations might be in order.[9] The weaknesses of the transfer system as it has been operating in India seem to stem from:

- the manner in which the revenues of the Center are devolved by the FC to the States;
- multiplicity of transfer channels with little effective coordination among them; and
- mediation of capital transfers (loans from the Center) without adequate regard for the repaying capacity of the recipient governments.

Infirmities of Statutory Transfers

Transfers mediated by the FC – commonly called statutory transfers – are made up principally of two components viz., tax devolution and grants-in-aid to States in need of assistance. Although the devolution of tax revenue of the Center is based on well-defined criteria, the FC's dispensations have come in for persistent criticism as a source of fiscal indiscipline in the system because of the "gap-filling" approach underlying them (Rao and Chelliah, 1991, Thimmaiah, 1981).

In principle, transfers need not lead to fiscal indiscipline if they are properly structured and do not purport to underwrite the actual budget gaps of the States. On the contrary, the transfer system can serve as a potent instrument for inducing fiscal discipline if the gaps of the recipient governments are measured with reference to objective norms of revenue capacity and expenditure needs as is the practice in Australia (Shah, 1996). Although the grants-in-aid recommended by the FCs in India for States facing revenue deficit are based on their (FC's) own assessment of the revenue gap of each State and not the budget actuals or what the States project, the assessments cannot be said to have been invariant to the States' decisions regarding expenditure and revenue raising.

To a large extent, this is because the starting point for the revenue and expenditures projections of the FC has been the 'base year' for which the actuals ultimately provide the basis. In the end result, every time an FC is appointed the projections of its predecessor are thrown into "the dustbin of history" (Chelliah, 2000a) and ultimately "history" dominates. The projections made by the FC, whatever be the norms they may adopt thus lose their

potency as signals for discipline. It may be noted that the Eleventh FC (EFC) tried to make some adjustments in the base year figures, but only to a limited extent.

The allocation of the other component of the FC's transfers – share of central taxes, which accounts for the bulk of the "statutory transfers" – is decided on the basis of formulae which are also believed to have generated wrong signals for fiscal discipline, the emphasis being on equity rather than efficiency. While the transfer formulae also contain weights for efficiency ("tax effort", fiscal self-reliance etc. – see Appendix I) their effects are often perceived to be weak and subdued by equity factors (Godbole, 2001).

The conflict between equity and efficiency in the transfer formulae is often overplayed as both can be taken care of simultaneously if the revenue gaps of the States are assessed normatively. However, for practical reasons, application of norms has not proceeded far and it may not be unfair to say that the persistence of gap filling approach in the FC's transfers noted above continues to generate perverse incentives for fiscal discipline among States. With such a transfer system, the States have found it profitable to undertake expenditure commitments exceeding their available revenues on the expectation that the gap would ultimately be made up by the FC. The design of statutory transfers thus has tended to create a bias towards improvident budgeting by "legitimizing incipient deficits" caused by inadequate revenue effort and imprudent expenditure decisions of the past (Lahiri, 2000).

Multiplicity of Transfer Channels and Central Mediation of Capital Transfers

Contrary to the scheme of intergovernmental transfer that was apparently contemplated in the Indian Constitution with FC as the chief mediator, central funds are transferred to States in India through other channels as well, of which Plan transfers constitute the main component.[10] . Some transfers are made directly by Central ministries for implementing centrally sponsored schemes (CSS).

With the inception of planning led by the public sector as the strategy of development, funds are provided by the Center to assist the States to implement their plans designed to subserve the overall objectives of planning. Plan grants have come to form the largest component of different categories of grants from the Center (Table 5). There is reason to think that the manner in which these transfers are provided has been a major destabilizing factor for State finances.

Initially, central assistance for the State plans used to be project-specific. In 1969, this system was replaced by the Gadgil formula whereby support for State plans was extended out of central budget in the form of grant and loan with the share of individual States determined largely on the basis of population, and, in part, with reference to relative income levels. Some weight was given to tax effort but its effect was submerged by the other factors. An element of discretion was provided in the form of weightage for special factors (Appendix-II).

In the case of general (non-special) category States, 30 per cent of plan assistance was given as grant and 70 per cent as loan, in consideration of the fact that the revenue content of the plan constituted, on the average, 30 per cent of the plan outlay and so the two sides of the Plan revenue budget were expected to match. However, the expectation was belied as revenue expenditures under the Plans expanded, going up from just about 30 percent in 1974-75 to 54 per cent in 1998-99 (Table 6). In some States, the revenue component exceeds 80 per cent of their Plan expenditure.[11] With dwindling surpluses on the non-plan revenue side, the plans came to be financed increasingly by borrowing.[12] While at least two-thirds of the Plan expenditure have always been debt-financed (since 1974-75), in 1998-99, borrowings of the States meant for Plan Financing reached an unprecedented high of 139 per cent of Plan expenditure, revealing the extent of use of borrowed funds for financing non-plan expenditures (Table 6).

Several other features of plan financing and plan transfers tended to generate imbalance in the revenue budget of the States, of which the following deserve mention:

➢ *Approval of State Plans by the PC in terms of the 'outlay' without specification of its revenue and capital components.* With this system in operation it was not possible to match the available revenue resources with the revenue component of the Plan. "Failure to appreciate this basic requirement of fiscal discipline is one of the main causes of the endemic fiscal disequilibrium" (Report of the Tenth FC, p. 6).

➢ *The practice of the PC according approval to large State Plans even when a State failed to achieve the targets set in the preceding year by a large margin.*[13]

➢ *Plan, non-Plan dichotomy in budget accounting with the revenue component of a Plan project shown under 'Plan' for the given Plan period but under 'non-Plan account' thereafter.* This added to the State's 'committed' expenditure, which the FCs found difficult to ignore. It also provided a built-in incentive to launch new programs involving substantial expenditure on current account without regard for the consequence for future budgets, apart from resulting in the neglect of operation and maintenance (O&M) expenses (Vithal, 1999).

➢ *Lack of effective coordination between FC and PC.* As a result, it was possible for a State to underplay its resource availability before the FC but present a different picture before the PC to obtain approval for its Plan of a size unwarranted by available funds.

➢ In the pursuit of national objectives like literacy program, the Center sponsors a number of schemes (CSS) under the 'Plan' which are implemented through the States but are not all funded fully by the Center adding to their expenditure commitment. Often they carry a matching component, casting an additional burden on the State budgets and distorting their priorities.

➢ Finally, resources transferred to States in the form of loans are made up largely of 'plan loans'. These are the on-lending by the Center from its own borrowing constituting the largest component of funds flowing from the Center to the States as loans (Table 7). These, together with the system of States' borrowing from the market mediated by the Center at uniform rates of interest and maturity (Roy, 2000), taking no account of the debt sustainability of individual States or their varying creditworthiness, constituted a potent source of budgetary instability of States

iii. Constraints on Manoeuverability

The States did not have much room for maneuver to keep their budgets in balance when faced with shocks. The residuary powers including those of taxation belong to the Center. Even in sales tax, their powers are subject to restrictions imposed by the Central Sales Tax Act on the sale of certain commodities within their jurisdiction.[14] There is a constitutionally imposed ceiling on the profession tax the States can levy. For many years the ceiling was Rs. 250, subsequently raised to Rs. 2500.

On the expenditure side too, the States' maneuverability is constrained in many ways. The centrally sponsored schemes, though largely funded by the Center during a Plan, often become the liability of the States after the conclusion of the Plan period. It is not easy for them to dismantle the administrative infrastructure set up for their implementation. Even in the matter of employees' emoluments, the States cannot possibly ignore the revisions made by the Center, although one may argue that it is not incumbent for them to follow Central scales of pay. When the salaries of employees are raised by the Center, it inevitably gives rise to demand for upward revision from the employees of State governments too. It goes to the credit of some of the States that they resisted the pressure for raising employees' salary valiantly even in the face of prolonged strikes. But the Center's action in the matter clearly puts the States in a bind[15]. It is therefore not surprising that faced with the three-fold shocks in the wake of the reforms (rise in interest rates, decline in tax devolution and grants because of a slump in Center's tax revenue – see Table 8 – and hike in employees' emoluments) the States tried to reduce their expenditure by cutting down on investments and even essential social services (Sen, Rao and Ghosh, 1994), and looked for whatever sources they could access for borrowing.

