

Report on Analysis of States' Debt and Bond Markets

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Acronyms

BE Budget Estimate.

CAG Comptroller and Auditor-General of India.

CGS Central Government Securities.

CMIE Centre for Monitoring Indian Economy Pvt. Ltd..

DBIE Database on Indian Economy.

DISCOM Distribution Companies.

EBR Extra Budgetary Resource.

ERD effective revenue deficit.

FC Finance Commission.

FRBM Financial Responsibility and Budget Management.

FRL Fiscal Responsibility Law.

G-Secs Government Securities.

GDP Gross Domestic Product.

GoI Government of India.

GSDP Gross State Domestic Product.

GST Goods and Services Tax.

IDMD Internal Debt Management Department.

NBC Net Borrowing Ceiling.

OBB Off-Budget Borrowing.

OD Overdraft.

PD Primary Dealer.

PDMC Public Debt Management Cell.

PSU Public Sector Undertaking.

RBI Reserve Bank of India.

RBI Act Reserve Bank of India Act, 1934.

RE Revised Estimates.

SDF Special Drawing Facility.

SDL State Development Loan.

SLR Statutory Liquidity Ratio.

SPV Special Purpose Vehicle.

T-Bill Treasury Bill.

UDAY Ujwal DISCOM Assurance Yojana.

WMA Ways and Means Advances.

1 Introduction

The delineation of responsibilities between Central (national) and the State (sub-national) Governments in India is envisaged in Article 246 and the Seventh Schedule of the Constitution of India. State Governments in India are responsible for a number of functions crucial for broader economic development, including the provision of public health and education. While States are allowed to raise both tax and non-tax revenue for financing their activities, they can also raise funds from markets to meet any shortfall between revenue and expenditures.

In India, both the Central Government and State Governments raise funds through fixed income securities or bonds. The Central Government can raise two kinds of bonds, short-term (also known as Treasury Bills (T-Bills), with maturities less than one year) and long-term duration (also called Government Securities (G-Secs), with maturities above one year). State Governments, on the other hand, only raise what are known as the State Development Loans (SDLs) (recently renamed as SGS, or State Government Securities).

Both Central and State Government Securities are considered to be risk-free, marketable securities, which are backed by the fiscal authority of the sovereign. However, the liquidity and the depth of the SDL market is seen to be significantly lower compared to that of the Central Government Securities (CGS) (namely G-Secs and T-Bills). This can hamper States' ability to raise resources for their developmental goals. This fact assumes extra significance in the aftermath of a global health emergency in COVID-19 and rising interest rates across the world, due to which States' debt burdens have risen sharply. State Government debt now accounts for almost one-third of the overall general government debt.

In a developed and liquid market set-up, markets should penalise fiscally imprudent States through higher cost of borrowing (higher yields). However, prior literature suggests that this relationship is often not found to be strong in the case of the SDL market. This not only allows errant States to fund expenditure at the cost of a future generations of taxpayers (by increased taxes) but can also indirectly (and unfairly) penalise fiscally prudent States who have stayed within their means. On the other hand however, there exist many States that face significant structural challenges (many of them historical) whose fiscal challenges can be exacerbated by illiquid markets, thereby contributing towards differing developmental trajectories of States across the Indian Union.

By way of both qualitative and quantitative analyses, this report seeks to examine issues pertaining to the SDL market in India. On the qualitative side, it explores the legislative and regulatory frameworks governing State borrowings, along with discussion around the various institutions involved, including the State Governments themselves, the Reserve Bank of India (RBI) (States' debt manager), the Finance Commission (FC) (the arbiter of State and Centre's financial relations), as well as internal departments for debt management. On the quantitative side, the report presents key stylised facts around SDL markets, including the liability profile of States (deficits and debts), ownership pattern of State Government bonds, issuances, cost of existing and new debt, and liquidity of SDLs. Based on this joint analysis, the report proposes some policy reforms to improve the State Government debt market and the required regulatory framework for a more efficient and functional market for State securities in India.

2 Legal Framework of State Borrowings

State borrowings are governed by the provisions of the Constitution of India, 1950 (Constitution), Financial Responsibility and Budget Management (FRBM) Act, 2003, the State Fiscal Responsibility Laws (FRLs), the Reserve Bank of India Act, 1934 (RBI Act) and the bilateral debt management arrangements between the RBI and the States. This legal framework is discussed below.

2.1 Constitutional and Legislative Framework

The Constitution under Part XII, Chapter II empowers the Central and State Governments to raise borrowings. *Article 292* of the Constitution governs the borrowing of the Government of India.

Article 292 of the Constitution reads as follows:

“The executive power of the Union extends to borrowing upon the security of the Consolidated Fund of India within such limits, if any, as may from time to time be fixed by Parliament by law and to the giving of guarantees within such limits, if any, as may be so fixed.”

The framers thus intended the Central Government to have the power to raise finances for any purpose within the domain of the Union. However, the Parliament did not enact any such law for more than five decades after independence.

The second half of the 1990s saw a steep surge in the fiscal deficit of both the Centre and State Governments. The combined fiscal deficit widened to 8.6% in 1984-1985 and breached 9% of Gross Domestic Product (GDP) in the following years.¹ Other variables such as interest payments to revenue receipts and interest payments as a proportion of total revenue expenditure also saw a deterioration. These factors shifted the climate of opinion on the need for formal fiscal rules that constrain the Government.

In the year 2000, the then Indian Finance Secretary, Dr. E.A.S. Sarma, chaired a ten-member committee to study the various aspects of the Centre’s fiscal architecture and to prepare a draft legislation on fiscal responsibility. This committee submitted its report in July 2000. The draft bill proposed by the Sarma Committee underwent amendments before being tabled in the Lok Sabha on 20 December 2000. The FRBM Bill aimed to bring financial discipline and sustainability by setting out fiscal targets to be achieved by the Central Government. The Bill was passed in 2003 and it was enacted in 2004 along with FRBM Rules. The Act mandates the Government to annually present the following documents along with the Budget: the Medium-Term Fiscal Policy Statement, the Macroeconomic Framework Statement, and the Fiscal Policy Strategy Statement.² The Act also provides projections for fiscal deficit and total outstanding liabilities as a percentage of GDP in the Medium-Term Fiscal Policy Statement.³ In 2009, the FRBM Act, 2003 was temporarily suspended owing to the global financial crisis.

The first major amendment to the FRBM Act was in 2012. This amendment introduced the concept of ‘effective revenue deficit (ERD)’ which was defined as the difference be-

¹ *FRBM Review Committee Report, Volume- I*. January 2017, p.3.

² Section 3, *Fiscal Responsibility and Budget Management Act, 2003*.

³ Section 4, *ibid*.

tween revenue deficit and grants for creation of capital assets, and stipulated that ERD shall be eliminated by 31 March 2015. Additionally, the amendment required the Central Government to reduce revenue deficit to 2% by 31 March 2015. However, the deadline for the elimination of ERD and for reduction in revenue deficit were extended to 31 March 2018 *vide* the Finance Act, 2015. The 2012 amendment also inserted Section 7A which empowered the Comptroller and Auditor-General of India (CAG) to review the compliance with the provisions of the Act. Subsequently, the 2018 amendment to the FRBM Act removed the ERD and the revenue deficit target. Further, the Central Government was to reduce fiscal deficit to 3% of the GDP by 31 March 2021.

The 2018 amendment introduced the concept of ‘general government debt’ which is the sum total of the Central and State Governments’ debt. The amendment capped the general government debt to 60% of the GDP of which the Central Government debt was capped at 40% of the GDP by the end of financial year 2024-25.⁴ The Central Government was mandated to provide annual targets for the reduction of fiscal deficit, and deviation from such targets was allowed in certain instances: issues of national security, war, natural calamity, collapse of agriculture severely affecting farm outputs, structural reforms in the economy with unanticipated fiscal implications, and decline in real output growth of a quarter by at least 3% below the average of the previous four quarters.⁵

Next, *Article 293* of the Constitution empowers the State executive to borrow within the Indian territory upon the security of the Consolidated Fund of the State.⁶ Article 293 consists of four clauses wherein Clause (1) empowers the State executive to borrow and give guarantees. However, the power given to the executive is subject to any limit imposed by the State legislature. Clause (2) allows the Government of India (GoI) to make loans to any State, subject to the conditions laid down by any law passed by the Parliament and the limit fixed under Article 292 of the Constitution.⁷ The Central Government is also empowered to provide guarantees with respect to loans raised by States. The amount required to make such loans is charged on the Consolidated Fund of India. Further, Clause (3) stipulates that the State must take consent of the Central Government to raise any loan in the event there is any outstanding loan made to the State by the Central Government or when any guarantee has been given by the Central Government for any loan raised by the State.⁸ The consent under Clause (3) may be granted subject to conditions imposed by the Central Government as it may deem fit.⁹

Pursuant to the language under Article 293(1), all States enacted individual FRLs by 2010-11.¹⁰ These laws have been revised by State Governments in line with the recommendations of each subsequent FC. The salient features of the FRLs of 14 States are set out in the Annex (Section 9). These States correspond to the top 10 States by market borrowings across the financial years 2020-21 and 2023-24, as identified in Table 2.

⁴Section 4(1)(b), *Fiscal Responsibility and Budget Management Act, 2003*.

⁵Section 4(2), *ibid*.

⁶Article 293(1), *Constitution of India, 1950*.

⁷Article 293(2), *ibid*.

⁸Article 293(3), *ibid*.

⁹Article 293(4), *ibid*.

¹⁰Paragraph 4.1, Chapter 4, *Fourteenth Finance Commission Report*. 2014.

2.2 Debt Management Framework

The RBI is empowered to act as an agent for, *inter alia*, the Central Government and the State Governments in managing public debt and bonds and debentures.¹¹ The management of the Central Government's public debt, including issuing of loans, carrying out the Government's remittance and other banking operations, vests with the RBI.¹² The RBI may also undertake the management of public debt of any State Government by way of an agreement entered between the RBI and the respective State Government.¹³ All States except Sikkim have entered into such agreements with RBI.¹⁴ Two landmark developments have shaped India's public debt management framework, namely: (i) the March 1997 supplemental agreement between the RBI and the Government of India establishing the Ways and Means Advances (WMA), and (ii) the FRBM Act, 2003.

In this context, the following provisions set out the role played by the RBI in managing the public debt of the Central and State Governments:

- The RBI is authorised to extend advances to the Central Government and State Governments repayable not later than three months from the date of making the advance.¹⁵ It offers these through the WMA facility to the Centre and the States. While the limit of WMA in respect of the Centre is fixed in consultation with the Government of India on an annual basis, the allocation among States is determined after taking into account the recommendations of the Advisory Committee on Ways and Means Advances and Overdrafts to the State Governments.¹⁶ Under the WMA Scheme, the facilities provided by the RBI are (i) Normal WMA, (ii) Special Drawing Facility (SDF) and (iii) Overdraft (OD).
- The RBI may exercise regulatory power over the government securities market.¹⁷ It has the power to regulate transactions in derivatives, money market instruments, etc.¹⁸ Further, it is authorised to issue and manage government securities.¹⁹

2.2.1 RBI's Agreement with the States

Pursuant to an agreement between RBI and the State Government, the RBI may conduct various businesses of the State which, *inter alia*, include (i) maintaining cash balances; (ii) handling all of its banking transactions; (iii) providing remittance and exchange facilities; and (iv) managing the public debt and issuance of new loans.²⁰

Some of the key aspects of such agreements are set out below through the example of Himachal Pradesh. The Governor of the State of Himachal Pradesh (HP Government)

¹¹Section 17(11), *Reserve Bank of India Act, 1934*.

¹²Sections 20 and 21, *ibid*.

¹³Section 21A, *ibid*.

¹⁴Reserve Bank of India. *Frequently Asked Questions, RBI as Banker to Government*. URL: <https://www.rbi.org.in/SCRIPTS/FAQView.aspx?Id=61>.

¹⁵Section 17(5), *Reserve Bank of India Act, 1934*.

¹⁶*Report of the Advisory Committee on Ways and Means Advances to State Governments*. Reserve Bank of India, 2021.

¹⁷Section 16 read with Section 29A, *Securities Contracts Regulation Act, 1956*.

¹⁸Section 45W, *Reserve Bank of India Act, 1934*.

¹⁹*Government Securities Act, 2006; Government Securities Regulation, 2007*.

²⁰Section 21A *Reserve Bank of India Act, 1934*.

and the RBI entered into an agreement dated 24 February 1971.²¹

- The HP Government shall employ RBI as: (i) its sole banker to receive and hold the whole of its cash balances and all such monies that may become payable to the HP Government; and (ii) its sole agent for investments made by it and RBI shall be entitled to charge commission for sales. The RBI may collect interest and the maturity values of such investments on behalf of the HP Government without charge.
- RBI shall manage the HP Government's rupee public debt, the issuance of new rupee loans and perform all duties relating thereto. It shall maintain a register, books and accounts of the said public debt as per the direction of the HP Government. Additionally, it shall conduct an audit of all payments of interest and act generally as agents in India for the HP Government in managing the said public debt.
- RBI shall not be entitled to receive any remuneration for handling the HP Government's ordinary banking business, other than any advantage that may accrue to it from holding the HP Government's cash balances free of obligation to pay interest thereon. The HP Government and RBI agree, from time to time, upon the minimum amount to be maintained towards such cash balances. However, RBI shall be entitled to make a charge for remittances made by the HP Government outside its jurisdiction, subject to restrictions set out in the agreement.
- RBI would be entitled to: (i) charge a half yearly commission at a specified rate on the amount of public debt; and (ii) remuneration under various heads for issuing new loans to the HP Government.
- RBI can make WMA to the HP Government if so required, at interest rates determined by the Bank, and the HP Government must fully pay back the outstanding advances within three months of the initial advance.
- Either party may terminate the agreement on giving one year's notice in writing, expiring on 31 March in any year.
- The disputes arising between the parties in relation to the terms and conditions of the agreement are to be referred to the Central Government whose decision shall be final and binding on the parties.
- This agreement has since been modified through several Supplementary Agreements. Some of the key changes were: (i) RBI has to keep the HP Government informed of the daily balance regularly; and (ii) the WMA may be taken and repaid on any day without previous notice. Further, in 2014, 'special WMA' was substituted by SDF.

In the case of Uttarakhand, their debt manual published in 2021, mentions that in the event the WMA outstanding continues for over 90 days from the date of advance, a higher interest of Repo rate plus 1% is to be charged.²²

The overdraft facility is initiated when the advances to the State exceed their SDF and

²¹Annexure II, Government of Himachal Pradesh Finance Department. *Debt Management Manual, Volume II*. 2022, p. 42-59.

²²Government of Uttarakhand Department of Finance. *Uttarakhand Public Debt Procedures Manual, Volume I*. 2021.

WMA limits. The State Government is not allowed to be in overdraft for over 36 working days in a quarter, and in the event this limit is not adhered to, the payments would be stopped. The RBI also manages the State Government's surplus funds in 14 Day Intermediate Treasury Bills and rediscounts in case of shortfall in the prescribed minimum cash balance. The State may also advise RBI to participate in treasury bill auctions as non-competitive bidders for investing their surplus funds.²³

2.2.2 Management of Public Debt: Internal Debt Management Department

The Internal Debt Management Department (IDMD) was created as a cell within the Secretary's Department in 1992, comprising the Public Borrowing, Open Market Operations and Ways and Means sections. It was fully constituted as an independent unit in 1992 and renamed as the IDMD in 2003.

It manages the public debt of the Government of India and State Governments, and is responsible for developing the Government Securities Market. The Department, in consultation with the Ministry of Finance, formulates a half yearly/annual calendar for primary issuance of the dated securities and the T-Bills. It decides the size, timing and maturity of issuances, and conducts auctions, taking into account the government's needs, market conditions and preference of various investor segments. It also regulates and supervises the Primary Dealers (PDs) through the issuance of prudential and regulatory guidelines on capital adequacy standards, risk management and other operational aspects. PDs are supervised through both off-site and on-site supervision.²⁴ The activities undertaken by the IDMD include:

- Floatation of Central/ State Government Loans.
- Fixing limits on WMA for Central and State Governments along with monitoring use of these limits on a daily basis.
- Regulation and supervision of the PD system.
- Market development activities such as introduction of new instruments, clearing and settlement systems and widening the investor base.
- Facilitating State Government's investment of their surplus cash balances in T-Bills and dated securities under various funds.

3 Issuance of State Debt: The SDL Market in India

The limit of borrowings for each State is given by the Government of India at the beginning of the year. The RBI in consultation with the respective State Governments and Government of India decides on the timing, tenure and notified amount of SDL keeping in view the borrowing requirements of the State Governments and market conditions. Since 2006-07, the market borrowings of State Governments have also been conducted entirely through the auction method.²⁵

²³Department of Finance, *Uttarakhand Public Debt Procedures Manual, Volume I*.

²⁴Reserve Bank of India. *Internal Debt Management Department*. URL: <https://www.rbi.org.in/commonman/Upload/English/Content/PDFs/RIA160609.pdf>.

²⁵Ibid.

3.1 Auction on the e-Kuber platform

G-Secs are issued by way of auctions conducted by the RBI on the electronic platform, e-Kuber, which is the RBI's Core Banking Solution (CBS) platform, implemented in 2012. Commercial banks, scheduled Urban Co-operative Banks (UCBs), and insurance companies and provident funds, who maintain funds accounts and securities accounts with RBI, are members of the e-Kuber platform.²⁶ E-Kuber allows its members to place their bids in the auction through the platform. RBI publishes the results of the auction at a stipulated time (1:30 PM for T-Bills and 2:00 PM or at half hourly intervals thereafter in the event of delay for dated G-Secs). Non-e-Kuber members may also bid in the auction through scheduled commercial banks or PDs. The platform may be used by Governments to update about the WMA. e-Kuber can be accessed through INFINET (Indian Financial Network), a Closed User Group Network for the exclusive use of member banks and financial institutions.²⁷

The following steps are involved in issuing of new SDL:²⁸

- The State Finance Department confirms to RBI the amount and tenor of securities to be raised a week prior to the date of auction.
- The State Finance Department, with RBI's assistance, prepares a specific notification containing the terms and conditions for issuance of SDLs. The said notification is provided to RBI, and published in national newspapers for wider dissemination and publicity.
- The auction is conducted on RBI's e-Kuber platform (normally on Tuesdays every week).
- The market cut-off rate is communicated to the Finance Department, based on the amount required and bids received. Thereafter, the State Finance Department determines whether the auction results are to be accepted or rejected, and informs RBI of the same.
- If the State Finance Department accepts the auction result, the notified amount is transferred to the State Consolidated Fund Account by the RBI. The State Finance Department can accept partial amounts at lower cut-off if bids are available at lower yields. In the event the Department rejects the auction result, the RBI will proceed to reject all the bids and the State would not receive any funds from the auction.
- The receipt of funds from the RBI is verified by the State Finance Department based on the State's daily position statement and the same is updated in the register/system of the State.

