Future of Fiscal Federalism in India

This editorial is based on "State Debt and the Constitution" which was published in Economic and Political Weekly on 22/06/2024. The article brings into picture the recent legal dispute between the Kerala government and the union over finances, highlighting a potential constitutional crisis regarding the union's control of subnational debt, which necessitates appropriate constitutional amendments.

For Prelims: Article 131 of the Constitution, Article 293 of the Indian Constitution, Fiscal federalism, Public Sector Undertakings, 14th Finance Commission, Union's share of state loans, Ujwal DISCOM Assurance Yojana , Blockchain Technology.

For Mains: Provisions and Limitations of Article 293 of the Indian Constitution, Measures to Adopt to Improve Fiscal Health of States.

The recent suit filed by **Kerala against the Union government** in the Supreme Court under Article 131 of the Constitution asking the Court to direct the union government to remove the ceiling on the amount of money that the state could borrow has brought the interpretation of Article 293 of the Indian Constitution into focus. This article governs the power of states to borrow money and the Union's authority to regulate such borrowing .While Kerala argues for **greater autonomy in borrowing**, the Union government emphasizes the **need for macroeconomic stability through debt regulation.**

Since this was the first time that Article 293 had to be interpreted, the matter was referred to the constitution bench under **Article 145** to be decided by a bench of five judges. The Supreme Court's upcoming decision on this matter will have significant implications for fiscal federalism in India.

What are the Provisions and Limitations of Article 293 of the Indian Constitution?

- **Provisions:**
  - **State Borrowing Power**: States can borrow within India upon the security of their Consolidated Fund of State, within limits set by the state legislature.
    - The Union government may give **guarantees for state loan**s within limits set by Parliament.
  - **Consent Requirement**: If a state owes any outstanding loan to the Union or guaranteed by the Union, it must obtain the **Union government's consent before raising any loan.**
    - The Union can impose conditions on such consent.
    - Consent is not required for temporary overdrafts or other such arrangements with the **Reserve Bank of India.**
  - **Continuation of Previous Loans**: Loans raised by a state which were outstanding at the commencement of the Constitution remain in force under the same terms and conditions.
- **Limitations:**

        - Article 293's authority to regulate state borrowing is linked to states owing money to the Union government.
            - This creates a potential **constitutional gap if states clear their Union debts**, as the article lacks provisions for regulating state borrowing without outstanding loans.
            - This could enable economically stronger states clearing Union debts and then borrowing without Union oversight.
        - Also, states are increasingly using Public Sector Undertakings (PSUs) to bypass Article 293 restrictions.
            - For instance, Kerala in the recent case argues that PSU debts should not count in state debt calculations.
            - As states increasingly borrow from other sources, there's a possibility that some may soon owe nothing to the Centre, potentially rendering Article 293 irrelevant.
                - This trend was first identified by the 14th Finance Commission.
            - This loophole allows states to exceed borrowing limits, **obscures true state indebtedness,** and complicates fiscal transparency and accountability, **posing hidden financial risks.**
- **Key Questions for the Constitution Bench:**
    - **State's Right to Borrow:** Whether a state has a **"right" under Article 293** to borrow and if the union can regulate this right.
    - **Public Sector Undertaking (PSUs) Debts:** Whether the debts raised by state government PSUs fall within the scope of Article 293.

What are the Latest Trends in State Borrowing from the Union?

- Recent RBI data shows a **dramatic decrease in the** Union's share of state loans, from 57% in 1991 to just 3% by FY 2020.
    - This shift reflects states' increasing reliance on market borrowings and other sources of finance.
    - Also, this reduction in Union loans to states directly impacts the applicability of Article 293, as its regulatory power is tied to states owing money to the Union.
- The Covid-19 pandemic temporarily reversed the trend of declining state borrowing from the Union, increasing it from **3% in FY 2020 to 8.6% in FY 2024** due to economic pressures and revenue shortfalls.
    - However, this is likely a short-term trend. As the economy recovers,**states may revert to pre-pandemic borrowing patterns.**

What are the Arguments in Favour and Against State's Uninterrupted Right to Borrow?