However, it cannot be gainsaid that even allowing for all their limitations, the States have often shied away from adequately exercising the powers they have to raise revenue or contain the growth of inessential expenditures. A glaring example is the case of taxation of agricultural income and wealth as also cost recovery for public services. Two-fold factors provide the explanation for the reluctance of the States towards greater revenue effort: one, the political institutions, and two, the absence of a truly hard budget constraint.

b. Political Institutions

The preceding discussion would show that the germs of subnational fiscal imbalance were embedded in India's federal system with the asymmetrical assignment of powers and functions. The transfer system while purporting to meet the resulting vertical imbalance generated signals that tended to undermine the incentives for discipline. These tendencies remained subdued in the first three decades after the Constitution came into being because of the character of political institutions.

Till mid-seventies the country was largely ruled by one political party at the Center as well as in the States under a centralized party system. The system of planning backed by the Center no doubt greatly helped to keep the States' finances in line with the Central plans. But that might not have been possible without the rule of a strong all-India party in the country. However, things had started changing even before the economy embarked on liberalization, because of shifts in the character of the political institutions. Rule by a monolithic party was replaced by a coalition government at the Center in 1977 and regional political parties started emerging in the States (Lahiri, 2000). The deficit bias of coalition governments accentuated the weaknesses of the fiscal institutions leading to faster growth of expenditure and slackening revenue effort.

This is evidenced by the fact that revenue expenditure of the States grew faster than their revenue receipts during the eighties and the nineties. Tax revenues from their own sources no doubt grew faster in the eighties as compared to the seventies, but revenue expenditure grew more rapidly (Table 8). Non-tax revenue growth from their own sources slowed down markedly[16] reflecting dwindling returns on investments in State enterprises, and loans to cooperatives on the one hand and failure to revise the user charges in line with rise in costs on the other. While slow growth in some of the components of non-tax revenue was caused by factors beyond the control of the State governments (like lag in revision of royalties on minerals, constraints on exploitation of forest products, and smaller grants from the Center), proliferation of subsidies in the form of losses of PSEs borne by the exchequer and poor cost-recovery of public services evidenced the weaknesses of political institutions. These tendencies were accentuated in the 1990s with the fragmentation of political parties and coalition politics at the Center.

Cost recovery of public services even of the 'non-merit' category on the average is now less than 10 per cent in most States (Srivastava and Sen, 2000). User charges and utility tariffs were not revised for years since the fifties and sixties. The huge losses of State Electricity Boards (now running at nearly Rs. 30,000 crore) partly reflect the political compulsions to supply power free to farmers that became increasingly burdensome with greater use of high yielding variety seeds requiring greater amounts of water, drawn to a large extent with electrical power (McCarten, forthcoming). Large irrigation losses also bear testimony to the weaknesses of the political institutions.

Failure of political institutions to exercise effective control on improvident public spending is manifest in the loose budgetary practices, with supplementaries routinely placed before the legislature to support deviations that cast doubt on the integrity of the budgets. Ineffectiveness of audit and the elaborate system of checks on unauthorized use of public funds postulated in the legal system – brought out by reports of the Comptroller and Auditor General (CAG) – also reveals the debility of the political institutions. Accounts of PSEs often remain unaudited for years – with impunity. Reports of CAG do not get the attention they

deserve "which is why each audit report reads like the one of the year before", laments a commentator.[17]

Thus, it is not liberalization as such that brought about the crisis. Imbalance was incipient in the system and signs had surfaced even in the eighties but things came to a head in the nineties with shocks in the form of increase in average effective interest rates from less than 6 per cent in 1980-81 to 9.19 per cent in 1990-91 and nearly 13 per cent in 1997-98 (Sen, 2000). The States' budgets were simply not in a position to adjust further to the fall in central transfers that took place in the 1990s, or to the burden of pay hike of government employees.

The question that arises next is, given the instruments at the disposal of the Center for preventing improvident budgeting by the States – Article 360 of the Constitution even empowers the Center to declare 'financial emergency' when the financial stability or credit of India or any part thereof is threatened – how did the hard budget constraint implicit in Article 293 get softened? The following section tries to find some answers.

III. SOFTENING OF STATES' BUDGET CONSTRAINT

The budget constraint on SNGs constitutes a crucial element in the fiscal institutions underpinning Center-State financial relations in a federation. In India, access of the States to resources being limited in various ways, their budget constraint would, on the face of it, appear to be hard. In reality, the constraint got softened because of weaknesses of the fiscal institution itself accentuated by compulsions of the political institutions. What encouraged and enabled the States to expand their expenditures with borrowing despite Center's surveillance basically are (a) loopholes that weakened the efficacy of Center's control over State borrowing and enabled the States to devise ways of circumventing the constitutional constraint; (b) permissiveness on the part of the Center in lending to States and mediating the flow of loans from financial institutions to States; and (c) absence of a firm commitment to a 'no bailout' policy.

a. Ways of Bypassing Borrowing Constraints

In India, like in most federations, the States in India cannot fund their deficit with seigniorage. Nor can they borrow abroad. Unlike the position that obtained in some of the LACs, none of them own any bank (except Jammu & Kashmir). Further, as mentioned at the outset, an important institutional constraint on State borrowing is implicit in Article 293 of the Constitution requiring the consent of GOI for any borrowing by States already indebted to the Center. Also, the major (Indian) commercial banks and financial institutions from whom the States can borrow are owned by the Central government. Thus, *prima facie* there is substantial *ex ante* central control over State borrowings which should have helped the Center to impose a hard budget constraint on the States all the time. In practice however, the budget constraints failed to bite because the States found it possible to bypass them through innovative ways.

The single most important source of borrowed funds for the States, over which the Center apparently has no control or does not exercise any control, is their share in the deposits in small savings schemes. Although the accretions to small savings used to be on-lent by the Center as 'non-plan loan', the transmission was automatic in that 75 percent of the net accretion was passed on to the States of origin, that is, where the deposits are made. Since 1998-99 the accretions are credited to a National Small Savings Fund (NSSF) out of which 80 percent goes to the States. Thus, the amounts lent by NSSF to the States do not appear on the Center's budget any longer although the ultimate liability to repay the depositors remains that of the Center. The cost of borrowing through this route is relatively high as the Center (and now the NSSF) adds the transaction costs of administering the schemes of small savings to the interest payable to depositors. In 1998-99, the rate charged on on-lent small savings stood at 14 percent per annum. Then there is the cost of income tax concession allowed on small savings, which though in the first instance borne by the Center, also impinges on the State budgets as their share in tax devolution gets reduced thereby. In addition, the States offer incentives in the form of lotteries, prizes, etc., and commission to agents. The States have

found this route a convenient way of meeting their budget needs regardless of the high cost and problems stored up for the future. In recent years, the share of small savings has emerged as the most important source of the States' borrowings (Table 7).

Accumulation in provident fund of employees constitutes another source of States borrowing over which the Center has no control. These registered sharp growth in the closing years of the nineties, with the impounding of a good part of the additional emoluments of employees consequent on their pay revision.

Another disingenuous device utilized by the States for bypassing the Center's vigil is borrowing through PSEs under their control, enabling them to float bonds against State government guarantees. Finding this a convenient way of circumventing the constitutional constraint, many States have set up corporations to undertake departmental jobs like road construction who then access the loan market backed by State government guarantee, thereby taking their finances out of the State budgets. Prior to 1994-95, borrowings of State-owned enterprises came under the ceiling on the States' borrowings from the market and the commercial banks. With the removal of loans taken by PSEs from the purview of the overall borrowing limits of the States, there has been a surge in such borrowing by State PSEs.