4 Fifteenth Finance Commission on State Borrowing

The FC is a constitutionally mandated body that evaluates the financial state of the Union and State Governments.²⁹ It recommends the manner of sharing of taxes between

²⁶Reserve Bank of India. *Government Securities Market in India - A Primer*. URL: <https://www.rbi.org.in/commonperson/English/Scripts/FAQs.aspx?Id=711>.

²⁷Tojo Jose. "What is e-kuber". In: (2019).

²⁸Finance Department, *Debt Management Manual, Volume II*.

²⁹Article 280, *Constitution of India, 1950*.

the Centre and the States and also *inter se* tax sharing between States. The FC aims to bring fiscal stability to the country and to improve the quality of public spending. The XV FC in volume I of the report had set out a fiscal consolidation roadmap with various recommendations, including the ideal borrowing limit that the State and the Union Government should adhere to, to ensure sustainable fiscal growth. Further, in volume IV of the report the FC has presented an evaluation of each State individually to understand them through various indicators. The combined reading of volume I and IV of the FC report sheds light on the issues surrounding the State Government debt.

This section will discuss the fiscal consolidation roadmap provided by the FC along with the challenges faced by States in relation to its borrowings and the legislative framework governing the same.

4.1 Fiscal Consolidation Roadmap

The XV FC report had set out the fiscal consolidation roadmap for the award period of 2021-2026.

The FC report noted that, with respect to Union finances, considerable progress was made with respect to fiscal consolidation between the period 2011-12 to 2018-19. Fiscal deficit was reduced from 5.9% to 3.4%, and revenue deficit dropped from 4.5% to 2.4%. The debt to GDP ratio steadily declined between 2011-12 to 2018-19 from 51.8% to 47.9%. However, despite the significant drop these figures remained higher than the fiscal adjustment path recommended by XIII FC and XIV FC. Further, the COVID-19 pandemic adversely affected the union fiscal consolidation path.³⁰

At a State level, between the period of 2011-12 and 2018-19, there was an increase in the aggregate gross fiscal deficit and revenue deficit relative to GDP by 0.6 and 0.4 percentage points. However, the States managed to keep their fiscal deficit within the given targets, excluding the Ujwal DISCOM Assurance Yojana (UDAY) component. Some States remained under stress despite the higher transfers made by the Union Government due to the fall in own tax revenue and increasing revenue expenditure. The aggregate outstanding debt and liabilities, as a proportion of GDP, increased from 22.6% in 2011-12 to 24.5% in 2018-19. The fiscal indicators for the period 2015-16 and 2016-17 were adversely affected by the borrowings under the UDAY programme.³¹

The FC provided the glide path for State Governments with respect to their borrowing capacity during the award period. The FC recommended that the normal limit for net borrowing may be 4% of Gross State Domestic Product (GSDP) in 2021-22, 3.5% in 2022-23, and be maintained at 3% of GSDP from 2023-24 to 2025-26. The term ‘normal’ indicates that additional borrowing to manage the shortfall in Goods and Services Tax (GST) compensation or the incentive-based additional borrowing capacity recommended by the FC with respect to power sector reforms, have not been accounted for.³²

States were allowed an additional borrowing of 0.5% of the GSDP in the first four years of the award period, i.e., 2021-25 on undertaking power sector reforms. Such reforms shall include: (i) reduction in operational losses; (ii) reduction in revenue gap; (iii) reduction

³⁰Paragraph 3.123, *Fifteenth Finance Commission Report*. 20.

³¹Paragraph 3.124, *ibid*.

³²Paragraph 12.61-12.63, *ibid*.

in payment of cash subsidy by adopting direct benefit transfer; and (iv) reduction in tariff subsidy as a percentage of revenue.³³ Further, any unutilised borrowing capacity granted to the State within the first four years of the award period (2021-22 to 2024-25) may be utilised in any of the subsequent years within the award period. The FC also recognised the strain on the revenue account of the Union Government and allowed for an elevated path of fiscal deficit with a terminal year target of 4% of the GDP as opposed to the existing statutory limit of 3% by 31 March 2021 under the FRBM Act.³⁴

The XV FC also proposed a glide path for the States with respect to total liabilities as a percent of GSDP. The glide path required the States to reduce total liabilities to 33.1% (FY 2020-21), 32.6% (FY 2021-22), 33.3% (FY 2022-23), 33.1% (FY 2023-24), 32.8% (FY 2024-25) and 32.5% (FY 2025-26) as a percent to GSDP.³⁵

However, the data shows a considerable heterogeneity amongst the States in relation to the glidepath recommended by the XV FC. Table 1) shows the performance of States in relation to the glide path.

- Out of the 31 States, only 13 States met the FC target set out for FY 2020-21. While 15 States met the target in FY 2021-22, 19 States met the target in FY 2022-23 (as per Revised Estimates (RE)), and as per the Budget Estimate (BE), 18 States are likely to meet the target in FY 2023-24.
- In these four financial years there are a few States that have never met, and are not likely to meet, the target set for liabilities to GSDP. These States include Arunachal Pradesh, Bihar, Goa, Himachal Pradesh, Kerala, Manipur, Meghalaya, Mizoram, Nagaland, Punjab, Rajasthan, and West Bengal.
- On the other end of the spectrum are States whose total liabilities to GSDP is estimated to be less than or equal to the target set out by the FC in the four financial years. These include Assam, Chhattisgarh, Gujarat, Karnataka, Madhya Pradesh, Maharashtra, Odisha, Sikkim, Tamil Nadu, Telangana, Uttarakhand, National Capital Territory (NCT) of Delhi and Puducherry.
- States like Haryana, Jharkhand, Tripura, Uttar Pradesh and Jammu & Kashmir have improved their performance with time. That is to say that, these States have made an effort to reduce their total liabilities to GSDP. While Andhra Pradesh was only able to meet the target in the last financial year, i.e., 2022-23, it is set to marginally surpass the FC target in FY 2023-24, as per the BEs.
- Few States, irrespective of whether they met their targets, have seen a consistent decline in total liabilities to GSDP. These include States like Chhattisgarh, Gujarat, Karnataka, Kerala, Mizoram, Nagaland, Odisha, Tamil Nadu, Tripura, Uttar Pradesh, Uttarakhand, West Bengal and Jammu & Kashmir.

³³Paragraph 10.100, *Fifteenth Finance Commission Report*.

³⁴Paragraph 12.64, *ibid*.

³⁵Table 12.4, *ibid*.

Table 1: Total Outstanding Liabilities as per cent of Gross State Domestic Product

Total Outstanding Liabilities – As per cent of Gross State Domestic Product				
State/UT	2021	2022	2023 (RE)	2024 (BE)
Andhra Pradesh	36.9	33.6	32.5	33.5
Arunachal Pradesh	46.1	45.3	48	50.4
Assam	25.4	24.8	25.6	26.6
Bihar	40.1	39.6	39.1	37
Chhattisgarh	28.8	26.2	24	24
Goa	35.2	35.4	35.5	38.3
Gujarat	22.5	20.1	18.6	18.2
Haryana	33.2	32.1	30.7	29.9
Himachal Pradesh	44.4	41.7	44.3	44.2
Jharkhand	36.8	31.6	30.2	30.1
Karnataka	25.9	25.7	23.9	22.7
Kerala	40.3	38.6	37.2	36.9
Madhya Pradesh	30.2	28.6	27.6	28.7
Maharashtra	20.9	19.5	18.5	18.6
Manipur	43.9	41.9	43.4	39.5
Meghalaya	43.5	43.6	44.1	42.1
Mizoram	42.7	39.4	39.5	36.2
Nagaland	51.1	49.6	53.2	44.3
Odisha	26.1	20.7	16.8	13.9
Punjab	47.9	46.4	47	47.6
Rajasthan	40.3	38.1	35.3	35.7
Sikkim	29.2	30.6	31.2	31
Tamil Nadu	31.8	32.2	31.4	31
Telangana	28.8	27.9	26.8	27.8
Tripura	40.2	35.9	32.2	32
Uttar Pradesh	36.5	32.7	30.7	28.6
Uttarakhand	31.8	29	26.5	26.9
West Bengal	43	40.2	38.4	38.3
Jammu & Kashmir	33.3	34.1	32.1	30.4
NCT Delhi	1.2	1.7	1.4	1.7
Puducherry	29.2	28.1	29	30.8
15th FC target	33.1	32.6	33.3	33.1

Source: RBI

The FC report recognised the need for revaluation of the time-table for defining and achieving debt sustainability.³⁶ It also recommended the constitution of a High-powered Inter-governmental Group to draft the new FRBM framework and to oversee its implementation.³⁷ It called for greater transparency in the financial position of the States through the introduction of a credit rating mechanism. It was noted that by building such a mechanism, the States will be incentivised to maintain fiscal discipline. Such credit rating will also allow for a broader investor base and lead to better pricing of SDLs.³⁸ The Commission recommended that the States may form independent public debt management cells to chart out their borrowing programme efficiently.³⁹ Additionally, the report recognised the need for avenues outside of WMA/OD for short-term borrowings.⁴⁰

4.2 Challenges in the Fiscal Framework of States

The FC in volume IV of the report attempts to understand each State through its geographic, demographic, macroeconomic, socioeconomic and fiscal indicators. Through this analysis, the FC has highlighted certain overarching challenges confronting the fiscal framework of States. The challenges related to debt are discussed below.⁴¹

³⁶Paragraph 12.76, *Fifteenth Finance Commission Report*.

³⁷Paragraph 12.76, *ibid*.

³⁸Paragraph 12.24, *ibid*.

³⁹Paragraph 12.19, *ibid*.

⁴⁰Paragraph 12.26, *ibid*.

⁴¹This analysis is based on data from 2011-12 to 2018-19.

- *Compliance with FRBM Act:* Many States including Kerala, Uttar Pradesh and Punjab were non-compliant with the targets prescribed under their laws. Various States were in partial compliance of the target.⁴² In the case of Andhra Pradesh, the FRBM targets were not fixed by the State Government from 2015-16 to 2017-18 and thus it could not be ascertained whether the State was compliant with the targets. States like Tamil Nadu and Assam have been in compliance with their laws. The FC has suggested that States need to bring down their fiscal indicators in line with the latest FRBM Act and XV FC recommendations. To this end, States need a credible debt path and careful calibration of expenditure for generating future streams of income.
- *Off-budget borrowing:* There is lack of uniformity in the treatment of Off-Budget Borrowings (OBBs). Telangana and Maharashtra have high OBB, however these are not included while calculating the fiscal targets under their respective FRLs. Therefore, the FC notes that OBBs through parastatals need to be accounted for in order to avoid possible fiscal shocks. Karnataka, on the other hand, has included OBB within the scope of “total liabilities” in their State FRL.
- *Power sector-related debt:* Under the UDAY scheme, the States had to take over a part of the Distribution Companies (DISCOM) debt stock on their own balance sheet. This has contributed to the higher debt burden of some States like Rajasthan and Punjab.
- *Cash flow management issues:* Some States such as Andhra Pradesh and Punjab, were facing cash flow issues, with their expenditure exceeding their revenue. Cashflow issues lead to an increasing dependence on WMA/OD.
- *Guarantees by State Governments:* States such as Himachal Pradesh and Manipur had provided guarantees for the debt taken by Public Sector Undertakings (PSUs). While these guarantees are not accounted for when calculating a State’s debt burden, they become payable by the State Governments in the event of default by the PSUs. Therefore, there is a need to restrain such government guaranteed borrowings to PSUs.

The cohort analysis undertaken by the FC highlights the increasing debt burden on various States. While most States did not adhere to the debt limits set in their respective FRBM legislations, States such as Kerala, Punjab, Telangana, and West Bengal have displayed unhealthy levels of debt. The FC has uniformly suggested the above mentioned States to adhere to the targets set within the FRBM legislations. Further, the Commission noted that State finances had been hit by the implementation of UDAY, pay commission awards, and farm loan waivers, which has wider moral hazard implications.

5 Subnational Borrowing: International Experience

Across jurisdictions, different fiscal arrangements operate between national and subnational governments. Many countries have seen an increase in subnational borrowings and have adopted various measures to contain them. In order to understand these measures, this section highlights the key aspects of the fiscal devolution of powers to the

⁴²For example, Rajasthan, Telangana, West Bengal and Madhya Pradesh comply with one of the two indicators of fiscal deficit to GSDP or debt to GSDP.

subnational governments in Brazil, the United Kingdom (UK) and the United States of America (US).

5.1 Brazil

Brazil has a high degree of fiscal decentralisation wherein the subnational governments have a substantial degree of revenue autonomy.⁴³ However, this was not always the case. The country has a long history of subnational fiscal challenges, the 1966 tax reforms reduced the tax autonomy of States which led to high dependence of States on the financial markets.⁴⁴ Additionally, the lack of expenditure restraints on subnational governments resulted in subnational indebtedness reaching unsustainable levels by 1980s.⁴⁵

In response to this crisis, the 1988 Constitution promoted decentralisation of tax competency in favour of subnational governments.⁴⁶ However, borrowing restrictions were not strictly enforced and there was no clarity in the assignment of spending responsibility.⁴⁷ As a result, subnational debt increased further in the early 1990s. To counteract this, several rounds of subnational debt rescheduling initiatives were undertaken. In the late 1990s, the States and several municipalities entered into contracts with the Federal Government known as the Restructuring and Fiscal Adjustment Programs.⁴⁸ Through these contracts, the subnational governments committed to implement fiscal adjustments and targets in exchange for Federal Government help to restructure their debts.⁴⁹

In 2000, Brazil passed its FRL which provides the guidelines for budgetary and financial affairs at three levels of the Government. As per the legislation, to facilitate a higher degree of control of the Federal Government over subnational borrowing, the States are not allowed to issue bonds. Instead, they may raise loans from banks.⁵⁰ The limit on the credit issued by banks to subnational government is determined by the National Monetary Council (NMC).⁵¹ NMC is an institution of the National Financial System and is in charge of formulating credit and monetary policies.⁵² The Federal Government incentivises fiscal discipline among States by subscribing to a grading system. Under this, States with healthier finances can qualify for Federal guarantees that allow the States to borrow at rates comparable to those prevailing for Federal debt. Such Federal guarantees are kept in check through annual global limits approved by the Senate, with separate limits for external and domestic debt.⁵³ Additionally, the legislation sets out limits for

⁴³Paragraph 1, *Brazil Technical Assistance Report - Strengthening the Framework for Subnational Borrowing*. International Monetary Fund, 2019.

⁴⁴Chapter 12: The Subnational Financial Crisis, Krishna Srinivasan Antonio Spilimbergo. *Brazil: Boom, Bust, and the Road to Recovery*. International Monetary Fund, 2019.

⁴⁵Chapter 12: The Subnational Financial Crisis, *ibid*.

⁴⁶Chapter 12: The Subnational Financial Crisis, *ibid*.

⁴⁷Chapter 12: The Subnational Financial Crisis, *ibid*.

⁴⁸Chapter 12: The Subnational Financial Crisis, *ibid*.

⁴⁹Paragraph 3, *Brazil Technical Assistance Report - Strengthening the Framework for Subnational Borrowing*. International Monetary Fund, 2020.

⁵⁰Paragraph 6, *Brazil Technical Assistance Report - Strengthening the Framework for Subnational Borrowing*.

⁵¹Table 1, *Brazil Technical Assistance Report - Strengthening the Framework for Subnational Borrowing*, page 12.

⁵²Banco Central do Brasil. *National Monetary Council*.

⁵³Paragraph 6, *Brazil Technical Assistance Report - Strengthening the Framework for Subnational Borrowing*.

debt, debt issuance, personnel expenditure, and debt service.⁵⁴ States that breach such limits are restricted from raising further borrowings and are restricted from receiving new voluntary transfers from the Federal Government.⁵⁵

In 2017, a program for States in fiscal distress was introduced. This program provided financial assistance to States that met certain conditions and agreed to implement a financial adjust plan with the Federal Government.⁵⁶

The Tribunal de Contas da União (TCU) also known as the Federal Court of Accounts and the local courts of accounts are tasked, under the FRL, with overseeing the fiscal management of Governments at all three levels.⁵⁷ These institutions enjoy high degree of functional and political autonomy.⁵⁸ The local courts of accounts are responsible for overseeing that the subnational governments are complying with the expenditure and borrowing limits prescribed under the FRL. The courts are also responsible for alerting bodies and branches of Government when they approach the prescribed limits.

It was observed that despite the initial success of the FRL framework, the compliance with the debt and spending limits was uneven.⁵⁹ This was due to legal uncertainties surrounding implementation of the FRL, differences in accounting standards and reporting, weak internal and external control, and loosening administrative controls on borrowing.⁶⁰

5.2 United Kingdom

In the UK, political and administrative powers were devolved to the three administrations of Scotland, Wales and Northern Ireland in the late 1990s.⁶¹ Their legislatures were established through devolution legislations passed by the UK Parliament.⁶²

The funding for these devolved administrations includes block grants from the UK government, their own revenue-raising powers, and their borrowing powers. Out of these, the allocation of block grants are determined through a formula which is adjusted to reflect their revenue-raising power.⁶³

The Scottish and Welsh Governments and the Northern Ireland Executive have the power to borrow for capital investment from the National Loans Fund under the Scotland Act

⁵⁴Paragraph 6, *Brazil Technical Assistance Report - Strengthening the Framework for Subnational Borrowing*.

