



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 loans** 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.

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)**

PDF Reference URL: <https://www.drishtiias.com/printpdf/future-of-fiscal-federalism-in-india>

