Centre State Relations in India

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Lecture 33: Borrowing by Union and State

Greetings to all of you. Today, we are discussing important area on how the finances work between the Centre and the States. We are discussing different provisions which are touching upon the issues of finances and how the Constitution deals with on the subject matter. In this regard today we will be taking up a very important area on borrowing by Union and the States. This provision becomes important because of the very fact that for stabilized economic system there is a requirement of macroeconomic planning at the national level. So, that the stability in the system ensured and we can very well visualize that borrowing power of Union or the States can very well disturb macroeconomic stability, if it is not properly regulated.

That stability may get disturbed because of rising revenue deficit or fiscal deficit or uncontrollable inflation. And thus the discussion on borrowing becomes very important to understand the mechanism led down under the Constitution on an important area of macroeconomic stability that what the Constitution says about it. So, what we shall discuss in today's discussion on borrowing is that we will discuss that what are the constitutional provisions with regard to borrowing, what has been debated in the Constituent Assembly on this matter, limitations which are there with the power of the State on borrowing, how the Court has interpreted the issue of Articles 292 and 293. And we will also briefly discuss the significance of a law enacted by the Parliament which primarily aims on maintaining fiscal responsibility.

And we know that there is an ongoing issue on a matter of borrowing between the State of Kerala and the Union of India matter is sub-judice. We will also touch upon this issue and try to

understand that how the matter which is pending for the Supreme Court, it is related with Centre State relation and what constitutional provision is there Centre to give a kind of authority to the Centre and autonomy to the State on the matter of borrowing. We know very well that there is a mismatch on revenue and expenditure, the capability of the government to generate revenue and the commitment towards public services, welfare goals and amount required for meeting those commitments are not enough and not commensurate with the revenue which is being generated by the respective States or respective governments and because of that mismatch what happens that there is always an exploration of avenues for generating resources. One such avenue we have studied where the Central government parts with it is resources on the recommendation of the Finance Commission.

Other avenues which are available and one prominent one is borrowing which applies to both the Centre and the States because of a decentralized federal economy where responsibilities and resources are clearly demarcated in the constitutional scheme. The question on maintaining a financial stability becomes very pertinent because government may argue that autonomy is guaranteed under the Constitution and therefore, there shall be no regulation on such autonomy even if the excise of autonomy leads to a financial crisis leads to instability in the economic market. Thus, even with the decentralized federal economy it is desirable to have an institutional mechanism, a clear cut structural framework on the matter of a spending and borrowing. If such framework is absent then there would be a possibility of the States going for loan or debt in unmanageable manner. Thus, it is suggested that that the responsibility somewhere should be there with the Centre or Union government to keep a control on borrowing power of the States.

And this may happen also because of a reason that the interest of the State may not align with the interest of the Central government. For example, the State governments may prioritize social infrastructure and for that it may go for huge borrowing whereas, the Central government prioritize physical infrastructure or the State government may go for subsidized public servicing which may cause a dent on fiscal stability. Obviously, it is expected that in situation of instability it is the Union we should come forward and bail out the States. If this is expected that Union shall come out then also it is very well connected that or it is legitimately expected that the Union government shall keep a close eye close visual on fiscal policies of the States. Because of

fiscal imbalances which are very natural we have already studied about it. The governments they look for options for options for getting the money for meeting the expenditure.

So, in order to minimize the gap between revenue and expenditure governments they go for an alternate route of ensuring availability of money through borrowing or loans. So, public borrowing has become a well-known feature of covering the gap between the expenditure and available resources of the State government. It is very convenient to imagine that public borrowing would be a preferred route over levying new taxes upon the people because later on would amount to burdening the people. Public borrowing would not result into burdening the people by imposing newer taxes. At the same time any decision on public borrowing also requires fiscal prudence because borrowing should be done in such a way so that timely repayment of such borrowing is ensured in order to maintain stability in the fiscal market, in order to ensure that the revenue deficit is under control.

When you look at the Indian Constitution there are subject matters which is which are there in List I and List II on public debt. Entry 35 of List I and Entry 43 of List II refer to public debt of the Union and of the States respectively. Additionally there is a categorical provision under the Constitution which empowers the Union and the States to borrow money from other sources. And that is what is given under Article 292 and Article 293 of the Constitution. Now with a glance of this provisions which are there in the constitution which we shall discuss in detail little later. Let us look at that what is the reference point of Article 292 and Article 293 from where the framers of the Constitution got a reference on providing this provisions under the Constitution.