⁵⁵Paragraph 6, *ibid*.

⁵⁶Paragraph 6, *ibid*.

⁵⁷Tribunal de Contas da União. *The Fiscal Responsibility Law*.

⁵⁸Brookings. *Brazil's Fiscal Responsibility Law and the Quality of Audit Institutions*. URL: https://www.brookings.edu/wp-content/uploads/2016/06/12_brazil_pereira.pdf, page 1.

⁵⁹Paragraph 18, *Brazil's Fiscal Framework: Challenges and Options for Reform*. International Monetary Fund, 2023.

⁶⁰Paragraph 18, *ibid*.

⁶¹A Scottish Parliament and a National Assembly for Wales were decided to be established through referendums in September 1997. In Northern Ireland, the referendum in May 1998 supported the devolution agreed under the Belfast (Good Friday) Agreement.

⁶²Government of United Kingdom. *Guidance on Devolution of powers to Scotland, Wales and Northern Ireland*. 2019. URL: <https://www.gov.uk/guidance/devolution-of-powers-to-scotland-wales-and-northern-ireland>.

⁶³HM Treasury (UK). *Block Grant Transparency: June 2021 publication*.

1998,⁶⁴ Wales Act 2006,⁶⁵ and Northern Ireland (Loans) Act 1975.⁶⁶

However, the Scottish and Welsh Governments also have the power to borrow from commercial lenders and issue bonds, excluding any bonds transferable by delivery, to finance capital investment.⁶⁷ The Scottish Government is considering the options for a bond issuance in the latter half of 2025-26.⁶⁸ The Scottish and Welsh Governments are solely responsible for meeting their liabilities and the UK Government will not provide guarantees on the bonds issued by them. If there is an increase in the Scottish or Welsh Government's borrowing limits, the UK Government will also review devolved administrations' powers to issue bonds. These Governments need further approval from the HM Treasury to issue in any currency other than sterling.⁶⁹ The repayment arrangements are to remain consistent with the respective legislations. Under these arrangements, the term of any loan would normally be for 10 years, but where the lives of the assets being purchased through the loan justify longer or shorter terms, these can be agreed.⁷⁰

The statutory limit on borrowing for capital expenditure applicable currently is GBP 3 billion cumulatively in both Scotland and Northern Ireland, and GBP 1 billion in Wales. The annual limit is usually set at 15% of the overall cap.⁷¹ The Scottish and Welsh Government notify the Treasury monthly on their planned capital borrowing, its outstanding debt and repayment profile, but will be able to borrow within the agreed limits as it deems appropriate.⁷²

Further, they also have resource borrowing powers for forecast error and in-year cash management. Their borrowing powers are further discussed in their respective fiscal frameworks.⁷³ Each Government also maintains a reserve to be held within the UK Government, for depositing any resource or capital funds which can be drawn down to fund future spending. The Scottish and Welsh fiscal framework mandates cooperation for sharing information with the Office of Budget Responsibility (OBR) for it to perform its statutory functions of forecasting.⁷⁴ The Northern Ireland Executive has short-term resource borrowing powers to assist cashflow management in the Northern Ireland Con-

⁶⁴Section 66, *Scottish Act 1998*, this Act was most recently amended through the Scotland Act 2016.

⁶⁵Section 121, *Government of Wales 2006*, this Act was most recently amended through the Wales Act 2017.

⁶⁶Section 1, *Northern Ireland (Loans) Act 1975*, this Act was most recently amended through the Northern Ireland (Miscellaneous Provisions) Act 2006.

⁶⁷*Scottish Act 1998; Government of Wales 2006*.

⁶⁸Scottish Government. *Memorandum on Scottish Government Capital Borrowing and Bonds*. December 2023.

⁶⁹HM Treasury (UK). *Debt Management Report 2023-24*.

⁷⁰Welsh Government. *The agreement between the Welsh Government and the United Kingdom Government on the Welsh Government's fiscal framework*. December 2016; Welsh Government, *The agreement between the Welsh Government and the United Kingdom Government on the Welsh Government's fiscal framework*.

⁷¹HM Treasury. *Statement of funding policy: Funding the Scottish Government, Welsh Government and Northern Ireland Executive*. October 2021.

⁷²Scottish Government, *Memorandum on Scottish Government Capital Borrowing and Bonds*; Welsh Government, *The agreement between the Welsh Government and the United Kingdom Government on the Welsh Government's fiscal framework*.

⁷³HM Treasury (UK), *Debt Management Report 2023-24*.

⁷⁴Welsh Government, *The agreement between the Welsh Government and the United Kingdom Government on the Welsh Government's fiscal framework*; Welsh Government, *The agreement between the Welsh Government and the United Kingdom Government on the Welsh Government's fiscal framework*.

solidated Fund.⁷⁵

5.3 United States

Most States in the US have a separate operating and capital budget, unlike the Federal Government. While the operating budget relies on continuing revenue, a huge amount of capital finance is generated by issuing debts.⁷⁶ The Federal Government does not impose fiscal rules on subnational governments. Each State sets fiscal limits for itself and for its local governments. Thus, the ceilings, prohibitions, and conditions on deficit and debt vary from State to State.⁷⁷ However, almost every State and local government is required to maintain a balanced operating budget. Balancing the general fund budget, which in almost all States receives most of the tax and fee collection along with miscellaneous revenues, is what is commonly referred to as balancing the state budget.⁷⁸

Various State Constitutions govern when and for what period the State can issue debt to cover deficits that emerge after the budget's adoption.⁷⁹ As per the General Accounting Office, some balanced budget requirements are based on interpretations of statutes rather than on an explicit statement that the State must have a balanced budget.⁸⁰

US States have two options for borrowing. The first is by way of *long-term bonds*, used to finance long-term infrastructure projects. These are repaid over years or decades and represent a vast majority of municipal debt. The second is by way of *short-term borrowing*, which commonly takes the form of anticipation notes to manage cash flow. These options do not provide sufficient flexibility to the States to deal with fiscal emergency situations such as the disruption caused during the pandemic.⁸¹ For instance, in order to better manage the cash flow pressures in municipal markets caused by the pandemic and other revenue delays faced by the municipalities, the Federal Reserve established the Municipal Liquidity Fund, establishing Federal Reserve as a source of emergency financing for the subnational governments.⁸²

Most State and local bond debt is long term debt which aids in financing capital expenditure, primarily infrastructure projects. States typically prohibit use of bond proceeds to fund operating expenses. Some States also issue short-term revenue anticipation notes in order to help them in managing their cash flow. This debt is required to be repaid within the fiscal year. Interest costs are low in the case of most States and localities.⁸³

In certain States, executive branch officials have some limited authority to initiate short-term borrowing for cash flow purposes, but in many other States, even such short-term loans require legislative approval. Restrictions on borrowing also leads to States holding

⁷⁵HM Treasury (UK), *Debt Management Report 2023-24*.

⁷⁶*NSCL Fiscal Brief: State Balanced Budget Provisions*. National Conference of State Legislatures, 2010.

⁷⁷*United States Federal Country*. 2016.

⁷⁸*Ibid*.

⁷⁹Michael Mazerov, Elizabeth McNichol. "State Borrowing No Substitute for Additional Direct Aid to Help States Weather COVID Downturn". In: (2020).

⁸⁰Teresa Ter-Minassian. *Fiscal Federalism in Theory and Practice*. International Monetary Fund, 1997.

⁸¹Jeff Chapman. "States Contemplate Borrowing to Help Manage Pandemic's Fiscal Impact". In: (2020).

⁸²US Government Accountability Office. "Federal Grants to State and Local Governments". In: (2022).

⁸³*State and Local Borrowing*. Center on Budget and Policy Priorities, 2018.

reserves. Reserves measured as a percentage of State spending is an important measurement of its fiscal well being.⁸⁴

About 48 States limit issuance of general obligation debt in some form or the other. These limits are usually prescribed in the State constitutions, and also in the form of standalone or supplementary statutory restrictions. 33 States require, at a minimum, voter or a super majority legislative approval for introducing a specified borrowing program or issuance of bond. Many States also borrow from outside capital markets, in an effort to deal with a structural budgetary imbalance.⁸⁵

While several studies have been conducted on the effectiveness of subnational government rules in the context of US States, most authors conclude that rules do enforce some budget discipline on the States, in terms of lower deficits and quicker reactions to negative fiscal shocks.⁸⁶

6 State Bond Markets: Stylised Facts

Recent years have seen an increased reliance of States on market borrowings. A deep and liquid bond market with efficient price discovery is an important instrument in incentivising States towards greater fiscal prudence. This section presents some facts about the functioning of the State bond market. It begins with an analysis of the outstanding liability profile of States. It also looks at the issuance calendar and borrowings by states followed by a deep dive into the primary and secondary market for SDLs.

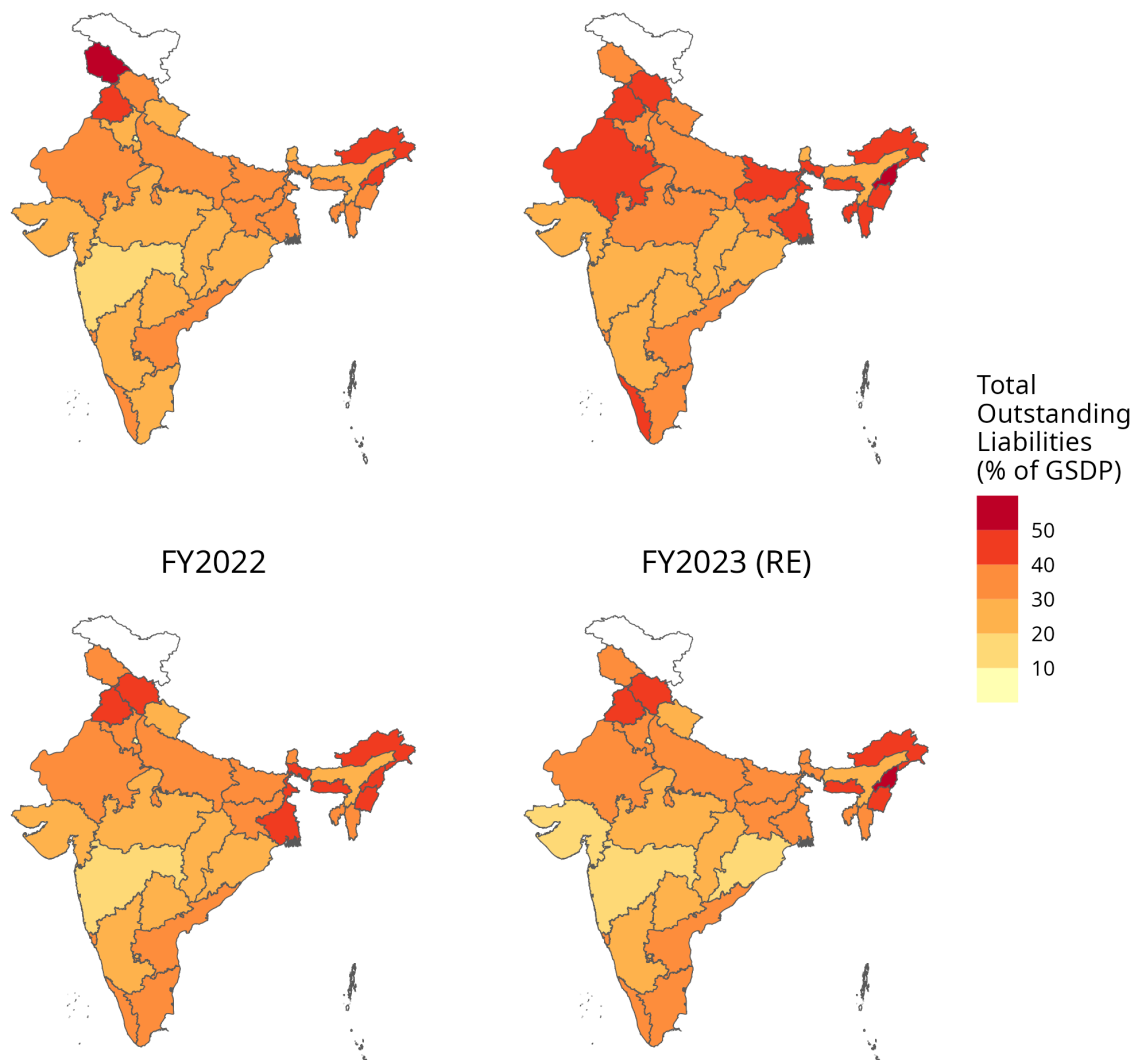
⁸⁴NSCL *Fiscal Brief: State Balanced Budget Provisions*.

⁸⁵*New York: State of Debt*. The Volcker Alliance, 2022.

⁸⁶Violeta Vulovic. *Sub-National Borrowing, Is It Really a Danger*. Dec. 2011.

6.1 Liability Profile of States

Figure 1: Total outstanding liabilities percent to State GDP
FY2020 FY2021



Source: RBI

Figure 1 maps State-wise total outstanding liabilities as a percentage of GSDP for the last four financial years, i.e., 2019-20 till 2022-23.

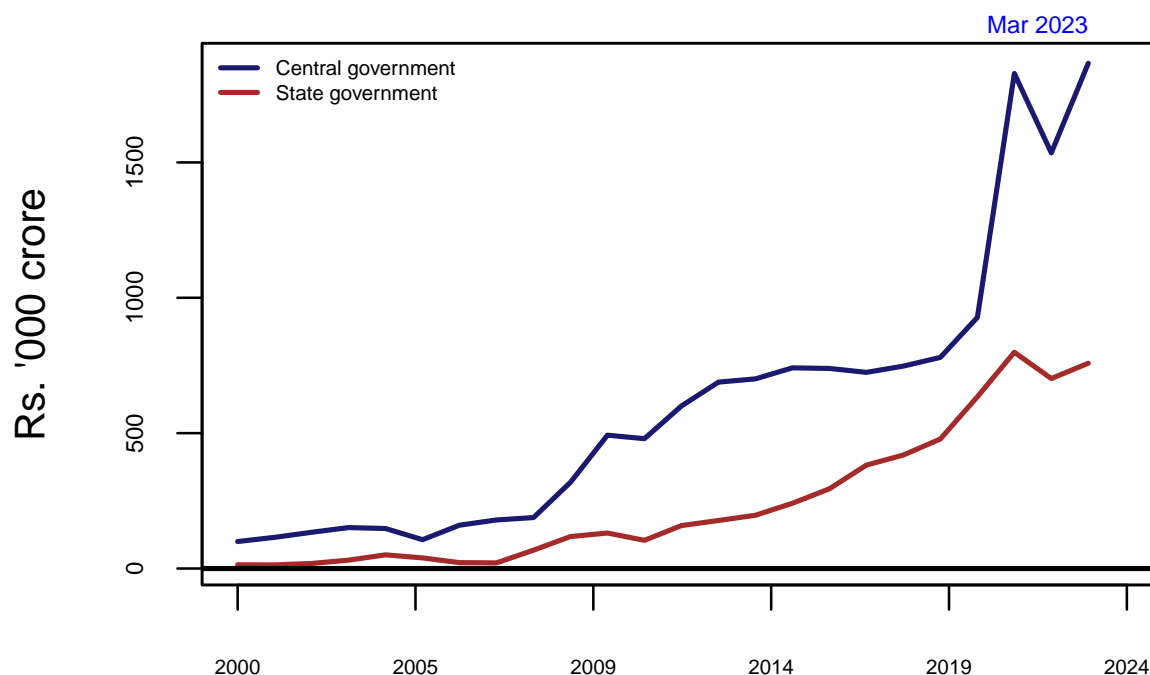
Few patterns are noteworthy: First, total liabilities as a percent to GSDP for all States increased in FY 2021, due to the COVID-19 pandemic. Second, North-Eastern States, along with Punjab and Haryana have the highest ratio of total liabilities as percent to GSDP, when compared to the rest of States.

6.2 Borrowings by Central and State Governments

Market borrowings have become an important instrument for raising finance for States post the recommendation of the XIV FC that excluded them from the National Small

Savings Fund financing facility (except for Arunachal Pradesh, Delhi, Kerala and Madhya Pradesh).⁸⁷ Figure 2 plots gross market borrowings of the Centre and State Government from 1999-2000 till 2022-23. It clearly reflects the increased reliance of States on market borrowings.

Figure 2: Gross market borrowing by the Governments



Source: Handbook of Statistics, Database on Indian Economy (DBIE)

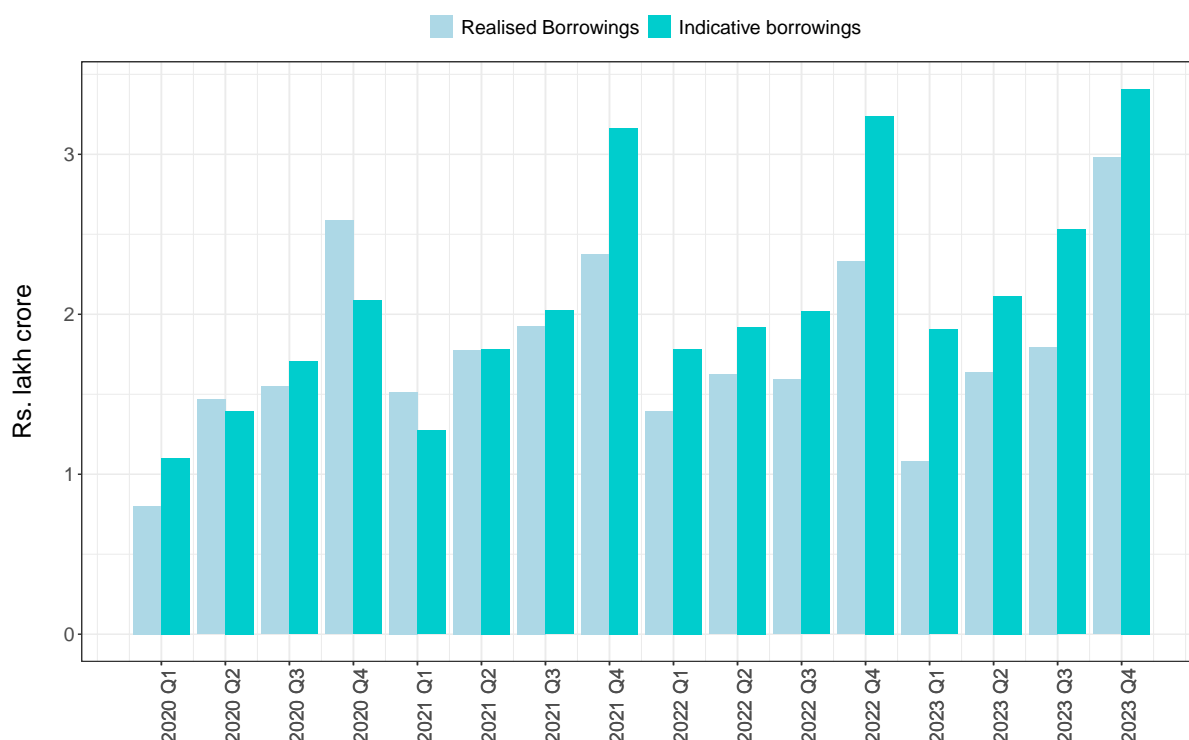
The COVID period saw a sharp increase in the borrowings of both the Central and State Governments, the highest since 2000. Central Government borrowings increased by around INR 900 thousand crore, while State Government borrowings increased by around INR 164 thousand crore. Market borrowings since then have remained elevated.