- **Arguments in Favor:**
    - **Fiscal Autonomy:** Borrowing empowers states to manage their finances independently, aligning with the **principles of federalism.**
        - It enables states to fund development projects and meet local needs without solely relying on Union grants, **fostering a sense of self-reliance.**
        - It also provides states with the **flexibility to respond quickly to economic challenges or opportunities specific to their region**, enhancing overall governance efficacy.
    - **Economic Development:** State borrowing facilitates financing of large-scale infrastructure projects that can significantly stimulate economic growth.
        - By bridging temporary revenue shortfalls, borrowing helps maintain continuity in essential services and development programs.
        - Moreover, it **enables states to leverage their borrowing capacity to attract private investments** and forge public-private partnerships, potentially accelerating economic progress.
        - **Example:** Maharashtra's **₹46,000 crore Mumbai-Nagpur Expressway** project, largely financed through borrowing, showcases how states can use debt to fund large-scale infrastructure that stimulates economic growth and connectivity.

- **Flexibility in Financial Management: Borrowing** provides states with a crucial buffer against economic shocks and revenue fluctuations, enhancing their financial resilience.
    - This flexibility also provides an **alternative to increasing taxes, which may be politically challenging or economically undesirable,** especially during periods of economic stress.
- **Accountability to Local Electorate:** The power to borrow makes state governments **more directly accountable to their constituents,** as they must justify their borrowing decisions and demonstrate effective use of funds.
    - Voters can assess the government's performance based on how borrowed funds are utilized, **leading to more informed electoral choices.**
    - This dynamic can contribute to a **more engaged and fiscally aware citizenry**, potentially improving the quality of democratic governance at the state level.
- **Competitive Federalism**: The ability to borrow allows states to compete in attracting investments and businesses, potentially leading to innovative development strategies.
    - Such competitive federalism can lead to the **identification and spread of best practices across states**, contributing to overall national development.

- **Arguments Against**:
    - **Risk of Fiscal Indiscipline:** Unrestricted borrowing power may lead states to **accumulate** unsustainable levels of debt, **jeopardizing their long-term fiscal health**.
        - Political considerations, such as **short-term electoral gains**, might override economic prudence in borrowing decisions, leading to **misallocation of resources**.
        - Excessive state debts could have spillover effects, potentially **destabilizing the national economy and affecting other states.**
        - **Example:** Punjab's **high** debt-to-GSDP ratio, reaching 53.3% in 2021-22, partly due to borrowing for populist schemes.
    - **Macroeconomic Stability Concerns**: Uncoordinated and excessive state borrowing can interfere with national monetary and fiscal policies, complicating economic management at the Union level.
        - Furthermore, it might **negatively impact the country's overall credit rating and borrowing costs** in international markets, affecting the entire nation's financial standing.
        - **Example:** In 2020-21, when states' gross market borrowings increased by 55%, it led to higher yields on state development loans, potentially affecting overall interest rates and Union government borrowing costs.
    - **Inter-State Disparities:** The **varying economic strengths of states** can lead to significant differences in their borrowing capacities, potentially exacerbating existing regional inequalities.
        - Economically stronger states may secure loans at more favorable terms, while **poorer states might face higher borrowing costs,** further straining their finances.
        - Consequently, it may necessitate increased Union intervention to maintain balanced regional development, potentially complicating federal relations.
    - **Complexity in Debt Management:** Multiple states borrowing independently can significantly complicate overall public debt management at the national level.
        - Monitoring and regulating diverse state borrowings can be administratively challenging, **requiring sophisticated oversight mechanisms.**
        - There's also a risk of **overlapping or conflicting debt obligations between states and the Union**, which could create legal and financial complexities.
        - **Example**: The introduction of the Ujwal DISCOM Assurance Yojana (UDAY) in 2015, where states took over power distribution companies' debts, complicated overall debt management and blurred lines between state and PSU borrowings.
    - **Potential for Default and Bailouts:** States facing severe financial distress might default on their loans, which could have far-reaching consequences for creditors and the broader financial system.
        - There often exists an implicit expectation that the Union government would bail out states in case of defaults, creating a **moral hazard that could encourage irresponsible borrowing.**
        - The possibility of state defaults or bailouts could also undermine investor

confidence in the Indian market as a whole, affecting overall economic stability.