As borrowing is an important strategy for fulfilling the requirement of the people, important instrument for meeting the needs. The provisions related to borrowing also featured under the Government of India Act 1935. Section 163 talked about borrowing to be done by the Provincial government where it says that executive authority of a province extends to borrowing within such limits as fixed by the Act of Provincial Legislature. Clause 2 said that Federation to keep such conditions to make loans and raise guarantees in respect of loans. Section 163 also provided that if the Province seeks borrowing from an agency outside India then the Province needs to obtain consent from the Federation. If there is any outstanding part of a loan which is made to

the Province and the conditions can be imposed by the Federation and such consent must not be withheld unreasonably

This important provision was debated in the Constituent Assembly considering the specialized subject. Expert Committee on the Financial Provisions of the Union Constitution was constituted under the chairmanship of Mr. Nalini Ranjan Sarker. The Committee suggested that borrowing from the market should be with the consent of the Federal government. So, that there shall be a kind of check on the quantum, check on the deficit, check on the kind of revenue and an expenditure mismatch. Committee also suggested that with this kind of control on the province by the Federal government there is also a requirement to provide autonomy to the provinces that provinces shall have autonomy in terms of borrowing.

So, that they can plan their welfare goals based on receipt what they would get one from the Centre under the constitutional scheme other from the market. Dr. Ambedkar suggested that the security for the purpose of borrowing should be based on Consolidated Fund and not revenue of India. Because that is something where they said that the entire receipts on tax and non-tax comes and let it be categorically indicated in the constitutional provision.

Mr. Shibban Lal Saxena made a point that the power of the Executive to borrow upon the security of the revenues shall have limited parliamentary control. Mr. HV Kamath proposed that the purpose for which the loan is raised must be laid before Parliament and approval of Parliament must be sought. Being a Chairman of Drafting Committee Dr. Ambedkar clarified that it is the Parliament which has been conferred with necessary power to make a law on the borrowing and through which Parliament can control the borrowing powers of the Executive, but it is desirable that that power shall lie with the Executive and not to be interested upon the Legislature because it requires a policy considerations and the Executive is better placed on deciding such policy issues.

So, this is what is the structuring done under Article 292. It extends to borrowing upon the security of the Consolidated Fund of India and within such limits as fixed by the Parliament by law. So, Article 292 categorically says that broader guidelines can be laid down by the Parliament on the issue of borrowing by the Union. Borrowing power of the Union must be

subjected to that Parliament, parliamentary legislation. However, it was also made very clear that security of the Consolidated Fund of India should not mean that the borrowing power of the Union shall be limited to the Fund available in Consolidated Fund.

It says security of the Consolidated Fund. So, it can go beyond what is there in the Consolidated Fund. Article 292 also makes it very clear that the Executive need not obtain prior statutory clearance from Parliament to borrow funds. So, it is the Parliament which makes a law lays down a broader guidelines and then Executive is there to decide upon what shall be the quantum of borrowing, which agency to be approached for borrowing. So, Parliament may by law puts the limits and conditions on borrowing and once such limitations and conditions are been laid down, then it is for the Executive to simply take a call on borrowing.

Because we have a decentralized financial federal relation in India, the power on borrowing has also been conferred upon the States. States can also borrow. However, there are limitations categorically spelled out on the power of the States on borrowing. So, there are two sources for borrowing by the States under Article 293. One is they can directly borrow from the sources within the territory of India based on the security of the Consolidated Fund of the State and second borrowing they can do it from Government of India they can take loan.

So, they can take borrowing from market also, but they cannot go for borrowing outside India. It has to be sources within the territory of India. Any borrowing from foreign agencies shall be done only by the Central government. So, what are the limitations laid down on borrowing by the States? First it says on a similar line which is there for Article 292 that Legislature can make a law whereby Legislature can determine a limit and define conditions on which borrowing can be get guided and then there are provisions under Article 293 which sets the limitations. Let us look at what are the provisions which are there. First one it says the State government cannot borrow from outside India.

It has to borrow within the territory of India. Second one is it says executive power of borrowing is limited by law made by the State Legislature which is similar to the Union government or position given for the Centre. Then it says Union may give loans to the State upon the conditions as a laid down or under any law made by Parliament. So, it says that loan can be given by the

Union based on the conditions as per the parliamentary legislation. So, there is a parliamentary control there is a control by the Centre on borrowings by the States.