Taking advantage of this relaxation, 'special purpose vehicles' have been launched for funding urban infrastructure projects by municipalities, often backed by State government guarantee. The guarantees take many forms including letters of comfort, automatic debit mechanisms, tripartite structured payment arrangements, and escrow arrangements. With the government to back them, such bond issues do not encounter any problem in raising funds from the domestic market as the lenders and credit rating agencies do not consider it necessary to assess project specific risks. The phenomenon of off-budget borrowings through public enterprises, fortified with State government guarantees, has assumed serious proportions in the last decade in several States. The extent of contingent liabilities implicit in these guarantees has gone up from Rs. 42,682 crore in 1993 to Rs. 79,625 crore in 1999 (till September, 1999, vide RBI, 1999) constituting roughly 5 per cent of GDP.

In addition to the guarantees given for PSE loans, State governments face contingent liabilities also on account of unpaid bill of creditors, unfunded pension obligations and even current emoluments of employees. The PSEs too accumulate liabilities which ultimately become payable by the States even though they do not figure anywhere among their debt. No firm data are however available for liabilities under these heads.

To enable the States to get over temporary cash flow problems, the RBI provides Ways and Means Advance (WMA) to the States and also an overdraft facility. After crossing the limit set by WMA plus special WMA, a State goes into overdraft (OD), which carries a higher rate of interest. These facilities are available only for a limited period. The OD cannot run for more than ten continuous working days and carries a higher rate of interest. But several States have been using them as a way of softening their budget constraint by rolling them over. Some States have been in overdraft for more than 200 days in a year.

b. Permissive Lending and Mediation of State Borrowing by Center

While on the one hand the States have found ways to bypass Center's control over their borrowing as noted earlier, the Center itself advances loans to States in ways which are scarcely conducive to fiscal discipline. Although the share of central loans in the aggregate outstanding debt of the States has been declining, they still constitute the largest source of borrowed fund for most States (Table 1). The bulk of the central loans, excluding the States' share of small savings, is made up of lending under the rubric of 'Plan loan', comprising the loan component of central assistance for State plans dispensed on the basis of the Gadgil formula and other Plan loans (Table 7), like those advanced as special assistance for externality aided projects (EAP). The loans coming under the category of EAP flow from international agencies but are routed through the Center, the sovereign liability (and so the

foreign exchange risks) being that of the central government. The Center also advances discretionary loans to the States, but their share in total central loans is small.

The quantum of market borrowings of the States, which are raised through bonds taken up by the banks in fulfillment of their statutory liquidity ratio (SLR) requirements, financial institutions like the Life Insurance Corporation (LIC), and Unit Trust of India (UTI) and non-government pension and provident funds, is also decided by the central government who allocates the available amounts among the States. As for the central loans for the Plan, their allocation is made out of the total central assistance for the Plan in a given year under the Gadgil formula, based on factors indicated earlier. Though apparently based on a preset formula, the process of transfer through this route suffers from an element of non-transparency in that the amounts finally transferred are decided through bilateral negotiations between the PC and the States in the course of annual plan discussions. Although the resource availability for the year from all sources is assessed while approving the annual plan and thus specifying the amounts likely to be available from borrowing of the States, there is no evidence that any formal analysis of their repaying capacity is undertaken in the process. The debt ceiling set for individual States comes out of the process of bargaining in the annual plan discussions and does not appear to take account of dynamic debt sustainability conditions as McCarten (forthcoming) points out. Thus, the debt creating potency of the plan resulting from 70 percent loan financing against more than 50 percent revenue component of the Plan is accentuated by the process through which the annual Plan outlays and the borrowing limits of individual States are set.

In any case, the limits, if any, lose their meaning when as described above the States can access borrowing through the small savings and other mechanisms, and no adjustment is made against their borrowing limits for these borrowings.

The RBI has introduced greater market orientation into the debt management of the States over the years. Earlier. the administered rates of interest (coupon rate on State government bonds) were usually lower than the market rates. These are now aligned more to the market. Also, earlier the RBI informally ensured marketing of all State government bonds at a uniform rate of interest and uniform maturity periods for all States by bundling the more acceptable bonds with the least acceptable ones. This allowed the States not favored by the market to reach the allocated market borrowing limit without paying any risk premium. The RBI has now discontinued this practice, and introduced the option of raising market loans through auctions to the extent of 5 to 35 per cent of the allocated market borrowings. Some States have taken advantage of the more market-oriented new system (Roy, 2001). Although the auction system should provide some advantage to the better-managed States, this would be apparent only with the removal of the system of central allocation of net market borrowing. The SLR has also been brought down progressively but still provides a captive market for the central and State government bonds. This, coupled with the rationing of net market borrowings among States, prevents full play of market forces in the matter of States' access to borrowing, resulting in a softening of their budget constraint.

c. Absence of Hard Budget Constraint

In essence, one may say that as in other federations plagued by problems created by sub-national borrowing, fiscal indiscipline of the States in India has its origin in the absence of a credible hard budget constraint, as evidenced by instances of bailouts extended by the Center from time to time. Relief has been granted by the Center on various occasions particularly through schemes of rescheduling recommended by the FC or on their own. Since the Sixth, all the FCs have recommended schemes of debt relief of varying magnitudes, tied, of late, to improvement in fiscal performance as judged by the specified indicators.

There have been occasions when promises were held out to write off large loans selectively on political considerations. The reported proposal to allow one-time "write-off" of the dues of State Electricity Boards (SEBs) to central agencies provides yet another instance of how the States can count on the Center to come to their rescue when in trouble[18]. It should

also be noted that a large part of the loans incurred by the States (viz., from NSSF) carries implicit central guarantee and thus weakens any incentive for the depositors to exercise judgement about the creditworthiness of the schemes. How the need to observe prudence and avoid RD was undermined by Center's permissiveness can be seen from the relaxation of the requirement of creating sinking funds for amortizing loans allowed in 1975 (Lahiri, 2000).

Laxity in the commitment to a hard budget constraint is also shown by the accumulation of huge arrears by SEBs to central agencies like the National Thermal Power Corporation (NTPC) and Coal India. At times, an attempt is made to recover these dues by deduction from the Plan grants but these are subject to a ceiling of 15 percent of grants. This obviously has not deterred the SEBs from running massive arrears of dues to NTPC. Evidently, the Center has hesitated to apply harsh measures such as stopping power supply to defaulting States, signifying a reluctance to impose a hard budget constraint.

What induces a subnational government to incur expenditure beyond its available or projected revenues and resort to borrowing it cannot service is the expectation of being bailed out sooner or later by the national government. If fiscal discipline is to be inculcated among SNGs, ideally there has to be a clear understanding that there will be no access to central funds under any circumstances beyond what is provided under a scheme of transfers through a pre-announced, transparent system of transfer designed to meet their budget imbalance. However, for reasons mentioned below, in the real world, strict adherence to a no-bailout commitment, though eminently desirable, often turns out to be infeasible for national governments.

A compelling reason is that when a constituent unit of a federation creates a situation by an unaffordable spending policy whereby it is unable to meet its debt obligation, the default may spill over to the country's economy. Also, if the government in distress fails in its obligation to provide some of the basic services, its citizens will look up to the national government as their ultimate savior. Besides, failure of a constituent unit to honor its payment obligations can have adverse impact on the country's credit abroad and, in such a situation the national government cannot stand aloof. The compulsion may be strong if the State in distress is 'big' ("too big to fall" as Wildasin, 1997 argues) or the services that are threatened are too sensitive (Grewal, 2000). Like in a sequential game, the externality is first created by a "self-serving" subnational government incurring debt it cannot service, and then asking for a special bailout grant or takeover of the debt by the Center. The Center then faces a dilemma: not acceding to the bailout demand may in the end turn out to be costlier than granting it in time - a "time-consistency problem" as it is called (Rodden *et al*). Spillovers however are not the only reason for bailouts, as noted above.