The share of State Government borrowings in total government borrowings increased to almost 30% in the last six financial years, i.e., from 2016-17 till 2022-23. Prior to FY 2016-17, the share was mostly flat at around 20% of the total government borrowings.

Before the issuance and auction of SDL, RBI in agreement with the States, publishes an indicative calendar of State market borrowings. This calendar is published at the start of every financial year quarter. It entails information on which States would be borrowing on what dates within that quarter along with the tentative amount of borrowings for each State.

⁸⁷ *State Finances: A study of Budgets of 2023-24*. Reserve Bank of India, 2023.

Figure 3: Indicative and actual borrowings of the State Governments



Source: Indicative calendar of market borrowings by State Governments and Public Debt Statistics, RBI

Figure 3 plots indicative borrowings by the States and their actual or realised borrowings for each quarter, from FY 2020-21 till FY 2023-24.⁸⁸ There have been a few instances when the States have borrowed far more than what they earlier intended. This is particularly true during the few quarters of COVID years, i.e., in 2020 Q2 and from 2020 Q4 till 2021 Q1 which could be on account of higher expenditure commitments due to the pandemic.

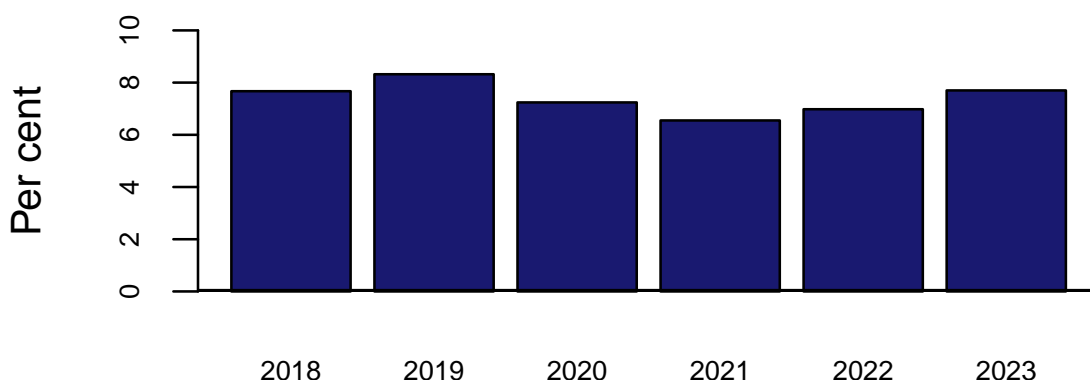
After the first quarter of 2021, the actual market borrowings of the State Governments have consistently remained lower than the indicative borrowings.

Figure 4 plots the weighted average cut-off yield for State Government securities in last six years. The cost of borrowing eased during the COVID period but since then it has inched up on account of rate hikes by the RBI in 2022-23.⁸⁹

⁸⁸2023 Q4 realised borrowings are from 1 January 2024 till 21 March 2024.

⁸⁹To enable State Governments to undertake COVID-19 containment measures, RBI had announced an increase in Ways and Means Advances limit of the states and UTs by 60 percent over and above the level as on 31 March 2020, which remained valid till 31 March 2021. The Reserve Bank decided to retain the interim limit of WMA till 30 September 2021 and later extended it till 31 March 2022.

Figure 4: Weighted average cut-off yield for State Governments (in %)



Source: Public Debt Statistics, DBIE

6.3 Primary Bond Market: Issuances

This section looks at the issuances data in the primary market to analyse the top borrower States and their quantum of borrowings when compared with the rest of the States.

Table 2: Top 10 States in terms of notified amount of SDL

State rank	2020-21	Amount (Rs. crore)	2021-22	Amount (Rs. crore)	2022-23	Amount (Rs. crore)	2023-24	Amount (Rs. crore)
1	Tamil Nadu	82,977	Tamil Nadu	87,000	Tamil Nadu	87,000	Tamil Nadu	1,08,000
2	Uttar Pradesh	75,500	West Bengal	67,390	Maharashtra	72,000	Maharashtra	1,02,000
3	Karnataka	69,000	Maharashtra	64,000	West Bengal	62,000	Uttar Pradesh	87,150
4	West Bengal	59,680	Uttar Pradesh	62,500	Andhra Pradesh	57,478	Karnataka	78,000
5	Rajasthan	55,859	Karnataka	59,000	Uttar Pradesh	55,612	Rajasthan	68,628
6	Maharashtra	55,750	Rajasthan	50,149	Haryana	45,158	Andhra Pradesh	68,400
7	Andhra Pradesh	50,896	Andhra Pradesh	46,443	Rajasthan	45,057	West Bengal	65,500
8	Madhya Pradesh	45,573	Telangana	45,716	Punjab	45,005	Telangana	47,900
9	Gujarat	37,700	Haryana	29,000	Madhya Pradesh	40,158	Bihar	47,612
10	Telangana	35,373	Gujarat	28,500	Telangana	40,150	Haryana	43,000
Total notified amount for all states (in Rs. crore)	7,59,264		6,93,858		7,49,597		9,52,819	
Share of top ten in total notified amount for all states (in%)	74.85		77.78		73.32		75.12	

Source: Public Debt Statistics, DBIE

Table 2 shows the top 10 States in terms of the notified amount of SDL and their share in the total notified amount for all States in the primary market. Market borrowing seems to be concentrated amongst seven States, particularly, Tamil Nadu, Uttar Pradesh, West Bengal, Rajasthan, Maharashtra, Andhra Pradesh, and Telangana. Punjab, Karnataka, Gujarat, Haryana, Madhya Pradesh, and Bihar also feature amongst the top 10 borrowers in some years.

⁹⁰Data as of 21st March 2024.

Borrowings of the top 10 States in all four financial years has accounted for more than 70 percent of the total market borrowings by all States.⁹¹

One of the reasons behind borrowings being concentrated amongst few States could be their higher debt as a percent to GSDP. Table 3 puts forth the total outstanding liabilities as a percent to GSDP of the seven States. It can clearly be seen that the total outstanding liabilities as a percent to GSDP for these States has remained elevated at around 30 percent, with Maharashtra and Telangana being the notable exceptions.

Table 3: Total outstanding liabilities percent to GSDP for the seven States

States	FY 2019-20	FY 2020-21	FY 2021-22	FY 2022-23 (RE)
Andhra Pradesh	33.20	36.90	33.60	32.50
Maharashtra	18.10	20.90	19.50	18.50
Rajasthan	35.40	40.30	38.10	35.30
Tamil Nadu	26.50	31.80	32.20	31.40
Telangana	23.70	28.80	27.90	26.80
Uttar Pradesh	32.30	36.50	32.70	30.70
West Bengal	37.80	43.00	40.20	38.40

With some basic facts about borrowing in place, it is important to look at the maturity profile of SDLs being issued by States in India.

Table 4: Maturity bucket-wise share in total notified amounts of SDLs

Maturity bucket	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24 ⁹²
Above 1 year and upto 5 years	3.49	11.11	5.30	17.25	5.16	2.14	2.08
Above 5 years and upto 10 years	70.49	64.76	68.42	50.32	48.91	43.06	34.62
Above 10 years and upto 14 years	9.35	5.50	9.90	7.33	14.09	15.10	25.18
Above 14 years	16.68	18.42	16.38	25.10	31.84	39.70	38.12

Source: Public Debt Statistics, DBIE

Table 4 shows the maturity wise share in total notified amount of the SDLs. It indicates that while the bulk of the SDLs are issued in the 5-10 year bucket, the share of securities issued in the longer tenure: above 10 years and upto 14 years, and above 14 years has been increasing post COVID. Concomitantly, the share of securities with less than 10 year maturity has been declining since 2020-21.⁹³

6.4 Ownership pattern of Outstanding State Government Loans

Table 5 shows ownership of SDLs, in the July to September quarter of each financial year starting from 2015 till 2023. Some observations are outlined below:

- Banking sector along with insurance and provident funds together account for almost 80% of the SDL ownership.
- Share of insurance and provident fund has remained within the range of 45.77 – 55.75%.

⁹¹ *A thematic study on the SDL trading behaviour and valuation framework*. Financial Benchmark India Private Limited, 2022.

⁹² Data as of 21 March 2024

⁹³ *A thematic study on the SDL trading behaviour and valuation framework*.

- While banking sector is a dominant investor of SDL, there has been a gradual but consistent slowdown in the purchase of SDLs by commercial banks. With reduction in Statutory Liquidity Ratio (SLR) requirements, the demand for securities by banks will be impacted.⁹⁴ On the other hand, with the recent regulations lifting the cap on banks' Held to Maturity (HTM) portfolio, banks could be inclined to invest in G-Secs and SDLs.⁹⁵
- The participation of Foreign Portfolio Investors (FPIs) in the SDL market has been limited. Despite the increase in limits for FPI investments in state government securities, the utilisation by FPIs is abysmally low. A few studies have highlighted the need for making high frequency data available to investors to enhance the attractiveness of SDLs for foreign investors.⁹⁶
- The share of mutual funds, financial institutions, corporates, pension funds and non-bank primary dealers has been increasing, albeit marginally.

Table 5: Ownership pattern of SDL: In percent

	Sep 2015	Sep 2016	Sep 2017	Sep 2018	Sep 2019	Sep 2020	Sep 2021	Sep 2022	Sep 2023
Banking Sector ⁹⁷	44.58	44.43	42.46	39.41	36.77	38.79	39.54	38.26	37.47
RBI	0.01	0.01					0.85	0.79	0.69
Subtotal	44.59	44.44	42.46	39.41	36.77	38.79	40.39	39.05	38.16
Insurance Companies	33.48	32.67	34.00	33.74	33.39	30.26	27.50	27.71	26.97
Provident Funds	16.42	16.84	18.37	21.04	22.36	21.31	18.27	20.18	21.70
Subtotal	49.90	49.51	52.37	54.78	55.75	51.57	45.77	47.89	48.67
Mutual Funds	0.63	1.62	1.92	1.05	1.12	1.96	1.97	2.08	1.86
Financial Institutions	0.18	0.27	0.22	0.43	0.33	1.92	1.72	1.71	1.65
Corporates	0.20	0.14	0.11	0.17	0.28	0.39	1.32	1.85	1.87
Foreign Portfolio Investors		0.08	0.16	0.10	0.05	0.02	0.03	0.02	0.02
State Governments				0.07	0.16	0.18	0.18	0.21	0.27
Others including State Governments	4.24	3.59	2.37	3.48	4.98	4.80	8.38	2.32	2.34
Pensions Funds								4.73	4.82
Non-Bank Primary Dealers	0.26	0.35	0.38	0.58	0.72	0.54	0.44	0.36	0.61
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Public Debt Statistics, DBIE

Thus, over the years there seems to be no considerable difference in the ownership pattern of SDLs. Banking, insurance companies and provident funds are the major owners of SDLs. Retail investors still have a limited presence in the SDL market. It is only in the recent few years that their share seems to be increasing but not considerably.

Similar is the case with CGS too. Table 6 shows the ownership pattern of CGS for the July to September quarter for each financial year from 2015 till 2023. It can be seen that:

-

- Banking sector, RBI, insurance companies and provident funds are the major players in this market, with more than 80 percent of CGS being held by them. Though over the years their share has seen a moderation from around 87 percent (September 2015) to around 83 percent in September 2023.⁹⁸

⁹⁴In the Statement on Development and Regulatory Policies published in December 2018, it was decided to reduce the SLR by 25 basis points every calendar quarter until the SLR reaches 18 per cent of NDTL. The first reduction of 25 basis points in SLR commenced from January 2019.

⁹⁵These changes will come into effect from 1 April 2024. See, RBI. *Master Direction - Classification, Valuation and Operation of Investment Portfolio of Commercial Banks (Directions)*, 2023.

⁹⁶Vardhana; Nath Golaka C; Pawaskara and Priyanka Shiraly. *Trends in the SDL markets in India*. The Clearing Corporation of India Limited, 2019; B.P. Kanungo. *State Government Market Borrowings - Issues and Prospects*. Sept. 2018.

⁹⁷Includes Commercial and Co-operative Banks.

⁹⁸A thematic study on the SDL trading behaviour and valuation framework.

- Participation of mutual funds, State Governments, pensions funds, and non-bank primary dealers has seen a marginal improvement with time.
- While share of financial institutions, corporates and FPIs has experienced a moderation.⁹⁹

Table 6: Ownership pattern of CGS: In percent

	Sep 2015	Sep 2016	Sep 2017	Sep 2018	Sep 2019	Sep 2020	Sep 2021	Sep 2022	Sep 2023
Banking Sector ¹⁰⁰	45.67	42.46	42.99	43.92	41.67	40.41	39.32	38.24	39.48
RBI	12.08	14.80	12.84	11.76	14.99	15.00	16.98	15.28	13.06
Subtotal	57.75	57.27	55.83	55.68	56.66	55.41	56.29	53.52	52.54
Insurance Companies	22.09	22.68	23.49	24.61	24.86	25.33	24.18	25.94	26.05
Provident Funds	7.17	6.25	5.99	5.71	4.87	4.77	3.77	4.66	4.42
Subtotal	29.26	28.92	29.48	30.33	29.73	30.09	27.95	30.61	30.47
Mutual Funds	2.69	2.13	1.86	1.41	0.77	2.42	2.91	2.58	3.02
Financial Institutions	0.60	0.84	0.78	0.97	1.15	1.42	1.17	0.98	0.54
Corporates	0.84	1.09	1.04	1.01	0.92	0.94	0.72	1.58	1.21
Foreign Portfolio Investors	3.57	3.82	4.58	3.65	3.31	2.05	1.81	1.38	1.61
State Governments	1.75	1.84	1.92	1.99	1.99	1.86	1.67	1.83	2.04
Others Including State Governments	4.75	5.79	6.11	6.58	7.05	7.32	8.79	5.14	5.64
Pension Funds								3.84	4.32
Non-Bank Primary Dealers	0.54	0.14	0.33	0.37	0.42	0.34	0.35	0.38	0.66
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Public Debt Statistics, DBIE

6.5 Spread between SDL and CGS

SDLs are considered to be riskier than CGS. Literature suggests that State Governments have less fiscal sovereignty and lower tax collecting capacities than the Central Government, hence they pay larger default risk premia on their bonds, when compared to the CGS.¹⁰¹

Figure 5 plots the spread between SDLs with 10 years maturity and 10 year CGS¹⁰².

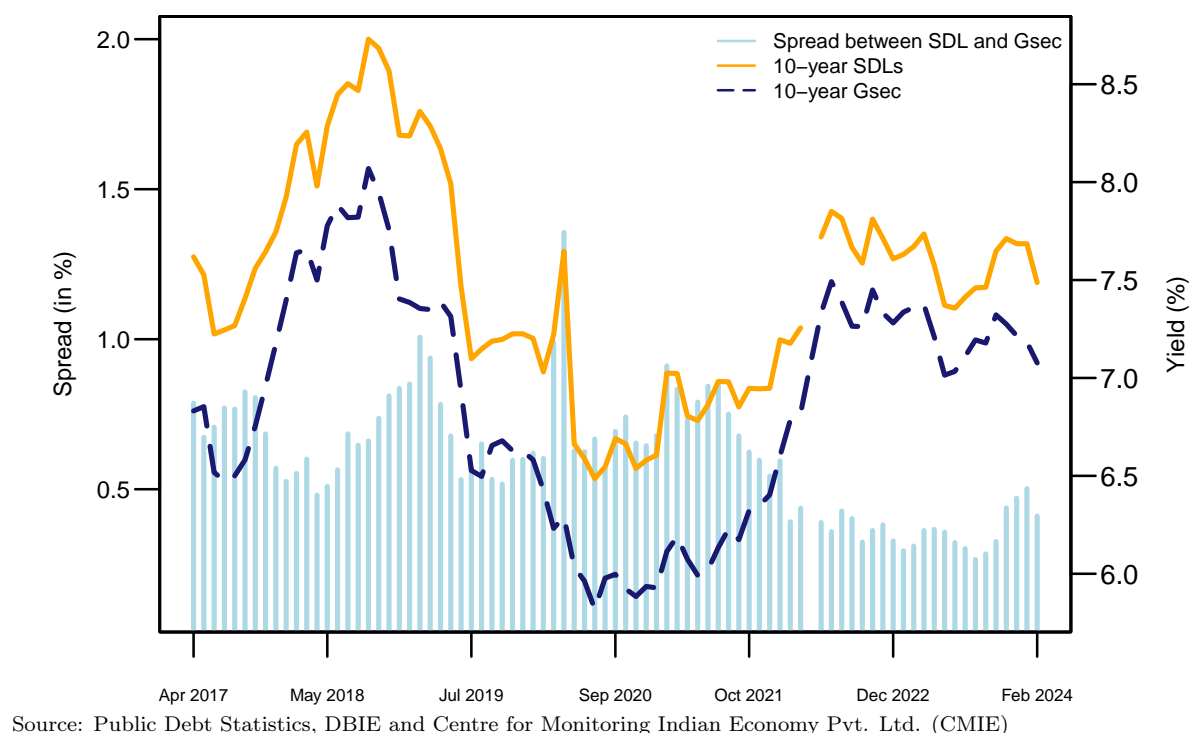
⁹⁹Barry Eichengreen, Poonam Gupta, and Ayesha Ahmed. *India's Debt Dilemma*. 2023.