Further Article 293(3) which is a significant one in the context of Centre State relations it says that a State cannot borrow without the consent of the Union if there is any outstanding subsisting. If there is an outstanding loan from the Government of India consent is needed. Even if the State is targeting to take a loan or borrow money from non-governmental agencies not from Government of India is still consent is to be taken. This one can very well visualize that this is a very obvious provision because the creditor must be taken into confidence if any further borrowing is being planned before settling the credit of the creditor before settling the loan of the creditor this is very obvious provision. Clause 4 says that Union is empowered to put conditions before granting consent and the conditions which Union government can decide. So, when you compare the power of the Union and the power of the States on borrowing you find that power to the Union is unrestricted including they can borrow from abroad because the only limitation on the borrowing power of the Centre is as let down by the Parliament under Article 292.

In contrast the borrowing powers of the State you find that there are very defined limitations. One they cannot borrow from outside agencies from foreign agencies, it has to be within the territory and Centre can put a kind of conditions if there is any outstanding loan on the States. So, a State has got no power to raise loans outside India. Within India they may raise a loan from the Government of India or float public loans. However, it says that a State cannot raise a public loan without the consent of Government of India if there is an outstanding power of the loan. Needless to emphasize that the very provisioning given under the Constitution under Article 292 and Article 293 presents an asymmetrical borrowing power between the Centre and the States gives more space to the Centre in comparison to the State. So, borrowing power is favoring the Centre because there is a no control over the Union and thus Union can go and approach the RBI for mitigating the deficits the State have to stick to the overdraft limit let down by RBI.

And you can very well visualize that public borrowing plays a very important role in meeting the expenditure requirement of the governments. An expenditure requirement has got a larger connotation it is about both a regular expenditure as well as something which has been planned by the government with an aim to bring welfare power to the people. Thus, it is been seen that

public debt has increased considerably in the recent years. Parliament has enacted a law known as Fiscal Responsibility and Budget Management Act 2003. If you look at the objective it reads intergenerational equity in fiscal management and long term macro-economic stability with which I started this session by removing fiscal impediments in the effective conduct of monitoring policy.

Because inflation is bad for the country, revenue deficit is bad for the country, fiscal deficit is bad for the country and thus it is required that there shall be a macro-economic stability on economic planning of the country and that is what this Act addresses. It also says that there shall be a prudential debt management consistent with fiscal sustainability through limits on the Central government borrowings debts and deficits. So, that government should not go for borrowings more than the capacity to return. Government needs to look at the financial health and accordingly needs to go for borrowing. And accordingly it is suggested that transparency is required on fiscal operations of the Central government.

The Act provided that Central government is duty bound to present the fiscal policy along with annual financial statement on the floor of the House and that policy shall contain medium-term fiscal policy statement, fiscal policy strategy statement, macro-economic framework statement, medium-term expenditure framework statement. Further it says that the fiscal policy strategy statement shall contain the policies of the Central government for ensuring ensuing financial year relating to taxation that from where they are expecting revenue to get generated, what are their plans for meeting the constitutional requirement on public services and public goods, market borrowing and other liabilities, lending and investments, what are the strategic priorities of the Central government for the ensuing financial year in the fiscal area. You find that the government keeps on working on different priorities. For example, you must have seen in the last 4 or 5 years is a focus on strengthening renewable energy in this country and thus accordingly the government makes a plan on expenditure on that front. The key fiscal measures and rational for any major deviations in fiscal measures pertaining to taxation, subsidy expenditure, administered pricing and borrowings. The fiscal policy strategy statement should also have an evaluation as to how the current policies of the government are in conformity with the larger fiscal management principles which is set out in Section 4. Section 4 says that central

government shall take all appropriate measures to limit the fiscal deficit up to 3 percent of gross domestic product.

So, the law has categorically indicated that what shall be the kind of quantified limit in in terms on the matter of fiscal deficit. Management principle also says that Central government shall put in endeavor to ensure that general government debt does not exceed 60 percent and Central government debt does not exceed 40 percent of GDP by the end of financial year 2024-2025. It also says that not to give additional guarantees with respect to any loan on security of the Consolidated Fund of India in excess of one half percent of gross domestic product in any financial year. Further, it says that endeavor shall be made to ensure that the fiscal targets as specified in Section 4(1)(a) and Section 4(1)(b) which is about 3 percent and overall debt of 60 percent or 40 percent for the Central government are not exceeded after stipulated target debt. So, the law has been made by Parliament wherein broader guidelines have been set for borrowings by the Union.

Section 6 talks about transparency it says that duty shall lie with the Central government to ensure that fiscal transparency is maintained. Government shall take suitable measures to ensure greater transparency in public interest and minimize as far as practicable secrecy in the preparation of annual financial statement and demands for grants. So that the issue of economic planning, financial planning must be done with accountability. The Act provides for monitoring mechanism it says that Ministry of Finance shall review half yearly basis planning of the government, the trends in receipts and expenditure in relation to what has been projected in the budget and responsibility of the Ministry to place that information on the floor of the House. Central government shall prepare a monthly statement of its account. So, Central government has the power to make rules for carrying out the provisions of 2003 Act and thus the rules are also been made in pursuant to the provisions of this Act.