How the fiscal institutions help the States to avoid a hard budget constraint has been noted in Section II. The political institutions of the Central government also bear vitally on the credibility of its no bailout commitment to lower level governments. Whether to expect the Center to help a State government in distress depends on the lobbying strength of the creditors whose moneys are at stake and also that of the concerned States' representatives in the central legislature.

Case studies of subnational bailouts in four OECD countries show that political formation often played a significant part in the central decisions to bail out SNGs. Bailouts are granted more readily to SNGs that are closely connected to the Center through party affiliation or ideology (Von Hagen *et al*, 2000). It is not surprising to find that fiscally irresponsible SNGs are able to secure bailouts because of their 'weight' or affinity to the Center either by virtue of their relationship with the ruling party at the Center or by trading votes with other legislators. This sometimes becomes blatant when the central government happens to be "a loose coalition of log-rolling regional interest groups" – a process that was most visible in Brazil and has been found occurring in India (Rodden *et al*, forthcoming).

Instruments of control on subnational borrowing fail to produce results when the political institutions required to enforce them are weak as is seen from the experience of

LACs (Dillinger *et al*, 2000). Given these realities, bailouts to undeserving SNGs keep occurring even though they may be harmful for the fiscal stability of the economy and so ways need to be found whereby a hard budget constraint can be made binding on the States.

IV. PATHS TO REFORM

a. Hard Budget Constraint through Market-based Discipline

Fiscal discipline among SNGs, it is now widely acknowledged, is best promoted by the "market" or market-like mechanisms, – the capital markets, competition for votes, land markets and owners of mobile factors viz, workers and investors (Rodden *et al*, forthcoming). Competition for credit from the market helps to promote fiscal discipline by punishing the poor performers with higher cost or 'constrained access'. Poor credit rating also provides signals to voters regarding their governments' performance. Experience of industrial countries show that federally imposed controls and constraints usually do not work. What helps more is societal norms and political activism of the electorate. After reviewing the system of fiscal coordination in mature federations, Shah (1998) concludes: "Ultimately capital markets and bond-rating agencies provide more effective discipline on fiscal policy." However, the efficacy of the credit market in enforcing fiscal discipline depends on a number of factors.

First of all, there must be a well developed and well regulated capital market. If in the public sector, the lending institutions should be allowed to function autonomously, guided purely by prudential norms, insulated from politics. What is more, full information must be available on the finances of the government, covering current revenues and expenditure, as also assets and liabilities including contingent ones of the public sector as a whole. Disciplining by voters and other market-like mechanisms, the bond markets or mobile factors cannot be effective when full information is lacking or the electoral choices are guided by considerations other than the economic performance of the government (such as caste), or are hijacked by musclemen. Further, the lending institutions should have no expectation of a bailout from the Center under any circumstances as, otherwise, they are likely to be less vigilant and 'moral hazards' will tend to influence their decisions.

The only two federations where the state/provincial governments are required to rely entirely on the market for obtaining credit are USA and Canada (Bird and Tassonyi, forthcoming). But, these countries had to go through a painful process before the markets came to function efficiently and the no-bailout commitment by the federal government acquired credibility.[19] Hence, while emphasizing the need for reforms to help improve market-oriented oversight, analysts recognize that market mechanisms are often insufficient in developing countries and suggest that "an additional line of defense" is required in the form of hierarchical mechanisms and regulation by the central government (Rodden *et al*, forthcoming).

In fact, in most developing countries subnational borrowing is subject to centrally imposed restrictions. An IMF study covering 53 countries found that all but six had such restrictions; in 16 of these lower level governments were barred from public borrowing while in 19 overseas borrowing was not allowed. In the other countries controls were exercised by the Center in ways categorized as (a) rules-based controls, (b) administrative controls and (c) cooperation by different levels of government in the design and implementation of debt control. (Ter-Minassian and Craig, 1997).

While not ruling out the role of market based control, the IMF study suggests that market based discipline can serve as a useful complement to other forms of borrowing controls, of which rules-based controls seem more preferable. Rules are usually laid down by law. In some cases, they set limits to the absolute level of debt of subnational governments while in others they permit borrowing upto a point consistent with a specified maximum level of debt service ratio.

Detailed administrative control, more common in unitary countries, often involves the central government in micro-level decisions which the lower tier governments may be in a

better position to take, thus negating the efficiency benefits associated with decentralization. Besides, with administrative control involving the Center in the borrowing operations of the lower level governments, it may be difficult for the Center to absolve itself of any responsibility and deny bailout in the event of default by a borrowing SNG. Strong hierarchical constraints are likely to be more effective in small homogenous political entities like Norway or within a Canadian province over their municipalities than in "large diverse federations" (Rodden *et al*, forthcoming). Even so, considering that conditions required for the market system to work may take time to come about, hierarchical mechanisms cannot always be dispensed with. However, the message that comes out of *a priori* considerations and country experiences is that such control should rely primarily on transparently operated rules laying down limits on overall borrowing and guarantees by governments rather than going down to details of how budgets are to be framed.

b. A Middle Road

For all the reasons cited above, the preferred option emerging from current literature on the subject seems to be market based discipline supplemented by rules- based control. Rules-based controls have the merit of transparency and "even-handedness" but to be effective require clear and uniform accounting standards, full information on off budget transactions, comprehensive definition of public debt and a modern financial management information system for governments. The rules may impose constraints on borrowing on both borrowers and lenders, *ex ante* and *ex post* on the lines suggested by Dillinger *et al.* (vide Box below).

In the context of rules-based approaches, Ter-Minassian and Craig (1997) also underline the value of "increased cooperation of all levels of government in containing (or reversing, if needed) the growth of public debt." The Australian Loan Council provides an example of how subnational borrowing can be kept in check through mutual cooperation and thus surveillance among States and the federal government. However, the success of the Loan Council is attributed to a great extent to the dominant position of the Center, arising from the acute degree of vertical imbalance in the Australian federation (Grewal, 2000). It is however, salutary to remember that Australia is a homogenous federation with only eight States (including the Capital Territory) as against 28 in India. Nevertheless, the value of cooperation and mutual agreement arrived at in a transparent manner in a multi-lateral forum cannot be overemphasized for a country as diverse as India. The concluding observations of Ter-Minassian and Craig reproduced below merit special attention in the Indian context:

"A multilateral forum for discussion of budgetary policies and prospects of various levels of government should facilitate the recognition of any need for reforms of the existing system of intergovernmental fiscal relations and help muster adequate political consensus for such reform."

Box

Channels for Control of Subnational Borrowing

	For Borrowers	For Lenders
Ex-ante controls	- Central government review of fiscal capacity to carry debt. - Prohibition of international borrowing	- Credit rationing to States
Incentives	- no bailouts	- Regulations require provisioning against debt from fiscally weak SNGs
Ex-post	- Government does not hold SNG debt	- strong supervision of banks
Consequences	- debt service withheld from transfers	

(Source: Dillinger *et al*, 2000)

V. Directions of Reform for India

Coming to the Indian situation, failure of hierarchical controls despite constitutional constraints on subnational borrowings and the Center's dominant position in financial and administrative areas seems paradoxical. Given the way the institutions governing intergovernmental fiscal relations have functioned over the years, however, the paradox should not look surprising. Here is a classic case of a federal system in which the States are given responsibilities that they cannot meet out of their own resources, making them dependent on the Center for financing a good part of their budgets while they also have access to borrowing from sources over which the Center's control does not seem to apply (small savings, borrowing through PSEs, etc.) – a deadly combination as Rodden and Eskeland (forthcoming) put it.

This is not to make light of the weaknesses of the transfer system to provide the right incentives for discipline but to point out that incentives cannot work unless the vertical imbalances are met on a fair estimate of both the Center's and the States' revenue domains and spending needs and the States are given more autonomy in raising revenue and reducing costs, along with a tighter rein on their borrowing.