¹⁰⁰Includes Commercial and Co-operative Banks

¹⁰¹Dhritidyuti Bose, Rajeev Jain, and L. Lakshmanan. "Determinants of Primary Yield Spread of States in India: An Econometric Analysis". In: (Aug. 2011).

¹⁰²The gap in the 10 year SDL line is because no SDLs with a maturity of 10-years were issued in April 2022 by the states.

Figure 5: Spread between SDL and CGS



The lines represent the yields on the ten year government security and on SDL with a ten year maturity. The difference or the spread is represented by the bars in the figure. The spread spiked during the initial months of the first COVID-19 lockdown, i.e., March and April 2020. Another spike in the spread was witnessed from January 2021 till July 2021. Subsequently, the spread has narrowed. However, in recent few months starting from September 2023 till January 2024, the spread widened again, with a moderation being registered in February 2024. Higher SDLs yields could be on account of higher market borrowings by State Governments.¹⁰³

6.6 Secondary Bond Market

In terms of the secondary bond market activity, there exist significant disparities across states. For instance, in FY 2023, securities of larger and richer states, such as Tamil Nadu and Gujarat, accounted for a significant proportion of secondary market activity (See Table 7). On the other hand, the north-eastern States in particular, witnessed next to zero market activity. This might indicate that market participants are perhaps unable to sell these securities in the secondary market, or are unwilling to sell them at a discount. This could also indicate lack of interest from the *buyer's* side, who are unwilling or unable to buy these SDLs at a discount.

¹⁰³State-wise spread is discussed in the section on Issues.

Table 7: SDL Secondary Market Yields and Volume, FY 2023

S No.	State	Yield (%)	Volume ('000 crore)
1	Andhra Pradesh	7.55	46.44
2	Arunachal Pradesh	7.51	0.01
3	Assam	7.28	5.58
4	Bihar	7.48	14.46
5	Chhattisgarh	6.67	2.60
6	Goa	7.26	0.98
7	Gujarat	7.27	61.93
8	Haryana	7.27	39.46
9	Himachal Pradesh	7.44	7.88
10	Jharkhand	7.28	4.11
11	Karnataka	7.24	55.03
12	Kerala	7.28	23.41
13	Madhya Pradesh	7.39	41.54
14	Maharashtra	7.20	74.11
15	Manipur	7.58	0.60
16	Meghalaya	7.18	0.66
17	Mizoram	7.73	0.34
18	Nagaland	7.58	0.69
19	Odisha	6.18	3.86
20	Puducherry	6.89	0.69
21	Punjab	7.53	19.93
22	Rajasthan	7.24	40.91
23	Sikkim	7.65	0.68
24	Tamil Nadu	7.27	85.23
25	Tripura	7.52	0.10
26	Uttar Pradesh	7.32	61.49
27	Uttarakhand	7.22	3.79
28	West Bengal	7.60	46.17

Source: The Clearing Corporation of India (CCIL)

6.7 Summary: Stylised Facts

Throughout the analysis few stylised facts come to light.

In the primary market, it was seen that:

- Market borrowings by the States have seen a rising trajectory, with the recent financial years registering a considerable jump.
- Cost of borrowing for the States has increased in the recent few financial years.
- Market borrowings seem concentrated amongst a few States.
- Ownership of SDLs is still concentrated with banking sector, insurance companies and provident funds. The share of retail investors has improved, albeit marginally.
- SDLs with maturity above 10 years are more preferred by the State Governments as compared to SDLs with maturities of 10 years and less.
- State Governments tend to pay default risk premia, which entails that the SDL yields are higher than the yields on CGS.

In the secondary market, only the SDLs of a few States seem to be more liquid.

7 Issues

This section entails a discussion around the issues surrounding the State bond market, as identified from the analysis presented above.

7.1 Liquidity in the SDL Market

When compared to the CGS market, the SDL market seems to be rather illiquid. The illiquidity stems from the fact that majority of the SDLs are owned by insurance companies and provident funds. These investors tend to hold such securities till maturity, i.e., SDLs held by them do not tend to come in the secondary market.¹⁰⁴ In fact, even banking sector tends to hold almost 40 percent of the SDLs, which is also averse to trading due to valuation norms.¹⁰⁵

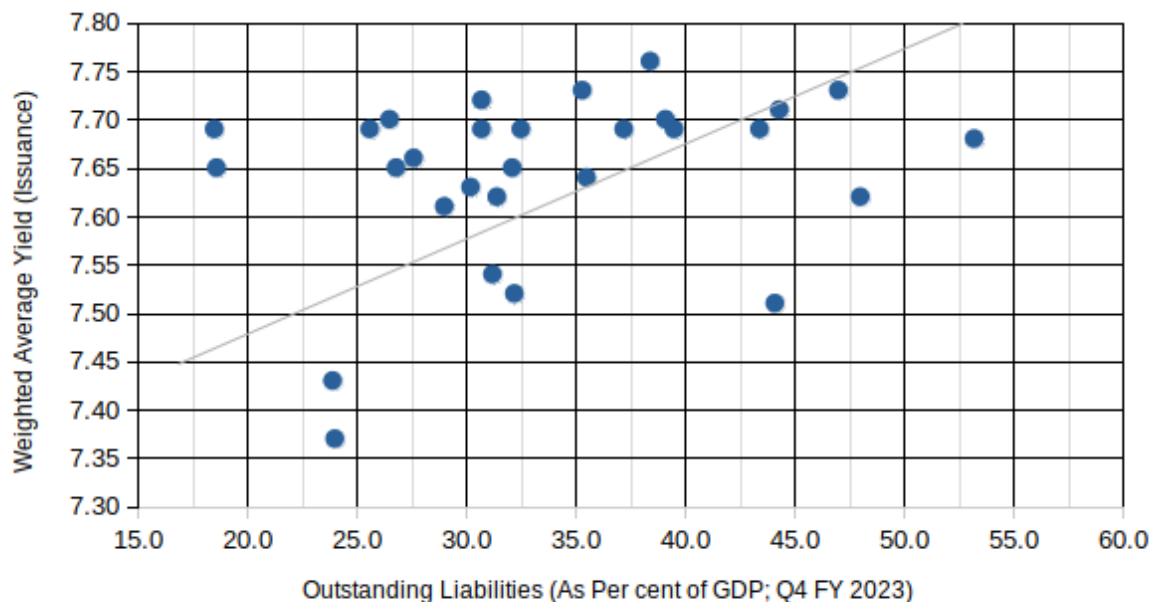
Further lack of participation of market maker such as Foreign Portfolio Investors, Non-Bank Primary Dealers, Corporates etc., in the SDL market that provide two-way quotes, is another reason for illiquidity in the market.¹⁰⁶

7.2 Absence of Risk Asymmetry

An important drawback of the state bond market seems to be that there is hardly any variation between the SDL yields of states with differences in fiscal health. This implies that the risk differentiation between the states is absent, when it comes to the cost of borrowings.¹⁰⁷

Put differently, States with good fiscal health, measured through total outstanding liabilities as a percent to GDP, should be rewarded through lower yields when compared with States with poor fiscal health.

Figure 6: Weighted average yield and total outstanding liabilities as a percent to GDP



Source: CCIL, and RBI

¹⁰⁴Kanungo, *State Government Market Borrowings – Issues and Prospects*.

¹⁰⁵Valuation norms facilitate an uptick in the price of SDL, in the books of the bank and provide insulation from market risks that are offered by holding to maturity dispensation.

¹⁰⁶Kanungo, *State Government Market Borrowings – Issues and Prospects*.

¹⁰⁷Ibid.

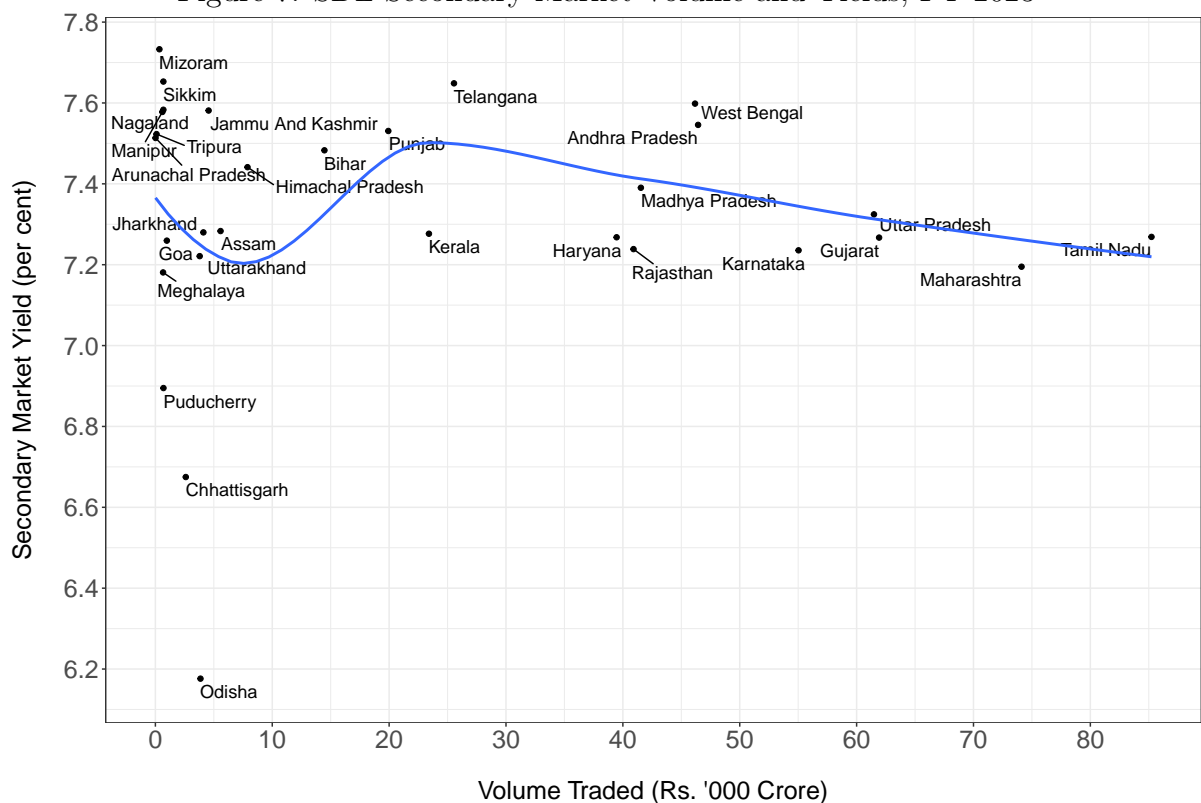
Figure 6 presents a scatter plot between weighted average yield (Q4 of FY 2023) at the time of issuances of SDLs and total outstanding liabilities as a percentage of GSDP for FY 2022-23. It can be seen that yields hardly capture the heterogeneity with respect to the fiscal healths of the States.

States with total outstanding liabilities as a percent to GSDP less than 20 percent have broadly the same borrowing cost or weighted average yield as those of states where the total liabilities to GSDP is more than 35 percent and closer to 40 percent.

Similar is the scenario in the secondary market. The disparity between trading volume is not reflected strongly in SDL yields. Figure 7 shows how yields vary with trading volumes. There does not seem to exist a direct, negative linear relationship between yields and volumes, which would be expected in a functional and liquid market. Rather the relationship seems only weakly negative. There exist instances of State securities with widely divergent trading volumes which differ only very slightly in terms of yields. Take the example of Meghalaya and Maharashtra both of whose securities traded around the 7.2 percent mark; with the latter actually trading at a higher yield, despite widely varying trading volumes (and more fundamental factors, viz. the states' respective economic performance and fiscal health). This is a clear indicator that even in the secondary market, SDLs do not constitute liquid securities.

One facet stands out however - a 'cluster' of States that have experienced close to zero trading of their securities (top left corner of the figure) are all from the North Eastern States: Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura.

Figure 7: SDL Secondary Market Volume and Yields, FY 2023



Source: CCIL

The absence of variation in borrowing costs encourages fiscal indiscipline as profligate States are not deterred from borrowing by the need to pay higher interest cost.¹⁰⁸

A well functioning bond market should reflect variations in the spread between the 10 year SDL and the 10 year CGS. Studies in the field suggest that variations in yield spreads over time can occur as a result of macroeconomic conditions and common risk factors. Variations across States in yield spreads could be attributed to State-specific perceived credit risk and liquidity.¹⁰⁹ However, this is not the case in the Indian SDL market. Indicators capturing the fiscal health of states are not the major determinants of yield spread.¹¹⁰ The analysis in this study also suggests a similar pattern.

Table 8 shows the State-wise spread between SDL and CGS of 10-year maturities, along with the share of the notified amount of the 10-year SDLs in the total notified amount across maturities of SDLs raised by a State in each month for FY 2022-23. This table includes only those States that raised an SDL with a maturity of 10-years in FY 2022-23. Also, a 100 percent share indicates that within that month a particular State only raised the 10-year SDL.

There does not seem to be a significant difference State-wise in the spread. In other words while States differ in their fiscal performance, the yield spread are broadly similar and do not capture the variations in the States' fiscal health.¹¹¹

¹⁰⁸Eichengreen, Gupta, and Ahmed, *India's Debt Dilemma*.

¹⁰⁹Ramesh Jangili, N.R.V.V.M.K. Rajendra Kumar, and Jai Chander. "States' Fiscal Performance and Yield Spreads on Market Borrowings in India". In: (Jan. 2022).

¹¹⁰Bose, Jain, and Lakshmanan, "Determinants of Primary Yield Spread of States in India: An Econometric Analysis".

¹¹¹Bose, Jain, and Lakshmanan, "Determinants of Primary Yield Spread of States in India: An Econometric Analysis"; Kanungo, *State Government Market Borrowings – Issues and Prospects*.

Table 8: Share and Spread of 10 year SDL over 10 year CGS

States	May 2022		June 2022		July 2022		August 2022		September 2022		October 2022		November 2022		December 2022		January 2023		February 2023		March 2023	
	Share	Spread	Share	Spread	Share	Spread	Share	Spread	Share	Spread	Share	Spread	Share	Spread	Share	Spread	Share	Spread	Share	Spread	Share	Spread
Andhra Pradesh	27.06	0.4															33.33	0.25	28.11	0.35		
Arunachal Pradesh															100	0.34						
Assam			75	0.36	100	0.44	66.67	0.4	100	0.28	100	0.4	100	0.37	100	0.29	100	0.33	100	0.33	100	0.35
Bihar							100	0.38	100	0.29	100	0.36	100	0.4	100	0.31	100	0.33	100	0.33	100	0.35
Goa			100	0.32					33.33	0.43	100	0.34	100	0.32	100	0.33	33.33	0.3				
Gujarat			66.67	0.32	66.67	0.4	100	0.41					60	0.27					30	0.29	31.25	0.32
Haryana			50	0.38	50	0.42	50	0.43	100	0.3	60	0.37			33.33	0.35	40	0.3	50	0.3	19.15	0.4
Himachal Pradesh					40	0.43									50	0.29					28.12	0.39
Jammu & Kashmir	100	0.39																				
Karnataka													12.5	0.34	25	0.32	50	0.26				
Kerala															100	0.35			38.46	0.29		
Madhya Pradesh			100	0.36					50	0.2							50	0.3			31.82	0.33
Maharashtra	12.5	0.37	20	0.4					50	0.38												
Manipur	100	0.39	100	0.33	100	0.44			100	0.45												
Mizoram			100	0.37							100	0.33										
Nagaland			100	0.39	100	0.43	100	0.41					100	0.49	100	0.37	100	0.33	100	0.31	100	0.38
Puducherry															50	0.35						
Punjab					19.61	0.46							11.63	0.29								
Rajasthan	28.57	0.37	9.09	0.34	20	0.42	40	0.45	40	0.39	55.56	0.37	100	0.49	100	0.33	33.33	0.31	25	0.3	26.53	0.4
Sikkim					100	0.43			100	0.19	100	0.4	100	0.49					100	0.3	100	0.38
Tamil Nadu			37.5	0.38	31.25	0.41	72.73	0.39			66.67	0.36			33.33	0.33	70	0.28				
Telangana																			14.29	0.28		
Uttarakhand											100	0.4					100	0.28	100	0.31	100	0.38
Uttar Pradesh							100	0.4	100	0.42	27.78	0.36							44	0.3	27.13	0.39
West Bengal	100	0.4	60	0.34	18.75	0.43			26.67	0.42					14.29	0.36						

7.3 Concentrated SDL borrowings

Borrowing within the SDL market was found to be concentrated within a few States, i.e., States that have high issuances.¹¹²

Further, States that have high debt as a percent to GSDP, for instances North-Eastern States do not fare in the top-10 list of borrowers. One of the reasons behind this could be their dependence on central transfers. Their dependence on transfers also explains relatively lower spreads as compared to other States, indicating implicit guarantee.¹¹³

7.4 Role of RBI as States' Debt Manager

Several committees and working groups, such as the Committee on Capital Account Convertibility (1997), Review Group of Standing Committee on International Financial Standards & Codes (2004), Percy Mistry Committee (2007), Internal Working Group on Debt Management, Ministry of Finance (2008) and the Financial Sector Legislative Reforms Committee (2013) have deliberated on the subject of separating the debt management functions from monetary policy functions. The RBI had suggested separation on attainment of three milestones: (i) development of the government securities market; (ii) durable fiscal correction; and (iii) an enabling legislative framework.¹¹⁴

Due to its dual role, the RBI has to balance multiple aspects, namely: the needs of the markets (manage liquidity), government (fiscal requirements), balance sheet of the banks (asset prices and interest rate movements), and general price level (growth of money supply).¹¹⁵

The main conflicts identified over sovereign debt management by the central bank are as follows:

- The RBI's role as a public debt manager may conflict with the prevailing monetary policy stance and the market participants. It is likely that the RBI may not increase interest rates to keep borrowing costs low and compromising its role in managing inflation.
- The RBI, as the debt manager, could take Government debt on its balance sheet to ensure successful Government borrowing.
- The imperatives of the Government borrowing program may influence the RBI's decision to reduce the SLR.