Certain issues are being raised in the 14th Finance Commission and that issues were raised considering the decline in outstanding liabilities of the State to the Union. Because when you read Article 293(3) particularly you would find that the Central government can control the borrowing power of the State, but such control is subject to any outstanding debt by the Government of India. So, if there is a no debt, if there is a no liability of the State to the Union

then Article 293(3) shall not be applicable then the State government shall be free on borrowing, but giving such freedom to a State may have a bigger ramification of sub national debt getting inflated to such a way that the entire economic system may collapse, which has happened in some of the Latin American countries. So, question is being raised that what kind of control by the Centre upon the State when situations are not under Article 293(3) when there is a no liability of the State. Because Article 293 says that conditions are to be imposed only when there is outstanding, consent is to be obtained only when there is an outstanding liability. This becomes an important question and possibly it requires a sort of constitutional amendment also because on a Centre State relation the issue of stability is very pertinent and Central government must have a complete control on maintaining that stability.

On the scope of Article 292 and Article 293 matter has come before the Kerala High Court in Matthew v. Union of India where the court has said that both the provisions are enabling provisions and the only limitations that can be imposed on the Union or the State that conditions shall be through parliamentary process through the legislation enacted by the Parliament or the State Legislature. So, what court observes, I read:

"In other words, the two provisions empower the Governments of India and the States to borrow money. The Constitution does not say that the borrowing has to be 'upto' the amount of money available in the Consolidated Fund." Because it says security, it does not say up to the money if you read the language of Article 292 or Article 293 it says security of the Consolidated Fund. So, it does not draw a limit that whatever money is available in that Fund loan shall be raised or borrowing shall be made only up to that. The framers have used the expression upon the security of. *"The framers have used the expression 'upon the security of'. In fact, the plain language suggests that the two Articles primarily contain enabling provisions. These authorize the respective Governments to borrow. Also to enact laws to regulate the borrowing. These do not place a limit or an embargo."* So, in a way the language of Article 292 and Article 293 does not limit the power of the Executive on terms of borrowing whatever limitations thus was limitations must come from the law enacted by to be enacted by the Parliament or by the State Legislature.

These days there is a controversy going on the capacity to borrow, on the limitations on borrowing between Government of Kerala and the Union of India. There is an original suit filed in the Supreme Court by the State of Kerala. The matter is sub-judice, but because we thought that we are discussing an important subject we thought of also highlighting this ongoing matter. In this matter Union government is setting limitations on borrowing by the Government of Kerala. Kerala government has brought in this argument that Article 293 clearly refers to fiscal autonomy for borrowing. It categorically says that is something which is entirely depend upon or should be get guided by the language of Article 293 which says for borrowing on the security of the Consolidated Fund of the State and it should be get governed by the law made by the State Legislature. In the instant case, Kerala Assembly has passed a law Kerala Fiscal Responsibility Act of 2003 and that is something given under the constitutional scheme Entry 43 of List II of the Schedule VII. So borrowing capacity is to be determined as alleged by the Government of Kerala that borrowing capacity is unnecessarily being curtailed by the Union under the Fiscal Responsibility and Budget Management Act whereas, the State has got a complete autonomy on the matter of borrowing. Union of India is contending that unthoughtful borrowing on the part of the State adversely affects the credit rating of the country and therefore, there should be some kind of control by the Centre.

It is Centre which has got a responsibility to maintain stability on macroeconomic front and thus Centre has to give permission if the State goes for borrowing from any other source. Now this crisis relates to the language of Article 293(4) and the scope and ambit of the Fiscal Responsibility and Budget Management Act of 2003. What is that? That what kind of limitations, conditions Centre can impose and how those conditions are required to be not attacking the autonomy envisaged under the Constitution. So in the context of Centre State relation, on the one hand autonomy is guaranteed to the State under Article 293 on borrowing and conditions are being imposed only when there is an outstanding liability. But even if there is no outstanding liability, it is desirable that some kind of oversight authority to be entrusted upon the Centre because after all it is a matter of controlling revenue deficit, controlling inflation and economic planning of the country. So States debt should not become unmanageable because at the end of the day it is the Centre which has to step in.

There is a situation when the financial condition of a State is under severe strain or it is at the stage of collapse then the Constitution entrusts the responsibility upon the Centre to make necessary intervention so that the financial health of the State can be restored and that's the design which is overall being followed under the Constitution. These are the references for this module. Thank you.