In this background, the remedy for fiscal laxity of States lies in corrective action in several directions encompassing the institutions underpinning intergovernmental fiscal relations. The thrust of the reforms should be (a) restructuring the transfer system in order to correct the adverse influence on fiscal discipline, (b) widening the tax powers of States and strengthening their hand in keeping down costs, and (c) operating a hard budget constraint with a combination of market based discipline and hierarchical mechanism operated under transparent rules in a cooperative framework.

a. Reform of Transfer System

Bird (2000) provides some useful guidelines on the design of intergovernmental transfers that can help to secure accountability and contain fiscal imbalances at the sub-national level where such transfers happen to be unavoidable and significant. Considering that both specific-purpose and general-purpose grants may be required, and within the first category, there may be need for some matching grants also, it is necessary first to create a total pool of resources for general-purpose transfers defined in a stable yet flexible manner. Bird's guidelines also point to the need for taking into account both need and capacity in the distribution of general-purpose transfers, but in a simple and transparent fashion. The general purpose grants should, in this scheme, be unconditional except for the requirement to maintain proper accounts.

The scheme of tax sharing now introduced in India with the recent amendment in the Constitution accords with Bird's guidelines in this respect. However, the manner in which these taxes are devolved and grants dispensed to the States leaves much to be desired from the angle of efficiency. To remove the perverse incentives from the transfer system it is necessary to base them more on normative assessment of revenue capacity and cost differences faced by the States. The problems faced in applying the normative approach arising from the partitioning of statutory transfers into tax devolution and grants-in-aid also need to be addressed.

The segmentation of revenue expenditure into 'plan' and 'non-plan' leaving the task of looking after the gap to two different agencies - the PC and the FC - is scarcely conducive to the determination of needs of each State in a holistic way. For the transfers to operate without creating moral hazard, it is necessary to integrate the revenue side and assess the gap objectively, leaving it to the States to raise revenue on their own if they wish to spend more than what is estimated normatively. Hence, all revenue transfers should be brought under the purview of the FC and the plans should focus on investment planning as was the original intention. This will call for a fundamental rethinking of the role and strategy of planning in a liberal open economy environment with the market determining interest rates and private investment flows. The transfer system will remain flawed unless its different components are integrated and guided by healthy principles.

Bird's guidelines also require that the general purpose grants should carry no conditions except that for maintaining proper accounts. Until recently, neither the grants-in-aid flowing from the FC's recommendations nor those dispensed by the PC as block grant under the Gadgil formula have been subjected to any conditionality. However, based on the majority report of the EFC a part of the grants-in-aid proposed by the FC will be released on fulfillment of a fiscal reform program. While the Center's anxiety to induce fiscal discipline among the States is understandable, it should be noted that attaching conditions to general purpose grants[20] violates the basic rationale of transfers meant to bridge the vertical and horizontal imbalances in a federal system.[21] With conditionalities on general purpose grants, federalism may be subverted through coercion to 'fall in line' with the Center's ideology, as happened in India during the days of pervasive central planning.

b. More Fiscal Room for States

Reform of the transfer system should be accompanied by a widening of the tax powers of the States and a review of the system whereby large responsibilities are cast on

them without regard for the consequences on their expenditure budget. In other words, the scheme of assignment of tax powers and functions needs to be reviewed so that the vertical gap is narrowed and the burden on the transfer system gets alleviated (Bagchi, 1998, Purohit, 2000). One way of giving greater fiscal room to the States would be to allow them power to tax services along with goods. A State tax piggybacking on the central personal income tax would be another. Removing the restrictions on the rates of tax on declared goods sold within their jurisdiction would also help augment the States' tax revenues substantially.[22]

On the expenditure side, any action on the part of the Center that entails large additional spending responsibilities on the States should be preceded by consultation with the State governments. At the same time, ways should be explored for introducing market discipline in the matter of borrowing by States.

c. Hard Budget Constraint with Market-based Control and Hierarchical Mechanism

Belying apprehensions about the inability of the market to enforce discipline in the system, the auctions of State government bonds in recent times shows that markets are active and are imposing higher risk premium on States with large outstanding debt and guarantees (Roy, 2001). Even so, the market based discipline will take time to operate efficiently, given the lack of information and transparency in the financial operations of the governments. In view of this, a hierarchical mechanism also would need to be in place to ensure that the States do not borrow imprudently. Consideration therefore, will have to be given to the question of putting a cap on the States' debt, until the market system is in a position to take over the responsibility of meeting their borrowing requirements.

One way would be to have a statutory rule of fiscal responsibility legislated by the States themselves, defined in a way that automatically caps debt at some level related to their debt servicing capacity as reflected, say, in the proportion of debt to GSDP or projected interest payments as a proportion of their revenue. The report of the Technical Committee on State Government Guarantees set up by RBI in 1999 provides useful suggestions for setting parameters and basis for imposing ceiling on guarantees. Caps on borrowings can be formulated on similar lines.[23] This has the advantage that it would be voluntary on the part of the States and would not be construed as an infringement of their fiscal autonomy. But it would be unrealistic to expect the States' politicians (and bureaucrats) to act prudently until the States' electorate becomes fully aware of the problems to engender such virtuosity. Fiscal responsibility may not come about voluntarily in all cases. Hence, some other capping mechanism may be necessary.

For this purpose, a simple, rule-based system would be preferable, as it would be easily understood and least controversial, as long as the control is not exercised by the central government but is left to an agency like the RBI to operate through prudential lending norms to be observed by the lending agencies. In sum, market based control should be supplemented by constraints on borrowing both *ex ante* and *ex post* and on both borrowers and lenders with the rules evolved and enforced through the RBI.

A possible drawback of market operated State borrowing system will be the disadvantage of economically weak States. One way to overcome the handicap of weak States would be for the Center to subsidize the lending FIs for the risk of funding the borrowing program of such States to enable them to undertake structural adjustment. It should be left to the lending FI to get the borrowing State to come up with a feasible action program to improve the fiscal balance.

It needs to be emphasized again that there should be a firm commitment to the no bailout policy from the Center, except under rare circumstances and that any bailout scheme should operate in an open and transparent manner through a system of mutual surveillance under guidelines formulated with the approval of the National Development Council (NDC). Center may be required to advance loans to needy States for investment in infrastructure or structural adjustment. Central assistance for the Plan is given partly as loans now.

Conditionalities are better attached to loans rather than any of general purpose grants. In any case it is essential that the conditionalities are formulated in terms of parameters set by a forum like the NDC and operated transparently by an empowered committee of State Ministers.

Lastly, there is much to be said for a cooperative approach in the matter of fiscal coordination in a federal country of such heterogeneity as ours. How fruitful such cooperation can be is demonstrated by the agreement reached at the recent meeting of Chief Ministers of States on a reform agenda for the power sector[24] and the manner in which the empowered committee of States' Finance Ministers is implementing the decisions on sales tax harmonization among the States. The activation of the inter-State Council is thus to be welcomed. Hierarchical controls with one State not knowing what others are being required to do and how the conditionalities are being administered as seems to have been the case with the MOUs (Rao, 2000) are not in keeping with the spirit of federalism that underlies the Constitution of India for all its unitary bias and provides the only way India can grow as a nation.[25]

VI. SUMMARY OF SUGGESTIONS

The system of intergovernmental transfers and checks on subnational borrowing in India need radical reform if fiscal discipline is to be inculcated among States. For this purpose:

- All revenue transfers from the Center to the States would need to be integrated by bringing them under the FC's purview. The FC's devolution formulae should be strengthened with 'normative' assessment of needs and capacity of the States.
- A new strategy of planning oriented to a liberalized economy focussing on Plans for investment would need to be evolved. The practice of extending loans to States by the Center as Plan assistance under the Gadgil formula without reference to specific investment projects should stop.
- The States should be required to depend on the market for their borrowing needs, with subsidy from the Center for the additional risk premium on interest on loans given by FIs to underdeveloped/poorer States. The States' repayment capacity should be judged by lending institutions on the basis of prudential norms, and rating by accredited agencies. The system should be transparent and the State budgets should disclose all transactions bearing on budgetary outcomes.
- In addition, there should be a cap on borrowing by States related to their repaying capacity as reflected by, say, the proportion of interest payments to their current revenue including central transfers. The cap should be included in the prudential norms of lending prescribed by RBI. It is encouraging to find that the RBI has tightened the prudential norms and capital adequacy requirements of banks subscribing government guaranteed bonds.[26]
- There should be a clear commitment to 'no-bailout' by the Center. For temporary accommodation, the system of WMA and overdrafts by RBI should continue. Until this system comes into full operation, loans may need to be given by the Center to the States for infrastructure investment and for structural adjustment. Conditionalties can be attached to such loans but within parameters set by a forum like the NDC.