7.5 Extra Budgetary Borrowings and its Impact on Debt Management by States

Government entities, such as companies, corporations, and autonomous bodies, actively participate in carrying out Government schemes and projects. While these entities are legally separate from the Government, they are controlled and significantly funded by it.

¹¹²Nath and Shiraly, *Trends in the SDL markets in India*.

¹¹³Bose, Jain, and Lakshmanan, "Determinants of Primary Yield Spread of States in India: An Econometric Analysis".

¹¹⁴Reserve Bank of India Harun R Khan. *Public Debt Management: Reflections on Strategy & Structure*. 2014.

¹¹⁵Charan Singh. "A Separate Debt Management Office". In: (Sept. 2013).

To finance program implementation, these entities raise funds through borrowings, with the Government providing guarantees. The Government also commits to servicing the borrowings made by these entities. However, these borrowings are not directly reflected in the accounts of the Government ministries or in financial documents required by the FRBM, namely, the Demand for Grants, Annual Financial Statement, Government Finance Accounts, and disclosure statements as required by the FRBM. This method of funding is termed as Extra Budgetary Resources (EBRs), and it exists outside the official government accounts.

Importantly, the expenditure facilitated through EBR is not factored into the calculation of fiscal indicators for the relevant year. The existing accounting framework and disclosure requirements do not fully reveal the details of such funding in the government accounts. The practice of resorting to OBB can be particularly risky during times of strained fiscal resources and volatile economic conditions.

Data on OBB is scarce and, for some States, even unavailable. As of 31 March 2021, the outstanding off-budget liabilities of all States combined were INR 2,52,308 crore. Telangana had the highest outstanding off-budget liability, followed by Andhra Pradesh, Karnataka, Kerala, and Tamil Nadu.¹¹⁶

It has been observed that some State FRLs and rules incorporate various measures, such as explicitly including OBBs in the definition of government debt or liabilities. These rules mandate the consideration of OBBs when calculating fiscal and revenue deficits. Additionally, they require the reporting of off-budget borrowings as part of the Fiscal Policy Strategy Statement or Medium Term Fiscal Policy Statement, both of which are presented in the legislature alongside the budget. Presently, the FRLs in only nine States incorporate OBBs in both their debt/liabilities definition and one of their fiscal statements.¹¹⁷ The numerical rigidity inherent in these FRLs is somewhat mitigated by soft compliance measures, allowing for a degree of flexibility.

In March 2022, the Union decided to treat States' OBBs in 2020-21 and 2021-22 as States' own borrowings, adjusting them against their Net Borrowing Ceiling (NBC) in 2022-23.¹¹⁸

Responding to concerns raised by the States, the Union, in June 2022, opted to incorporate OBBs into NBCs only from the FY 2021-22. This adjustment is set to take place over the period spanning from 2022-23 to 2025-26. Although this move alleviates States' retrospective EBR debt burden, they will likely experience reduced borrowing space when these borrowings are brought on their balance sheets.

The Union's request for States to furnish OBB details directly to the Union, without transparent public disclosure, raises concerns about fiscal accountability and transparency. Legislatures, markets, citizens, and researchers are left uninformed about these financial activities. Each of these entities holds a legitimate and crucial role in the analysis and regulation of subnational public debt. The lack of transparency poses challenges to effective oversight and informed decision-making in the management of fiscal matters at the State level. To achieve a comprehensive regulatory framework for OBB, both ele-

¹¹⁶Shruti Gupta and Kevin James. "An Analysis of Off-Budget Borrowings by Indian Governments in their Legal Context". In: (June 2023).

¹¹⁷Ibid.

¹¹⁸Ibid.

ments should be incorporated: requiring off-budget numbers to be added to major fiscal indicators and mandating separate disclosure.

8 Suggested Reforms

Through the above analysis, it can be seen that there exist significant impediments to the proper functioning of State bond markets in India. Some proposed reforms for improving the functioning of State debt bond markets are as follows:

8.1 SDL Market Development

While the Central Government, along with the RBI has taken a number of steps towards reforming the market for Government SDL markets, this still remains a work in progress. The following steps can be implemented to further develop a more liquid, and well-functioning market for SDLs.

- Development of derivatives markets with adequate safeguards:

Interest-rate derivatives for fixed income securities can help investors hedge interest rate risk, especially for longer-duration securities, and incentivise market participation. An active market for SDLs can therefore have the effect of making such securities more attractive from the ‘risk-reward’ perspective, and aid liquidity.

The RBI has taken steps towards this goal. In December 2023, it released its draft directions for developing a forwards market for both Central and State Government bonds.¹¹⁹ Building on these efforts, the RBI can look towards developing an active *futures* market for Government securities, wherein standardised contracts are traded on exchanges (instead of the customised nature of Over the Counter, or OTC forwards contracts). Futures markets can help a wide variety of market participants to easily hedge against risk compared to the more customised nature of forwards contracts.

In December 2023, the RBI released guidelines for Government Securities Lending (or GSL), which will allow collateralised borrowing/lending market of Government securities between market participants.¹²⁰ CGSs excluding T-Bills shall be eligible for lending/borrowing under a GSL transaction. Further, CGS (including T-Bills) and the State Governments shall be eligible for placing as collateral under a GSL transaction.

These directions will help in deepening the bond market and will encourage greater demand for SDLs as well.

- Asset Securitisation of select SDLs:

Asset securitisation refers to the process of bundling together securities to create a reference portfolio, against which claims called Asset-Backed Securities (ABS) created by an intermediary (such as a bank or other financial institution) are issued.

¹¹⁹ *Press Release: RBI releases Draft Directions on Bond Forwards under Section 45W of the RBI Act, 1934*. Dec. 2023.

¹²⁰ *Reserve Bank of India (Government Securities Lending) Directions, 2023*.

This is usually done to mitigate the liquidity and credit risk associated with less liquid and otherwise risky borrowers.

Asset securitisation could be of particular help for States who face structural and institutional impediments to their fiscal health, such as the North-Eastern States. By working with a designated financial institution, securitisation can help States raise funds more cheaply than what would otherwise be possible by the strength of their public finances. By pooling together illiquid SDLs, States can raise funds by selling the package to a financial intermediary, which in turn would convert them securities that are tradable, and benefit from the added ‘underwriting’ of their otherwise illiquid bonds.

- Further improving secondary market data infrastructure:

Currently, historical data available on the NDS-OM (Negotiated Dealing System - Order Matching system) platform contains tick data for SDLs, G-Secs, T-Bills. To get a better idea of liquidity in the SDL market, the NDS-OM historical database can be revamped to provide access to the entire order-book of trades, i.e. bid-ask spreads, along with open, high, low, close price/yield values for each security traded.

These data points are already in the public domain, via the live NDS-OM dashboard which is updated every few seconds. However, historical records (which facilitate more rigorous analysis) are not available for these variables. Additionally, given the large size of this data, API access could also be provided for easier access to market participants and researchers alike. The current limitation of 365 days of data downloaded can be removed.

8.2 Establishing a Credit Rating System

The XV FC report while setting out the views of the RBI pointed out that SDLs have not been able to attract investors, specifically foreign portfolio investors.¹²¹ The reason cited for this is the lack of financial information on the States.¹²² It was observed that States are neither rewarded nor penalised for their debt performance.¹²³ This concern was also echoed by States with better fiscal parameters.¹²⁴

To address this issue, RBI has taken various measures. These include setting the initial margin requirement for rated SDLs 1% lower than unrated SDLs for the same maturity bucket. This was done with a view to incentivise State Governments to get SDLs rated publicly.¹²⁵

¹²¹Paragraph 12.24, *Fifteenth Finance Commission Report*.

¹²²The FRBM Review Committee Report published in January 2017 noted that despite the SDL borrowing rates being market determined, the risk asymmetries across States were not being reflected in the cost of borrowings.

¹²³Paragraph 6.35, *Economic Survey 2016-17*. 2017.

¹²⁴Kanungo, *State Government Market Borrowings – Issues and Prospects*, page 21.

¹²⁵Other measures taken by RBI include, conducting weekly auctions of SDLs, publishing of high frequency data in the RBI Monthly Bulletin relating to the buffers that State Governments maintain with RBI, the financial accommodation availed under various facilities by each State Government from the RBI, the market borrowings, and the outstanding SDLs, lowering the interest rate on borrowing against the collateral of Consolidated Sinking Fund (CSF) and Guarantee Redemption Fund (GRF). CSF is used to meet the payment obligations of the State and the GRF is utilised to meet the guarantee obligations undertaken by the State for the benefit of PSUs, Special Purpose Vehicles (SPVs), and other

Credit-rating has largely been seen as an effective ex-ante regulation to ensure transparency and fiscal responsibility.¹²⁶ The reputation and creditworthiness of the borrower plays an important role when borrowing from the markets. Specifically in developing countries, metrics such as intergovernmental transfer scheme, default history, and pledged securities are scrutinised by the creditors. Here, credit-rating agencies play an important role by providing risk-related information to investors.¹²⁷ Other emerging economies have also taken steps to establish a credit-rating mechanism. For example, Colombia and Mexico mandate subnational governments to subscribe to a credit rating system, while in Argentina ratings are voluntary.¹²⁸

It may be noted that when it comes to subnational credit rating, the fiscal health of the sovereign and the financial relationship between the Central and the subnational governments are important parameters considered by credit-rating agencies. A weak institutional framework and poorly constituted fiscal arrangements usually translate to a poor subnational rating.¹²⁹ Additionally, implicit and contingent liabilities are integral to the rating process adopted by most credit-rating agencies.¹³⁰ Indian States often do not account for indirect debt such as OBBs while calculating their fiscal targets. For example, many States do not account for guarantees provided by the State against the borrowings raised by PSUs and SPVs in its assessment of liabilities under their respective FRLs.¹³¹ This disparity in assessment of liabilities will require States to closely monitor its OBBs and other indirect debts. Lastly, there must be a greater awareness that subnational credit-rating is only a part of broader reform requirements, such as developing a transparent budgetary and financial system, improving policy frameworks, establishing standardised accounting, auditing and reporting, and improving the intergovernmental fiscal system.

8.3 Safeguards for Fiscally Constrained States

Another important aspect to look at when it comes to the liability profile of the States is their capacity to repay that debt. As the SDL market sees progressive growth through reforms, some States whose revenue generation capacity is weak and are heavily indebted will suffer. They will have to pay higher interest cost as markets would penalise such States. There is a need to identify such States and institute some safeguards to enable them to borrow without an undue impact on their fiscal situation.

Figure 8 plots State's own-tax revenue as a percent to total revenue receipts, along with total outstanding liabilities as a percent to GSDP for FY 2022-23. The horizontal line

bodies. These funds provide comfort to investors against any possible risk of default. See, Kanungo, *State Government Market Borrowings – Issues and Prospects*; Reserve Bank of India. *Review of margin requirements under the Liquidity Adjustment Facility and Marginal Standing Facility*. 2018.

¹²⁶Paragraph 3.1, Violeta Vulovic Jorge Martinez-Vazquez. *How Well Do Subnational Borrowing Regulations Work?* Mar. 2016.

¹²⁷Chapter 5, Vidhi Centre for Legal Policy. *Examining the Legal Basis for the Conditions that the Government of India may Impose on States while Providing Consent under Article 293(3) of the Constitution*, pp. 32-33.

¹²⁸Paragraph 11.8.1, International Monetary Fund. *Developing Government Bond Markets A Handbook*. World Bank, 2001.

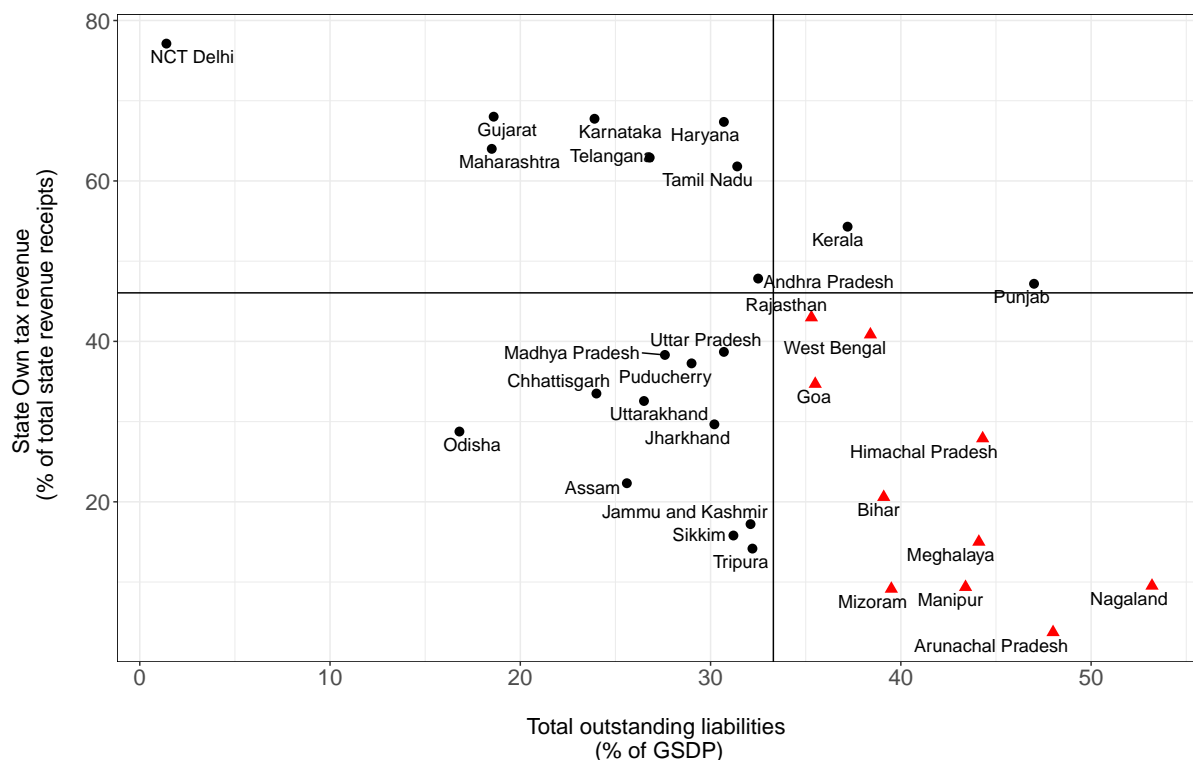
¹²⁹Section 7, Kim Song Tan Lili Liu. "Subnational Credit Ratings: A Comparative Review". In: (Aug. 2009).

¹³⁰Section 7, *ibid*.

¹³¹See, Annex (Section 9).

represents all India total for State's own-tax revenue percent to total revenue receipts, while the vertical line represents the XV FC target of 33.3 percent for the States with respect to the total outstanding liabilities as a percent to GSDP.¹³²

Figure 8: State own revenue generation capacity and debt levels
FY 2022–23



Source: RBI

The States marked in red triangles represent States that have high debt and low revenue generation capacity. Most of the North Eastern States, barring Assam, Tripura and Sikkim, are highly indebted with very low revenue generation capacity. Apart from these other States that fall into this category includes Rajasthan, West Bengal, Goa, Himachal Pradesh and Bihar.

As the SDL market develops further, and with increase in investor participation, a need to safeguard the fiscally constrained States arises. As the SDL market starts functioning efficiently, States that are fiscally indisciplined would get squeezed out or they might have to borrow at higher costs than fiscally disciplined States.

There is a need to give such States some kind of policy support in the form of non-market borrowings to finance some part of their borrowings.

8.4 Independent State Public Debt Management Cells

In line with the recommendation of XV FC, State Governments may consider establishing independent Public Debt Management Cells (PDMCs), with the purpose of charting

¹³²Due to lack of data, we do not cover Andaman & Nicobar Islands, Dadra & Nagar Haveli and Daman & Diu, Ladakh, Lakshadweep, and Chandigarh, for the purpose of this analysis.

their borrowing programme efficiently.¹³³ Presently, a PDMC exists at the Central level under the Department of Economic Affairs as an interim arrangement, with the intent to eventually establish a permanent public debt management agency. Some of the advisory functions assigned to this interim PDMC include:¹³⁴

- Plan borrowings of the Government, including market borrowings and other domestic borrowings.
- Manage Central Government's liabilities including contingent liabilities.
- Monitor cash balances of the Government, improve cash forecasting and promote efficient cash management practices.
- Develop interfaces with various stakeholders/ agencies in the regulatory/ financial architecture etc. to carry out assigned functions efficiently.
- Advice on matters related to investment and capital market operations.
- Undertake research work related to new products development, market development, risk management, debt sustainability assessment, other debt management functions, etc.

State Governments can form similar PDMCs at the State level for building efficiency and innovation in borrowings by State.

¹³³Paragraph 12.19, *Fifteenth Finance Commission Report*.

¹³⁴Department of Economic Affairs, Ministry of Finance (India). *Public Debt Management Cell*.

9 Annexure 1: State Fiscal Responsibility Legislations

9.1 Andhra Pradesh

The Andhra Pradesh FRBM Act, 2005 was enacted on 3 June 2005.¹³⁵ The Act was amended in 2010, 2011, 2020, and 2021. Under the Act, the State Government is mandated to present to the legislative assembly the macroeconomic framework statement, the medium term fiscal policy statement, and the fiscal policy strategy statement alongside the annual Budget.¹³⁶

It may be noted that under the Act, total liabilities have been defined such that they include borrowings of PSUs and SPVs and other equivalent instruments including guarantees where the principal and/ or interest are to be serviced out of the State budgets.¹³⁷

The Act, under Section 9, specifies fiscal targets to be achieved by the State.¹³⁸ The 2021 amendment to the Act specified the path to be followed by the State to reduce the revenue deficit for the period from FY 2021-22 to FY 2025-26.¹³⁹ This path has been set out in Table 9.