What are the Other Federal Systems of Managing Subnational Debts?

- **Brazil:** The Fiscal Responsibility Law imposes **strict borrowing limits** on all levels of government, ensuring fiscal discipline.
- **United States**: States have **high autonomy in borrowing** but are subject to market discipline, balancing independence with financial accountability.
- **Germany:** A cooperative federalism model with **shared fiscal responsibility between federal and state governments** ensures coordinated and balanced financial management.

Studying these international examples could help India create a more robust and adaptable system for managing state debts within its federal structure.

What Measures Can be Adopted to Improve Fiscal Health of States?

- **Incentive-Based Fiscal Responsibility Framework:** This approach would implement a tiered system of borrowing limits based on comprehensive fiscal performance metrics.
  - The framework would go beyond traditional indicators like debt-to-GSDP ratio, incorporating measures such as **revenue generation efficiency, development outcomes, and fiscal transparency.**
  - For instance, a state improving its own tax revenue by 10% year-on-year could be allowed to borrow an additional 0.5% of GSDP.
  - This system would create a positive feedback loop, encouraging states to improve their fiscal management continuously.
- **Technology-Driven Fiscal Monitoring System:** Developing a real-time, AI-powered fiscal monitoring system for all states would revolutionize fiscal management.
  - This system would track **revenue, expenditure, and borrowing patterns, providing early warnings of fiscal stress.**
  - Implementing blockchain technology would ensure the transparency and immutability of fiscal data, preventing manipulation and building trust.
- **Fiscal Insurance Pools:** States could contribute to a **collective insurance fund** based on their fiscal health. This fund would provide temporary relief during economic shocks, reducing the need for excessive borrowing.
  - The system would **incentivize fiscal prudence,** as contributions and payouts would be linked to a state's long-term fiscal performance.
- **Cross-State Fiscal Mentorship Programs:** Pairing fiscally stronger states with weaker ones in a mentorship program. The mentor state would provide expertise and guidance on fiscal management, potentially earning additional borrowing rights as a reward.
  - This peer-to-peer learning could **foster inter-state cooperation and spread best practices organically.**
- **Independent Fiscal Councils**: Establishing independent fiscal councils at the state level.
  - These non-partisan bodies can **analyze state budgets, provide objective assessments of fiscal health**, and offer recommendations for sustainable debt management practices.

Drishti Mains Question:

How do constitutional constraints and state borrowing practices impact the fiscal health of Indian states? Suggest potential reforms for enhancing fiscal stability of states.

UPSC Civil Services Examination, Previous Year Questions (PYQs)

Prelims:

Q. Consider the following statements: (2018)

1. The Fiscal Responsibility and Budget Management (FRBM) Review Committee Report has recommended a debt to GDP ratio of 60% for the general (combined) government by 2023, comprising 40% for the Central Government and 20% for the State Governments.
2. The Central Government has domestic liabilities of 21% of GDP as compared to that of 49% of GDP of the State Governments.
3. As per the Constitution of India, it is mandatory for a State to take the Central Government's consent for raising any loan if the former owes any outstanding liabilities to the latter.

Which of the statements given above is/are correct?

(a) 1 only

(b) 2 and 3 only

(c) 1 and 3 only

(d) 1, 2 and 3

Ans: C

***Mains*:**

Q. Public expenditure management is a challenge to the Government of India in the context of budget-making during the post-liberalization period. Clarify it. **(2019)**