Some of the elements of the proposed scheme have been proposed elsewhere (Chelliah, 2000b). Such a system will address the basic concerns of macroeconomic imbalances, State autonomy and special considerations, without unduly loosening the market regulations on sub-national borrowing. Ultimately, fiscal responsibility must become a matter of societal culture. And that can come about only through greater awareness among the

people of the consequences of imprudent budgeting for which transparency and access to information, and active involvement of the States are the prerequisites.

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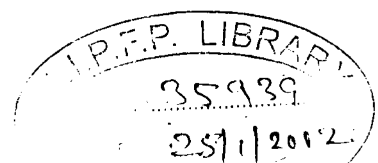
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Table 1: Outstanding Debt of State Governments

(Percentages)

Year	Total Liabilities / GDP	Share in Total Liabilities		
		Loans & Advances from the Centre	Market Loans	Others
1975-76	16.4	70.6	15.4	14.1
1980-81	16.6	70.9	12.5	16.7
1985-86	19.1	72.3	11.4	16.3
1990-91	19.4	67.2	14.2	18.6
1991-92	19.3	66.1	15.0	18.9
1992-93	19.0	65.0	15.8	19.2
1993-94	18.6	63.7	16.3	20.0
1994-95	18.3	63.2	16.3	20.4
1995-96	18.0	62.0	17.0	21.1
1996-97	17.9	61.2	17.5	21.3
1997-98	18.6	61.4	17.7	20.9
1998-99	19.4	59.6	17.6	22.8
1999-00	21.5	58.2	17.2	24.6

Source: RBI Bulletin, Study of Budgets of the States of India, various issues and Report on Currency and Finance, RBI, various issues.

Table 2: Debt and Interest Burden of States: Statewise

(percentages)

State	Total Debt/ GSDP	Total Liabilities/ Revenue Receipts		Interest Payments/ Revenue Receipts	
	1997-98	1990-91	1998-99	1990-91	1998-99
Punjab	35.24	347.12	362.70	17.90	37.75
Orissa	37.96	208.71	330.63	16.80	32.60
West Bengal	22.97	191.53	304.86	15.46	31.82
Uttar Pradesh	26.59	170.85	279.79	16.40	32.44
Bihar	33.13	213.58	250.14	16.29	25.95
Himachal Pradesh	48.51	160.72	247.15	13.74	21.82
Rajasthan	27.78	157.24	246.04	14.36	27.44
Kerala	23.99	184.85	218.12	14.49	20.41
Haryana	20.12	147.46	173.30	15.36	22.35
Madhya Pradesh	19.79	143.56	169.82	11.28	16.17
Andhra Pradesh	20.82	126.11	167.64	11.78	19.90
Assam *	26.95	238.32	151.68	14.78	11.56
Goa	32.88	298.94	146.56	12.71	24.76
Gujarat	16.27	184.37	145.66	14.12	19.46
Maharashtra	12.08	113.23	143.42	11.18	18.59
Jammu & Kashmir *	N.A.	308.72	140.50	12.21	15.39
Karnataka	16.88	119.04	137.52	11.64	15.19
Tamil Nadu	15.55	108.12	137.31	9.08	15.03
Nagaland *	N.A.	105.04	133.01	7.72	13.93
Manipur *	35.60	89.39	128.21	8.34	10.33
Tripura *	36.01	96.16	109.54	7.81	11.26
Mizoram *	52.84	26.41	99.32	8.84	9.74
Arunachal Pradesh *	57.55	94.97	93.72	4.77	7.87
Meghalaya *	21.37	58.64	85.35	5.07	8.35
Sikkim *	N.A.	93.75	35.05	7.10	11.69

* Special Category States
N.A. Comparable GSDP data (1993-94 series) not available

Source: *State Finances: A Study of Budgets of 2000-2001*, Reserve Bank of India, Mumbai, *Report on Currency and Finance, 1991-92*, Reserve Bank of India, Mumbai, and Report of the Eleventh Finance Commission, Annexure II-5, p. 184.

Table 3
State Expenditures and Receipts

(Rs. Crore)

Year	Expenditures		Own Revenue Receipts	(4)/(2) (%)	(4)/(2+3) (%)
	Revenue	Capital Outlay #			
(1)	(2)	(3)	(4)	(5)	(6)
1974-75	6037	1110	4181	69.3	58.5
1975-76	6967	1404	5120	73.5	61.2
1976-77	7940	1655	5852	73.7	62.0
1977-78	8911	1854	6286	70.5	58.4
1978-79	10511	2287	7221	68.7	56.4
1979-80	12081	2675	8138	67.4	55.2
1980-81	14808	3200	9882	66.7	54.9
1981-82	17075	3589	11468	67.2	55.5
1982-83	20237	3719	13111	64.8	54.7
1983-84	23803	4277	14913	62.7	53.1
1984-85	28349	4911	16809	59.3	50.5
1985-86	32770	5453	19842	60.5	51.9
1986-87	38132	6277	22857	59.9	51.5
1987-88	45151	6654	26066	57.7	50.3
1988-89	52228	7078	30025	57.5	50.6
1989-90	60217	7964	34932	58.0	51.2
1990-91	71776	9223	39582	55.1	48.9
1991-92	86186	10096	48462	56.2	50.3
1992-93	96205	10655	52752	54.8	49.4
1993-94	109376	12450	61656	56.4	50.6
1994-95	128468	17351	77395	60.2	53.1
1995-96	145004	18495	86760	59.8	53.1
1996-97	168948	17540	94645	56.0	50.8
1997-98	186634	22802	105667	56.6	50.5
1998-99	220090	23072	113163	51.4	46.5

Source: RBI Bulletin, Various Issues

\# Defined as total capital expenditure minus all loans repaid or advanced.

Table 4: Deficits of the Centre and States

(as per cent of GDP)

Year	Fiscal Deficit		Revenue Deficit	
	States and UTs*	Centre	States and UTs*	Centre
1	2	3	4	5
1970-71	2.01	2.83	0.04	-0.36
1971-72	2.17	3.51	-0.02	0.20
1972-73	2.58	4.66	0.13	-0.03
1973-74	2.23	0.24	0.18	-0.36
1974-75	1.63	2.74	-0.52	-0.98
1975-76	1.34	3.06	-1.14	-1.06
1976-77	1.71	4.15	-1.22	-0.31
1977-78	2.04	3.61	-1.00	-0.42
1978-79	2.44	4.93	-1.03	-0.26
1979-80	2.41	5.26	-1.28	0.57
1980-81	3.01	5.85	-0.62	1.18
1981-82	2.53	5.11	-0.77	0.17
1982-83	2.70	6.53	-0.47	0.66
1983-84	2.95	6.11	-0.10	1.09
1984-85	3.37	7.05	0.36	1.42
1985-86	2.79	8.38	-0.19	1.99
1986-87	2.99	8.40	-0.01	2.48
1987-88	3.09	7.61	0.29	2.57
1988-89	2.68	7.30	0.43	2.48
1989-90	3.03	7.31	0.72	2.44
1990-91	3.19	7.85	0.90	3.26
1991-92	2.82	5.56	0.87	2.49
1992-93	2.68	5.38	0.68	2.49
1993-94	2.28	7.01	0.40	3.81
1994-95	2.64	5.71	0.55	3.07
1995-96	2.71	5.10	0.74	2.52
1996-97	2.67	4.90	1.18	2.40
1997-98	2.86	4.83	1.10	3.06
1998-99 (RE)	4.15	4.54	2.29	3.43

Notes: Minus (-) sign denotes surplus. States include Union Territories (UTs)with Legislatures

Source: (i) Indian Public Finance Statistics, various issues. (ii) National Accounts Statistics, 2000, Central Statistical Organisation, Ministry of Planning and Programme Implementation, Government of India..