Table 9: Revenue deficit to GSDP for Andhra Pradesh

Year	Revenue Deficit to GSDP (in %)
2021-22	3.6
2022-23	3.3
2023-24	3.0
2024-25	2.7
2025-26	2.4

Source: Andhra Pradesh Fiscal Responsibility and Budget Management (Amendment) Act, 2021

Further, the amendment specified the path to reduce fiscal deficit for the period from FY 2021-22 to FY 2025-26.¹⁴⁰ This path has been set out in Table 10.

Table 10: Fiscal deficit to GSDP for Andhra Pradesh

Year	Fiscal Deficit to GSDP (in %)
2021-22	5.0
2022-23	4.5
2023-24	4.0
2024-25	4.0
2025-26	3.5

Source: Andhra Pradesh Fiscal Responsibility and Budget Management (Amendment) Act, 2021

The above limits include the additional borrowing of 0.5% of GSDP allowed based on the performance of the State in the power sector as per the criteria set by the Department of Expenditure *vide* letter F.No.40(02)/PF-S/2020-21.

¹³⁵ *Andhra Pradesh Fiscal Responsibility and Budget Management Act, 2005.*

¹³⁶ Section 5, *ibid.*

¹³⁷ Section 2(l) *ibid.*

¹³⁸ Section 9, *ibid.*

¹³⁹ Section 2(i), *Andhra Pradesh Fiscal Responsibility and Budget Management (Amendment) Act, 2021.*

¹⁴⁰ Section 2(ii), *ibid.*

Further, the path for reduction of outstanding total liabilities excluding government guarantees for the period from FY 2021-22 to FY 2025-26 has been set out in Table ??.

Table 11: Outstanding total liabilities to GSDP for Andhra Pradesh

Year	Total outstanding liabilities to GSDP (in %)
2021-22	35.6
2022-23	36.3
2023-24	36.1
2024-25	35.8
2025-26	35.5

Source: Andhra Pradesh Fiscal Responsibility and Budget Management (Amendment) Act, 2021

As per the proviso under Section 9 of the Act, the State may exceed the revenue and fiscal deficit limits specified in the Act in the event of unforeseen demands on the finances of the State Government arising out of internal disturbances, natural calamity, or other exceptional grounds as specified by the State.¹⁴¹ A statement must be placed before the State Legislature regarding the grounds, as soon as possible after the deficit amount exceeds the specified targets.¹⁴²

9.2 Bihar

The Bihar FRBM Act was enacted on 5 April 2006 and was amended in 2010, 2016, 2020, 2021, and 2022. The State in each financial year is mandated to present to the legislative assembly, the macroeconomic framework statement, the medium term fiscal policy statement, and the fiscal policy strategy statement along with the Budget.¹⁴³

It may be noted that under the Act, total liabilities have been defined such that they include borrowings of PSUs and SPVs and other equivalent instruments including guarantees where the principal and/or interest are to be serviced out of the State budgets.¹⁴⁴

The Act provides the fiscal targets to be achieved by the State. Debt was added as a fiscal indicator through Bihar FRBM (Amendment) Act, 2010.¹⁴⁵ It was defined as the amount taken by the State Government on credit with interest. The amendment also provided for the path to be followed by the State to lower its debt obligation. The path set out the yearly debt limits to be adhered to by the State from the period FY 2010-11 to FY 2014-15. However, these limits have not been revised since.

The 2021 amendment specified the fiscal deficit and annual borrowing limits for FY 2021-22.¹⁴⁶ As per the Act, for the FY 2021-22, the fiscal deficit and the annual borrowing limit was 4% of the GSDP, wherein the borrowing limit was subject to the conditions set out by the Central Government.¹⁴⁷ The State was also provided with an additional

¹⁴¹First proviso to Section 9(2), *Andhra Pradesh Fiscal Responsibility and Budget Management Act, 2005*.

¹⁴²Second proviso to Section 9(2), *ibid*.

¹⁴³Section 5, *Bihar Fiscal Responsibility and Budget Management Act, 2006*.

¹⁴⁴Section 2(1), *ibid*.

¹⁴⁵Section 5, *Bihar Fiscal Responsibility and Budget Management Act, 2006*.

¹⁴⁶Section 9(2)(b)(5), *Bihar Fiscal Responsibility and Budget Management Act, 2006*.

¹⁴⁷Section 9(2)(b)(5), *ibid*.

0.5% (of the GSDP) borrowing capacity subject to the conditions set forth by the Central Government.¹⁴⁸

The 2022 amendment of the Act set out the fiscal deficit targets and annual borrowing limits accorded to the State for the period from FY 2022-23 to FY 2025-26. The path set out for the reduction of fiscal deficit is specified in Table 12.

Table 12: Net borrowing limit for Bihar

Year	Fiscal deficit to GSDP (in %)
2022-23	3.5
2023-24	3.0
2024-25	3.0
2025-26	3.0

Source: Bihar FRBM (Amendment) Act, 2022

For the period from FY 2022-23 to FY 2024-25, it was stipulated that the annual borrowing limit shall be increased by 0.5% subject to the conditions set forth by the Central Government.¹⁴⁹ It was also stated that if the State is not able to fully utilise its sanctioned borrowing limit in any particular year from the period 2021-22 to 2024-25, it may have the option of availing this borrowing amount in any of the subsequent years within the XV FC award period.¹⁵⁰

Additionally, the State was required to reduce its revenue deficit to GSDP ratio by 0.1% (depending on the economic situation) every year beginning from FY 2006-07, eliminating it by FY 2008-09. A revenue surplus was to be generated thereafter.¹⁵¹ However, no further amendments have been made to this provision.

The State may exceed the limits specified in Section 9 for fiscal deficit and revenue deficit in the event of any unforeseen circumstances arising out of internal disturbance, or natural calamity, or any other exceptional grounds as specified by the State Government.¹⁵² A statement must be placed before the State Legislature regarding the grounds, as soon as possible after the deficit amount exceeds the specified targets.¹⁵³

9.3 Gujarat

The Gujarat Fiscal Responsibility Act, 2005 was enacted on 21 March 2005. It was amended in 2009, 2011, and 2021. Under the Act, the State Government is responsible to lay, in front of the legislative assembly, the medium term fiscal policy statement and the fiscal policy strategy statement along with the annual Budget.¹⁵⁴

The 2011 amendment set out the following fiscal management targets:¹⁵⁵

¹⁴⁸Section 9(2)(b)(5), *Bihar Fiscal Responsibility and Budget Management Act, 2006*.

¹⁴⁹Section 2(b)(6)(III), *ibid*.

¹⁵⁰Section 2(b)(6)(IV), *ibid*.

¹⁵¹Section 9(2)(a), *ibid*.

¹⁵²First proviso to Section 9(2), *ibid*.

¹⁵³Second proviso to Section 9(2), *ibid*.

¹⁵⁴Section 3(1), *Gujarat Fiscal Responsibility Act, 2005*.

¹⁵⁵*Gujarat Fiscal Responsibility (Amendment) Act, 2011*.

- Reduce the revenue deficit to zero by FY 2011-12 and maintain at this level or generate revenue surplus thereafter.
- Reduce fiscal deficit to 3% of estimated GSDP of the year from FY 2011-12 and maintain at that level thereafter.
- Cap total public debt of the State Government to 27.1% of the estimated GSDP of the year, for each year from FY 2011-12 till 2014-15.

The XIV FC recommended that the targeted limit of fiscal deficit to GSDP of 3% could be increased to 3.5% on meeting certain criteria. However, as the State Government was well within the limits of 3%, it did not make any amendments after 2011.¹⁵⁶ Note that pursuant to the 2021 amendment, an additional fiscal deficit of 2% over and above 3% of GSDP (i.e. upto 5%) was made permissible only for the FY 2020-21.¹⁵⁷

The revenue and fiscal deficit limits may be exceeded due to internal disturbance, natural calamity or any other exceptional ground as the State Government may specify.¹⁵⁸ A statement must be placed before the State Legislature regarding the grounds for unforeseen demands on the State Government's finances, as soon as may be after the deficit amount exceeds the specified targets.¹⁵⁹

9.4 Haryana

The Haryana FRBM Act was enacted on 6 July 2005, and was thereafter amended in 2006, 2009, 2010, 2011, 2020, and 2022. The State Government must present, to the legislative assembly, the macroeconomic framework statement, medium term fiscal policy statement, and fiscal policy strategy statement along with the budget in each financial year.¹⁶⁰

Under the Act, "total liabilities" extend to borrowings by PSUs and SPVs and other equivalent instruments including guarantees where the principal and/or interest are to be serviced out of the State budgets.¹⁶¹

Under the Haryana FRBM (Amendment) Act, 2022, the three fiscal indicators, namely – fiscal deficit as percent to GSDP, revenue deficit as percent to GSDP, and outstanding debt as percent to GSDP – in that particular year have to be as per the recommendations of the Central FC and as allowed by the GoI.¹⁶²

Further, the revenue or fiscal deficit limits may be exceeded in cases of internal disturbance, natural calamity, national security, or such other exceptional ground as the State Government may specify.¹⁶³ A statement must be placed before the State Legislature regarding the grounds for unforeseen demands on the State Government's finances, as

¹⁵⁶ *State Finances Audit Report of the CAG of India for the year ended 31 March 2022: Government of Gujarat*. 2023.

¹⁵⁷ *Gujarat Fiscal Responsibility (Amendment) Act, 2021*.

¹⁵⁸ Section 2, *Gujarat Fiscal Responsibility (Amendment) Act, 2011*, Added as first proviso to Section 5 of the Gujarat Fiscal Responsibility Act, 2005.

¹⁵⁹ Section 2, *ibid.*, Added as second proviso to Section 5 of the Gujarat Fiscal Responsibility Act, 2005.

¹⁶⁰ Section 5, *Haryana Fiscal Responsibility and Budget Management Act, 2005*.

¹⁶¹ Section 2(n), *ibid.*

¹⁶² Section 2, *Haryana Fiscal Responsibility and Budget Management (Amendment) Act, 2022*.

¹⁶³ Section 9(2), *Haryana Fiscal Responsibility and Budget Management Act, 2005*.

soon as may be after the deficit amount exceeds the specified targets.¹⁶⁴

9.5 Karnataka

The Karnataka Fiscal Responsibility Act, 2002 came into force on 1 April 2003, and has since been amended in 2009, 2011, 2014, 2020, 2021, and 2022. The State Government is mandated to present only a medium term fiscal plan along with the Budget, before the State Legislature in each financial year.

Under the Act, interest payment by Government towards borrowings by PSUs and SPVs and other equivalent instruments where liability for repayment is on Government, must be treated as revenue expenditure for calculating revenue deficit.¹⁶⁵

The following fiscal targets have been set out under the Act:¹⁶⁶

- The State Government had to reduce fiscal deficit to not more than 3% of the estimated GSDP within four financial years ending on 31 March 2006. However, by a 2022 amendment, the fiscal deficit for 2022-23 has to be capped at 3.5% of estimated GSDP.¹⁶⁷
- Revenue deficit was to be eliminated within four financial years ending on 31 March 2006. However, a new proviso has been added to provide that State revenue deficit would arise due to slow recovery of the economy from the COVID-19 and Omicron impact in 2022-23.¹⁶⁸
- Total liabilities were to be brought within 25% of the estimated GSDP within thirteen years ending on 31 March 2015.¹⁶⁹ For 2022-23, total liabilities would exceed 25% of the estimated GDP.¹⁷⁰
- The guarantees can be given for any amount exceeding the limit stipulated under the Karnataka Ceiling to Government Guarantees Act, 1999.¹⁷¹

The State Government may also notify a Fiscal Management Review Committee headed by the Chief Secretary to the Government, which will meet twice a year to review fiscal and debt position of the State, its progress on fiscal correction and advice corrective measures. The outcome of the review of any remedial measures proposed by the Committee will be placed by the Minister in charge of finance before the State Legislature.¹⁷²

The revenue deficit and fiscal deficit may exceed the limits on grounds of national security or natural calamity, subject to the condition that the excess beyond limits arising due to natural calamities does not exceed the actual fiscal cost that can be attributed to the calamities.¹⁷³ A statement must be placed before the State Legislature regarding the

¹⁶⁴Second Proviso to Section 9(2), *Haryana Fiscal Responsibility and Budget Management Act, 2005*.

¹⁶⁵Section 2(f), *Karnataka Fiscal Responsibility Act, 2002*.

¹⁶⁶Section 4(3), *ibid*.

¹⁶⁷Section 2, *Karnataka Fiscal Responsibility (Amendment) Act, 2022*.

¹⁶⁸Section 2, *ibid*.

¹⁶⁹Section 4(3)(f), *Karnataka Fiscal Responsibility Act, 2002*.

¹⁷⁰Section 2, *Karnataka Fiscal Responsibility (Amendment) Act, 2022*.

¹⁷¹Section 4(3)(e), *Karnataka Fiscal Responsibility Act, 2002*.

¹⁷²Section 6(2), *ibid*.

¹⁷³First proviso to Section 4(3), *ibid*.

grounds, as soon as possible after the deficit amount exceeds the specified targets.¹⁷⁴

9.6 Kerala

The Kerala Fiscal Responsibility Act, 2003 was enacted on 26 August 2003 and further amended in 2011, 2018, 2021, and 2022. It mandates the State Government to present a medium term fiscal policy statement and a fiscal policy strategy statement along with the annual Budget to the legislative assembly in every financial year.¹⁷⁵

Section 4(2) of the Act sets out the fiscal targets to be achieved by the State. The 2022 amendment set the following latest targets:¹⁷⁶

- Revenue deficit to be eliminated completely during the period from FY 2021-22 to FY 2025-26.
- Revenue surplus to be maintained as set out in Table 13.

Table 13: Revenue surplus to GSDP for Kerala

Year	Revenue surplus to GSDP (in %)
2021-22	0.5
2022-23	0.8
2023-24	1.2
2024-25	1.7
2025-26	2.5

Source: Kerala Fiscal Responsibility (Amendment) Act, 2022

- The targeted loan amount falling within the limit of fiscal deficit to be spent on asset development.
- Fiscal deficit to be reduced to 3% of GSDP within a period from FY 2021-22 to FY 2025-26 as set out in Table 14.

Table 14: Fiscal deficit to GSDP for Kerala

Year	Fiscal deficit to GSDP (in %)
2021-22	4.5
2022-23	4.0
2023-24	3.5
2024-25	3.5
2025-26	3

Source: Kerala Fiscal Responsibility (Amendment) Act, 2022

In addition to the targets set out above, the Act also allows for the State to avail additional borrowing space conditional on the performance of the State with respect to power sector and capital expenditure.¹⁷⁷

- The upper limit of fiscal deficit is inclusive of 0.5% capital expenditure-linked borrowing space and the State shall be eligible for an additional borrowing space of

¹⁷⁴Sixth proviso to Section 4(3), *Karnataka Fiscal Responsibility Act, 2002*.

¹⁷⁵Section 3(1), *The Kerala Fiscal Responsibility Act, 2003*.

¹⁷⁶Section 2, *Kerala Fiscal Responsibility (Amendment) Act, 2022*.

¹⁷⁷Section 2, *ibid*.

0.5% of GSDP linked to its performance in power sector during FY 2021-22 to FY 2024-25.

- The State is eligible for capital expenditure-linked borrowing if the targeted capital expenditure fixed for the State is achieved. In case of power sector performance-linked borrowing, all the entry level conditions and performance evaluation criteria stipulated for each year need to be fulfilled.
- If the State is not able to utilise its borrowing limit (excluding power sector borrowings) completely in any particular year during the first four years of FC award period (FY 2021-22 to FY 2024-25), the State shall have the option of availing the unutilised borrowing amount in any subsequent years within the award period.

The amendment further specified the yearly targets to reduce total debt liabilities as set out in Table 15.¹⁷⁸

Table 15: Total debt liabilities to GSDP for Kerala

Year	Total debt liabilities to GSDP in %
2021-22	34.7
2022-23	34.5
2023-24	33.7
2024-25	32.8
2025-26	32

Source: Kerala Fiscal Responsibility (Amendment) Act, 2022

9.7 Madhya Pradesh

The Madhya Pradesh Rajkoshiya Uttardayitva Avam Budget Prabandhan Adhiniyam, 2005 enacted on 26 August 2005 and was amended in 2012, 2015, 2017, 2020, 2021, and 2022. Under the Act, the State Government is mandated to present, before the legislative assembly, the fiscal policy strategy statement, medium-term fiscal policy statement, and macro-economic framework statement along with the Budget in every fiscal year.¹⁷⁹

The Act defines “total liabilities” to include the guarantee obligations of the State Government wherein the principal and/or interest is serviced out of the State budget.¹⁸⁰

The Act sets out the fiscal targets to be achieved by the State.¹⁸¹ With respect to revenue deficit, the Act states that it must be reduced in a manner such that revenue deficit is eliminated by 31 March 2009.¹⁸² No amendments have been made to this provision.

Under the Act, the State had to, as on 31 March 2015, ensure that the total liabilities did not exceed 40% of the estimated GSDP.¹⁸³ However, this provision was amended in 2012 to set out a path for the reduction of total outstanding debt from the period FY 2011-12 to FY 2014-15. No further amendments have been made to this provision.

¹⁷⁸Section 2, *Kerala Fiscal Responsibility (Amendment) Act, 2022*.

¹⁷⁹Section 5, *Madhya Pradesh Rajkoshiya Uttardayitva Avam Budget Prabandhan Adhiniyam, 2005*.

¹⁸⁰Section 2(j), *ibid*.

¹⁸¹Section 9(2), *ibid*.

¹⁸²Section 9(2)(a), *ibid*.

¹⁸³Section 9(2)(c), *ibid*.