Table 5: Centre - State Current Transfers

(Rs. Crore)

Year	Shared Taxes	Statutory Grants	Plan (Block) Grants*	Other Grants	Interest Payments by States to the Centre#	Net Transfers	Total Revenue Receipts of the Centre	Share of Net Transfers in Revenue Receipts of the Centre (%)	Net Transfers/ Gross Transfers (%)
1	2	3	4	5	6	7	7	8	9
1980-81	3792	335	995	1466	889	5699	12484	46	87
1990-91	14535	3394	3515	6384	5174	22654	54995	41	81
1991-92	17197	3446	5292	7067	6565	26437	66030	40	80
1992-93	20522	3853	5871	8219	7843	30622	74117	41	80
1993-94	22240	4044	7171	9741	9558	33638	75784	44	78
1994-95	24843	1701	10390	8206	11183	33957	91318	37	75
1995-96	29298	5287	8080	8210	13002	37873	109983	34	74
1996-97	35061	5337	9855	8353	15163	43443	126157	34	74
1997-98	43548	3097	11044	16311	17473	56527	133548	42	76
1998-99	39145	2891	12340	10474	21242	43608	149485	29	67

Notes: * Plan grants for specific purposes are included in other grants.
Interest Receipts of the Center include those from the Union Territories (UTs)

Source: (i) Indian Economic Statistics / Indian Public Finance Statistics, various issues. (ii) Budget Documents, Various Issues. (iii) Union Finance Accounts, Various Issues.

Table 6: Government Expenditures at the State Level

(Rs. Crore)

Year	Plan				Non-Plan	
	Revenue (% of 4)	Capital (% of 4)	Total Plan	Debt Financed [(4-7)/4] (%)	Expenditure	Revenue Surplus (+) / Deficit (-)
1	2	3	4	5	6	7
1974-75	29.5	70.5	2237.25	98	6396.20	35.80
1975-76	31.2	68.8	2822.84	89	7633.30	304.70
1976-77	33.0	67.0	3853.78	74	8018.20	1018.80
1977-78	31.7	68.3	4373.05	78	8985.00	946.00
1978-79	35.5	64.5	5574.93	74	10203.70	1443.30
1979-80	33.6	66.4	6083.82	73	12005.40	1623.60
1980-81	37.8	62.2	7359.81	88	15410.10	882.90
1981-82	38.2	61.8	8338.95	85	17231.80	1223.20
1982-83	41.0	59.0	9540.05	84	19556.50	1568.50
1983-84	44.9	55.1	11387.61	85	22280.10	1733.90
1984-85	48.4	51.6	12980.54	95	26765.20	660.30
1985-86	46.6	53.4	14009.28	82	30859.50	2564.60
1986-87	48.5	51.5	17863.66	79	34407.40	3818.90
1987-88	50.7	49.3	21155.28	74	38558.30	5442.10
1988-89	53.2	46.8	22144.12	75	44949.40	5471.50
1989-90	50.5	49.5	23258.64	88	53797.80	2737.00
1990-91	52.4	47.6	27432.87	90	63809.10	2657.70
1991-92	51.3	48.7	31084.46	90	77561.00	2974.70
1992-93	54.2	45.8	33391.47	83	85493.10	5598.00
1993-94	53.7	46.3	36730.03	79	97918.50	7645.20
1994-95	49.7	50.3	44513.70	88	117040.09	5243.62
1995-96	51.9	48.1	48449.91	84	129133.80	7669.60
1996-97	55.2	44.8	53045.93	94	149723.10	3113.30
1997-98	51.4	48.6	59260.01	98	168874.20	1426.60
1998-99	54.1	45.9	64870.70	139	201490.20	-25042.50

Source: RBI Bulletin, Various Issues

Note: Non-Plan Revenue Surplus/ Deficit equals Total Revenue Receipts (including Plan grants) less Non-Plan Expenditure

Table 7
Loans and Advances from the Center to the States

(Rs. Lakh)

Item	1997-98	1998-99	1999-2000 (RE)
1. State Plan Schemes	1,412,348	1,525,317	1,958,787
2. Central Plan Schemes	22,011	1,947	1,699
3. Centrally Sponsored Schemes	13,440	18,689	34,123
4. Non-Plan	1,509,427	2,270,862	2,726,057
I. Share of Small Savings	1,504,926	2,265,095	2,523,008
II. Relief for Natural Calamities	-	-	-
III. Others	4,501	5,767	203,049
5. Ways and Means Advances	58,930	206,400	114,400
6. Loans for Special Schemes	60,952	10,981	117,601
Total	*3,077,108*	*4,034,196*	*4,952,667*

Source: State Finances: A study of Budgets of 1999-2000, and the same of 2000-01, Reserve Bank of India, Mumbai.

Routed through State budgets

Table 8: Revenue Account of the States – Receipt, Expenditure and Deficit

(As percentage of GDP)

Year	Tax Revenue			Non-Tax Revenue			Total Revenue Receipts (=4+7)	Total Revenue Expenditure	Revenue Deficit (=9-8)
	Own Sources	Central Transfers	Total (=2+3)	Central Grants	Own Sources	Total (=5+6)			
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Avg. 74-75 to 78-79	4.2	1.8	6.0	1.7	1.9	3.6	9.6	8.6	-1.0
Avg. 79-80 to 83-84	4.8	2.5	7.3	1.8	2.0	3.8	11.1	10.4	-0.7
Avg. 84-85 to 88-89	5.2	2.6	7.8	2.2	1.9	4.1	11.9	12.1	0.2
1989-90	5.3	2.7	8.0	1.7	1.8	3.6	11.6	12.3	0.8
1990-91	5.3	2.5	7.8	2.2	1.6	3.8	11.7	12.6	0.9
1991-92	5.5	2.6	8.1	2.3	1.9	4.3	12.3	13.2	0.9
1992-93	5.3	2.8	8.1	2.4	1.7	4.1	12.2	12.9	0.7
1993-94	5.4	2.6	8.0	2.5	1.8	4.3	12.3	12.7	0.4
1994-95	5.5	2.5	8.0	2.0	2.1	4.1	12.1	12.7	0.6
1995-96	5.4	2.5	7.9	1.8	1.9	3.7	11.6	12.3	0.7
1996-97	5.2	2.6	7.8	1.7	1.7	3.4	11.2	12.4	1.2
1997-98	5.4	2.7	8.0	1.6	1.6	3.2	11.2	12.3	1.1
1998-99	5.0	2.2	7.3	1.4	1.4	2.7	10.0	12.5	2.5
Growth Rate (74-75 to 78-79)	13.8	11.1	13.0	24.3	13.9	18.8	15.2	14.5	N.C
Growth Rate (79-80 to 88-89)	16.2	14.1	15.5	18.9	12.7	15.8	15.6	17.5	N.C
Growth Rate (88-89 to 98-99)	15.0	14.3	14.7	10.4	13.5	11.9	13.8	15.0	N.C
Growth Rate (74-75 to 98-99)	15.7	15.9	15.7	15.0	13.7	14.3	15.3	16.6	N.C

Source: Basic Data, RBI Bulletin, Various Issues.

Notes: Minus (-) sign in Column (10) indicates surplus. Average revenue (in the first 3 rows) over the respective time periods pertains to the simple (five year) average of the ratios for the constituent years. N.C stands for *not computed*.

Weight in the Formula for Inter-se allocation by the Respective Finance Commissions

Factors / Elements of the Formula	XI	X	IX			VIII
		IT Plus 40 Per Cent of UED	First Report	Second Report		90 Per Cent of Shareable IT[$$] Plus 40 Per Cent of UED
			90 Per Cent of Shareable IT[$$] and 40 Per Cent of UED	IT	UED[$]	
Population	10.0	20.0	25.0	22.5	25.0	25.0
Distance	62.5	60.0	50.0	45.0	33.5	50.0
Inverse of Income[*]			12.5	11.25	12.5	25.0
Poverty Ratio			12.5			
Index of Backwardness				11.25	12.5	
Area	7.5	5.0				
Index of Infrastructure	7.5	5.0				
Tax Effort	5.0	10.0				
Fiscal Discipline	7.5					
Contribution[**]				10.0		
Tax Revenue Devolution	29.5 % of Net Proceeds of all Shareable Union Taxes and Duties	77.5 % of IT and 47.5 % of UED[#]	85 % of IT and 45 % of UED[##]	85 % of IT and 45 % of UED		85 % of IT and 45 % of UED[##]

Notes: UED: Union Excise Duties, IT: Income Tax

*: This is used with minor modification to compute the Income Adjusted Total Population (IATP) by the Ninth Finance Commission

**: Contribution is measured by assessment / collection / derivation

#: 7.5 percent of UED was to be distributed over the deficit States only

##: 5 percent of the UED was to be distributed over the deficit States only

$: The remaining 16.5 percent was to be distributed over the deficit States only.

$$: 10 percent of the shareable IT was to be distributed on the basis of contribution

Source: The respective reports of the Finance Commissions.

Gadgil Formula for Distributing State Plan Assistance*

Criteria	Share in central plan assistance (per cent)	Share of grants and loans	Criteria for distribution in non-special category States
A. Special category States (10)	30	90:10	
B. Non-special category States (15)	70	30:70	
(i) Population (1971)			60.0
(ii) Per capita income, of which			25.0
(a) According to the 'deviation' method covering only the States with per capita Income below the national Average			20.0
(b) According to the 'distance' method covering all the fifteen States			5.0
(iii) Fiscal performance, of which			7.5
(a) Tax effort			2.5
(b) Fiscal management			2.5
(c) National objectives			2.5
(iv) Special problems			7.5
Total			100.0

Note:
1. The formula as revised in December 1991.
2. Fiscal management is assessed as the difference between States' own total plan resources estimated at the time of finalizing annual plan and their actual performance, considering latest five years.
3. Under the criterion of the performance in respect of certain programs of national priorities the approved formula covers four objectives, viz. (i) population control, (ii) elimination of illiteracy, (iii) on-time completion of externally aided projects, and (iv) success in land reforms.

Endnotes:

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[1] Vide Report of the Eleventh Finance Commission (EFC), Table 2.2.

[2] EFC Report, Table 2.1. This is based on budget estimates in the case of States. Revised estimates for 1999-00 suggest that the deficit level may have been a little lower.

[3] Vide RBI Report (February 1999), Table 6. There are media reports of suicide among creditors in some States.

[4] Vide studies on State Finances carried out at NIPFP particularly Sen and Bhattacharyya (2000), Sen and Rao (2000), Rajaraman, Mukhopadhyay and Amar Nath (1999), Srivastava, Chattopadhyay and Jena (1999) and Srivastava, Chattopadhyay and Rangamannar (1999). See also Kurian (2000), Bajaj and Joshi (2000) and Chaudhuri (2000).

[5] Vide, for example, the articles in Burki & Perry (2000), Teresa Ter-Minassian (1997), Von Hagen *et al* (2000), and Rodden *et al* (forthcoming).

[6] The possibility of opportunistic behaviour because of the weak Wicksellian link may have increased with the 73rd and 74th amendments to the Constitution extending decentralisation to another tier of government, viz., the Panchayati Raj Institutions and the municipal bodies. While these amendments should greatly strengthen democratic governance in the country, the consequences for the public finances would depend very much on the transfer system that will evolve to support their functioning. Which way the results will go only future will tell although there is already some evidence of the consequences for State budgets in some States like Kerala (vide Economic and Political Weekly, March 3, 2000). Investigation of the possibility of perverse incentives getting accentuated by the system of transfers from the States to local bodies is beyond the scope of this paper.

[7] This would seem to corroborate the finding of Dillinger *et al* (2000) that decentralisation leads the public sector to expand. The causality assumption of this finding is however, questionable as the public sector expanded tremendously in the second half of the twentieth century in industrial countries even the unitary ones because of the emergence of the welfare State (Musgrave, 1998).

[8] According to RBI, the dominant component of the FD of States, like that of the Centre in the eighties as well as in the nineties, was structural and not cyclical (RBI, 1999).

[9] For a critical appraisal of the operation of the transfer system see, Rao and Chelliah (1991) and Rao and Sen (1996).

[10] Article 282 of the Constitution authorises the Centre and the States to make grants for any public purpose. However, whether transfers of the order that are made as 'plan grants' could legitimately be made on the strength of Article 282 has been a subject of controversy (vide NIPFP, 1993).

[11] See EFC report, Table II..8, p. 187.

[12] In the case of "special category" States, grants constitute 90 per cent of the plan assistance. This helps these States to have sizeable surplus on revenue account of their budget, yet they run into large FD. Reasons for this and their ramifications remain an area for investigation.

[13] This may be seen from the figures of approved plan (AP) and actuals (A), for Punjab and U.P. for the last four years.

(Rs. Crore)

	1997-98		1998-99		1999-00		2000-01	
	AP	A	AP	A	AP	A	AP	A*
Punjab	2100	1814	2500	1307	2680	1668	2420	2436
U.P.	7246	4179	10260	5436	11400	6405	9025	6795

* Latest estimates

Source : Planning Commission

[14] These are the 'goods' declared to be of importance to inter-State trade and commerce and also include commodities on which a tax rental arrangement has been in operation viz., textiles, tobacco and sugar. EFC's recommendations in this regard should however help to ease some of these limitations.

[15] For a discussion of how the Centre's actions impact on States' expenditures, see Sen (2000).

[16] See also Kurian (2000).

[17] The last financial year for which the account of the Delhi Electric Supply Undertaking went to the municipal authority was 1980-81, as per a report of the Comptroller and Auditor-General drawn up in 1995. See "Government Times", Times of India, 13 April 2001.

[18] Times of India, 4 March 2001.

[19] In the USA, this was facilitated by the 11th amendment of the Constitution which declared the States to be sovereign in their spheres and debarred the federal government from enforcing any creditor right against the States.

[20] Block grants for the State Plans as they are given now come under the category of general purpose grants and so in principle, should carry no conditionality unless they are related to some specific plan projects. In any case, since the block grants are dispensed under the Gadgil formula, introduction of any conditions for their release would call for the approval of the NDC.

[21] Whether attaching conditions to grants-in-aid provided under Article 275 of the Constitution is permissible is a moot question of law, which is not gone into here.

[22] However, this would require a destination-based VAT to minimise the scope for tax exporting.

[23] The Committee suggested four parameters for this purpose:

a. Total outstanding debt plus one-third of outstanding guarantee should not exceed, say, 50 per cent of NSDP with suitable modification for States where borrowing is made to raise resources for infrastructure.
b. Linking guarantee to revenue receipts.
c. Linking guarantees and debt to the Consolidated Fund of the State.
d. Keeping the ratio of incremental guarantees to incremental net market borrowings constant or brought down.

[24] See Times of India, March 4 2001.

[25] "India contains almost a billion people living in such a heterogenous group of States – in language, in religion, in culture, in level of development, and so on – that it is hard to see how it could possibly be governed except as a tight dictatorship (like the old Soviet Union) or a relatively loose federation." (Bird, 1994)

[26] With effect from 2000, 'risk weight' of 20 percent has been prescribed for State government guaranteed bonds that are in default. The weight was to go up to 100 percent for March 2001. Provisioning of 25 percent against such assets has also been prescribed (Roy, 2001).