In 2021 amendment of the Act set out the modified fiscal deficit limits to be adhered to by the State.¹⁸⁴ This fiscal deficit glide path has been specified in Table 16

Table 16: Fiscal deficit to GSDP for MP

Year	Fiscal Deficit to GSDP (in %)
2021-22	4.0
2022-23	3.5
2023-24	3.0
2024-25	3.0
2025-26	3.0

Source: Madhya Pradesh Finance Act, 2021

It was further specified that for FY 2021-22 to FY 2024-25, the fiscal deficit limit may be increased by 0.5% of the GSDP subject to the performance of the State in the power sector.

In 2022, the Act was amended to specify that the State Government may receive loans, as may be determined by the Central Government, during FY 2021-22 to FY 2025-26. These loans shall not be considered against any limit or target specified under Section 9(2).¹⁸⁵

The State may exceed the revenue deficit and fiscal deficit limits specified under the Act in the event of shortfall in the central tax devolutions in relation to the budgetary estimates of the Union of India and/or unforeseen demands on the finances of the State Government arising out of internal disturbance, or natural calamity, or such other exceptional grounds as the State Government may specify.¹⁸⁶ A statement must be placed before the State Legislature regarding the grounds, as soon as possible after the deficit amount exceeds the specified targets.¹⁸⁷

9.8 Maharashtra

Maharashtra FRBM Act, 2005 was enacted on 20 April 2005. It mandates that the State Government must present a medium term fiscal policy statement and the fiscal policy strategy statement along with the annual financial statement of demand and grants in the Budget session every financial year.¹⁸⁸

The State Government has identified 5 fiscal indicators, namely (i) fiscal deficit; (ii) revenue deficit; (iii) debt stock; (iv) contingent liabilities; and (v) interest as a percentage of revenue receipts.¹⁸⁹ The latest targets for the fiscal indicators are prescribed through the Rules.¹⁹⁰

¹⁸⁴Section 9(2)(b), *Madhya Pradesh Rajkoshiya Uttardayitva Avam Budget Prabandhan Adhiniyam, 2005*.

¹⁸⁵Section 9(6), *ibid*.

¹⁸⁶First proviso to Section 9(2), *ibid*.

¹⁸⁷Second proviso to Section 9(2), *ibid*.

¹⁸⁸Section 3(1), *Maharashtra Fiscal Responsibility and Budget Management Act, 2005*.

¹⁸⁹Rule 5, *Maharashtra Fiscal Responsibility and Budget Management Rules, 2006*.

¹⁹⁰Section 7(2)(d), *Maharashtra Fiscal Responsibility and Budget Management Act, 2005*, read with Rule 2, *Maharashtra Fiscal Responsibility and Budget Management (Second Amendment) Rules, 2011*.

- Maintain revenue surplus in 2011-12 and thereafter. Subsequently, following a series of amendments, the condition was relaxed till FY 2021-22.¹⁹¹ While calculating revenue deficit, the revenue expenditure will include the interest payable on OBBs.¹⁹²
- Fiscal deficit shall not exceed 3% of GSDP in 2010-11 and thereafter. Further, the fiscal deficit for FY 2021-22 were to not exceed 4% of the GSDP.¹⁹³ While calculating fiscal deficit, the OBBs during the year which need to be serviced by way of interest and principal repayment by State Government will be taken into account.¹⁹⁴
- Maintain outstanding debt to GSDP at the limits mentioned in Table 17. This target has not been revised since the second amendment to the Rules in 2011.

Table 17: Outstanding debt to GSDP for Maharashtra

Year	Outstanding Debt to GSDP (in %)
2010-11	26.3
2011-12	26.1
2012-13	25.8
2013-14	25.5
2014-15	25.3

Source: Maharashtra Fiscal Responsibility and Budgetary Management (Second Amendment) Rules, 2011

An amendment to the Rules in 2011 introduced the Monitoring Committee headed by the Chief Secretary to monitor achievement of annual targets.¹⁹⁵

The revenue and fiscal deficit limits may be exceeded due to natural calamity or any other exceptional grounds as the State Government may specify.¹⁹⁶ The rules extend these grounds to include civil disturbances, war, accidents of large magnitude and the like.¹⁹⁷ A statement must be placed before the State Legislature regarding the grounds, as soon as possible after the deficit amount exceeds the specified targets.¹⁹⁸

9.9 Punjab

Since its enactment, the Punjab FRBM Act was enacted on 1 May 2003 and has been amended in 2005, 2007, 2011, 2021, and 2023. The Act provides for the responsibility of the State Government to ensure inter-generational equity in fiscal management and long-term financial stability. For this purpose, it will achieve sufficient revenue surplus, contain fiscal deficits and manage debt consistent with financial stability by conducting fiscal policy in a medium term framework.¹⁹⁹

¹⁹¹Rule 2, *Maharashtra Fiscal Responsibility and Budget Management (First Amendment) Rules, 2022*.

¹⁹²Explanation(ii) to Rule 5, *Maharashtra Fiscal Responsibility and Budget Management Rules, 2006*.

¹⁹³Rule 2, *Maharashtra Fiscal Responsibility and Budget Management (First Amendment) Rules, 2022*.

¹⁹⁴Explanation(ii) to Rule 5, *Maharashtra Fiscal Responsibility and Budget Management Rules, 2006*.

¹⁹⁵Rule 3, *Maharashtra Fiscal Responsibility and Budget Management (Second Amendment) Rules, 2011*.

¹⁹⁶First proviso to Section 5(2), *Maharashtra Fiscal Responsibility and Budget Management Act, 2005*.

¹⁹⁷Rule 4, *Maharashtra Fiscal Responsibility and Budget Management Rules, 2006*.

¹⁹⁸Second proviso to Section 5(2), *Maharashtra Fiscal Responsibility and Budget Management Act, 2005*.

¹⁹⁹*Punjab Fiscal Responsibility and Budget Management Act, 2003*.

The Act mandates the State Government to present a medium term fiscal policy statement along the annual budget in every financial year, and to set forth three year rolling targets for prescribed fiscal indicators.

Under the Act, ‘fiscal deficit’ means revenue deficit plus budgetary capital expenditure including net loans advanced, minus other non-debt capital receipts. Importantly, the OBBs (i.e. borrowings by the State Government or its Agencies which are not reflected in the Budget) are to be treated as borrowings by the State Government, and the expenditure incurred on subsidies due to the enterprises in the power sector, whether paid or not, are to be treated as expenditure by the State Government.²⁰⁰

Under the Punjab FRBM (Amendment) Act, 2023, the three fiscal indicators, namely – fiscal deficit as percent of GSDP, revenue deficit as percent of GSDP, and debt as percent of GSDP in– that particular year have to be as per the recommendations of the Central FC and as allowed by the GoI.²⁰¹

Further, the revenue or fiscal deficit limits may be exceeded in cases of internal disturbance, natural calamity, national security or such other exceptional ground as the State Government may specify.²⁰² In such cases, the State Government shall identify the net fiscal cost of the calamity, and this cost would provide ceiling for the extent of non-compliance to the specified limits.²⁰³

9.10 Rajasthan

The Rajasthan FRBM Act, 2005 was enacted on 2 May 2005 and was subsequently amended in 2011, 2016, and 2021.²⁰⁴ The State is mandated to present to the legislative assembly a medium term fiscal policy statement and a fiscal policy strategy statement along with the Budget every financial year.²⁰⁵

The Act, under Section 6, sets out the fiscal targets to be achieved by the State. It mandates that the State must reduce its revenue deficit to zero within a period of four financial years from FY 2011-12 and thereafter maintain it or attain revenue surplus.²⁰⁶

With respect to fiscal deficit, the Act requires the State to achieve fiscal deficit of 3% of the GSDP by FY 2011-12 and thereafter maintain the said ratio or reduce the same.²⁰⁷

Further, the Act restricts the total outstanding debt up to 38.2% of GSDP within a period of six years starting from 1 April 2020 to 31 March 2026. The outstanding debt is to be maintained thereafter or reduced.²⁰⁸

The State is allowed to deviate from the revenue and fiscal deficit limits set under the Act.²⁰⁹

²⁰⁰Section 2(b), *Punjab Fiscal Responsibility and Budget Management Act, 2003*.

²⁰¹Section 2(ii), *Punjab Fiscal Responsibility and Budget Management (Amendment) Act, 2023*.

²⁰²Section 4(5), *Punjab Fiscal Responsibility and Budget Management Act, 2003*.

²⁰³Section 4(6), *ibid.*

²⁰⁴*Rajasthan Fiscal Responsibility and Budget Management Act, 2005*.

²⁰⁵Section 5(2), *ibid.*

²⁰⁶Section 6(a), *ibid.*

²⁰⁷Section 6(b), *ibid.*

²⁰⁸*Ibid.*, Section 6(c),

²⁰⁹First proviso to Section 6, *ibid.*

- Due to ground or grounds of unforeseen demands on the finances of the state Government arising out of national security or natural calamity;
- Due to developmental and other unavoidable expenditure;
- Up to the limits indicated by the Central Government from time to time;
- Due to take-over of loans of the Power Distribution Companies and interest thereon under UDAY;
- Due to additional borrowing limit allowed by the Central Government on account of COVID-19 pandemic; or
- Due to additional borrowing of 0.50% of GSDP for the period FY 2021-22 to FY 2024-25, allowed by the Central Government based on performance criteria in the power sector.

A statement must be placed before the State Legislature regarding the grounds, as soon as possible after the deficit amount exceeds the specified targets.²¹⁰

9.11 Tamil Nadu

Following the recommendations of the XII FC, the Tamil Nadu Government passed and implemented the Tamil Nadu Fiscal Responsibility Act on 17 May 2003. The Act was further amended in 2010, 2011, 2015, 2016, 2020, 2021, and 2023. As per the Act, the State Government must lay before the legislative assembly a medium-term fiscal plan along with the Budget.²¹¹

The Act, under Section 4(2), sets out the fiscal targets to be achieved by the State.²¹² The following are the targets prescribed by the Act following the amendment to the Act introduced in 2023:

- The State shall reduce the ratio of revenue deficit to revenue receipt every year by 3% to 5% depending on the economic situation in that year beginning from FY 2002-2003 and eliminate revenue deficit by FY 2025-2026 and adhere to it thereafter;
- The State shall maintain the ratio of fiscal deficit to GSDP as not more than 3% by 31st March 2025 and adhere to it thereafter; and
- The State is mandated to maintain the ratio of total outstanding debt to GSDP with medium term goal of not being more than 24.5% during FY 2011-2012; 24.8% during FY 2012-2013; 25.0 % during FY 2013-2014; 25.2% during FY 2014-2015 and thereafter maintain such percentage as may be prescribed. It may be noted that the targets with respect to total outstanding debt have not been updated beyond the aforementioned period (FY 2011-12 to FY 2014-15).

The State may exceed the fiscal and revenue deficit targets in the event of unforeseen demands on the finances of the State Government due to national security or natural calamity subject to the condition that the excess beyond limits arising due to natural calamities does not exceed the actual fiscal cost that can be attributed to the calamities.²¹³

²¹⁰Second proviso to Section 6, *Rajasthan Fiscal Responsibility and Budget Management Act, 2005*.

²¹¹Section 3(1), *Tamil Nadu Fiscal Responsibility Act, 2003*.

²¹²Section 4(2), *ibid*.

²¹³First proviso to Section 4(2), *ibid*.

A statement must be placed before the State Legislature regarding the grounds, as soon as possible after the deficit amount exceeds the specified targets.²¹⁴

9.12 Telangana

The Andhra Pradesh FRBM Act, 2005 was in force in the combined State. Thereafter, the Act was adapted to the State of Telangana, as the Telangana FRBM Act, 2005.²¹⁵

The State Government will lay before the State Legislature the macroeconomic framework statement, medium term fiscal policy statement, fiscal policy strategy statement, and the statement on the number of employees in Government, PSUs and aided institutions and expenditure of State Government towards salaries and pensions, along with the Budget.²¹⁶

Under the Act, “total liabilities” include borrowings by PSUs, SPVs, and other equivalent instruments including guarantees where the principal and/or interest are to be serviced out of the State budgets.²¹⁷

The Act specified the following fiscal targets²¹⁸ –

- Reduce revenue deficit to at least 0.32% of GSDP in each financial year from 2005-06 and eliminate by 2008-09 and generate revenue surplus thereafter.
- Reduce fiscal deficit to at least 0.25% of GSDP in each financial year from 2005-06 in order to bring it down to not more than 3% subject to fiscal deficit limits fixed by GoI from time to time. The Amendment Act, 2022 provided that for FY 2021-22 and 2022-23, the fiscal deficit shall be contained within 4% and 5% of GSDP respectively.²¹⁹
- For FY 2010-11 to 2014-15, the total outstanding liabilities do not exceed 27.6% of GSDP as prescribed by GoI in pursuance of the recommendations of the XIII FC.

The State Government may set up an independent agency to review periodically the compliance of the provisions of the Act and table these reviews before the State Legislature.²²⁰

The revenue and fiscal deficit limits may be exceeded due to internal disturbance, natural calamity or any other exceptional ground as the State Government may specify.²²¹ A statement must be placed before the State Legislature regarding the grounds for unforeseen demands on the State Government’s finances, as soon as may be after the deficit amount exceeds the specified targets.²²²

²¹⁴Second proviso to Section 4(2), *ibid.*

²¹⁵*Telangana Fiscal Responsibility and Budget Management Act, 2005.*

²¹⁶Section 5, *ibid.*

²¹⁷Section 2(1), *ibid.*

²¹⁸Section 9, *ibid.*

²¹⁹*Telangana Fiscal Responsibility and Budget Management (Amendment) Act, 2022.*

²²⁰Section 11(5), *Telangana Fiscal Responsibility and Budget Management Act, 2005.*

²²¹First proviso to Section 9(1), *ibid.*

²²²Second proviso to Section 9, *ibid.*

9.13 Uttar Pradesh

The State enacted the Uttar Pradesh FRBM Act was enacted on 26 February 2004 and further amended the Act in 2010, 2011, 2016, 2020, and 2021. The Act mandates the presentation of a medium term fiscal restructuring policy along with the annual Budget to the legislative assembly in each financial year.

The amendment to the Act in 2011 stated that the State must reduce its revenue deficit to nil by the end of FY 2011-12 and maintain a revenue balance or attain surplus thereafter.²²³ There have been no further amendments to this provision indicating revenue deficit targets to be achieved by the State in the subsequent years.

With respect to fiscal deficit, the Act sets out the path for its reduction as set out in Table 18.

Table 18: Fiscal deficit to GSDP for UP

Year	Fiscal Deficit to GSDP (in %)
2021-22	4
2022-23	3.5
2023-24	3
2024-25	3
2025-26	3

Source: UP Fiscal Responsibility and Budget Management (Amendment) Act, 2021

However, based on performance criteria in the power sector, an extra annual borrowing space of 0.50% of GSDP will be available for each of the years of period FY 2021-2022 to FY 2024-2025.

With respect to debt stock, the Act states that debt stock should be maintained as set out in Table 19.

Table 19: Debt Stock to GSDP for UP

Year	Debt Stock to GSDP (in %)
2015-16	31
2016-17	31
2017-18	30.5
2018-19	30.5
2019-20	30

Source: UP Fiscal Responsibility and Budget Management (Amendment) Act, 2016

It may be noted that the targets to be achieved by the State in relation to debt stock have not been revised to reflect the targets for the period from 2021-22 to 2025-26.

9.14 West Bengal

West Bengal passed the West Bengal FRBM Act on 30 July 2010 following which the Act was amended in 2011, 2020, 2021, and 2022. The Act mandates the presentation of a fiscal policy strategy statement and medium-term fiscal policy statement along with the Budget in every fiscal year before the legislative assembly.²²⁴

²²³Section 4(3)(a), *Uttar Pradesh Fiscal Responsibility and Budget Management Act, 2004*.

²²⁴Section 3(1), *West Bengal Fiscal Responsibility and Budget Management Act, 2010*.

It may be noted that under the Act, total liabilities have been defined such that they include borrowings of PSUs and SPVs and other equivalent instruments including guarantees where the principal and/ or interest are to be serviced out of the State budgets.²²⁵

The Act sets out the path for the State to reduce its revenue deficit, fiscal deficit and debt stock.²²⁶ The concept of 'debt stock' was added through an amendment in 2011. It refers to the total debt outstanding at the beginning of the financial year plus the gross borrowing during the year minus the liabilities discharged during the year.²²⁷

The Act was amended in 2020, wherein Section 4(2) was modified to set out the maximum amount of debt to be maintained by the State at the end of FY 2024-25. The amendment specifies the following:²²⁸

- Maximum debt stock of 34.3% of GSDP to be maintained upto the end of FY 2024-25;
- Target with respect to revenue deficit to be omitted; and
- Fiscal deficit to not exceed 3% of the GSDP in each year upto FY 2024-25. A proviso was added stating that the maximum fiscal deficit shall be 3.34% of the GSDP for FY 2019-20.

However, the 2021 and 2022 amendment to the Act modified the fiscal deficit limits to be adhered to by the State. These amendments stated the following:

- The 2021 amendment added a proviso to Section 4(2) to state that during FY 2020-21, the maximum fiscal deficit for the State shall be 5% of the GSDP;
- The 2022 amendment added another proviso to Section 4(2) increasing the maximum fiscal deficit for FY 2021-22 to 5% of GSDP; and
- The second amendment of 2022 further increased the fiscal deficit limit for FY 2022-23 to 5% of GSDP.

However, it may be noted that the State is allowed to exceed the fiscal targets set by the Act in the event of any natural calamity or other exceptional circumstances as the State may specify.²²⁹ A statement must be placed before the State Legislature regarding the grounds, as soon as possible after the deficit amount exceeds the specified targets.²³⁰

²²⁵Section 2(1), *ibid*.

²²⁶Section 4, *West Bengal Fiscal Responsibility and Budget Management Act, 2010*.

²²⁷Section 2, *West Bengal Fiscal Responsibility and Budget Management (Amendment) Act, 2011*.

²²⁸Section 2, *West Bengal Fiscal Responsibility and Budget Management (Amendment) Act, 2020*.

²²⁹First proviso to Section 4(2), *West Bengal Fiscal Responsibility and Budget Management Act, 2010*.

²³⁰Second proviso to Section 4(2), *ibid*.