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Section-XVII-A

IN THE SUPREME COURT OF INDIA
ORIGINAL JURISDICTION
OS No. 1 OF 2024

IN THE MATTER OF:

THE STATE OF KERALA	Petitioner (s)
Versus	
UNION OF INDIA	Respondent (s)

INDEX

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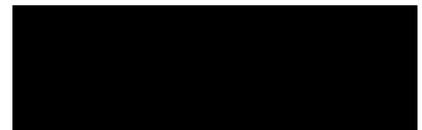

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I

Detailed Note on Critical Role of Sound Public Financial Management

Public Finance

1. Public finance encompasses financial activities of the Government at national, state and local levels. Its basic elements are revenue mobilization through tax and non-tax revenues of the Government, public expenditure on different services that the Government provides to citizens, capital formation in the economy for growth and public debt.

Public Financial Management

2. Public Finance Management (PFM) is the management of a country revenue, expenditure, debt management and financial administration through various rules, regulations, principles, policies and processes. PFM has both financial and economic objectives. Its financial objectives are to increase revenue, ensure fairness of taxation process, efficiency in resource-allocation, operational efficiency through achieving value for money in the delivery of public goods and services, transparency and accountability for expenditure and citizens' participation. Its economic objectives are to ensure macroeconomic stability of the nation, controlling inflation, delivery of adequate quantity of public goods to all citizens, and redistribution of income for reduction of inequality through constitutional processes and mechanisms. Fiscal sustainability and aggregate fiscal discipline, which means management of expenditure within the available resources, to the extent possible is one of the prime objectives of PFM. It should

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ensure that aggregate levels of tax collection and public spending are consistent with targets for the fiscal deficit, and do not generate unsustainable levels of public borrowing.

Public finance management is a national issue

3. Even though there is clear distinction between the taxing and legislative powers of the Union and the States in the Constitution of India, it cannot be said that there are separate territories in public finance for the Centre and the States. Finances of the State and Centre are intertwined at every stage and cannot be separated and treated as two watertight compartments. The grants made by the Centre become revenue for the States, and there is a regular mechanism for devolution of central resources to the States via the agency of Finance Commissions. The expenditure made by the Centre on Central Sector Schemes or Centrally Sponsored Schemes out of the Consolidated Fund of India benefit the States and generate income and hence taxes for the State, through creation of physical or social infrastructure within the States. Therefore, PFM does not work in isolation for the Centre and the States, and at every point, whether in respect of tax collection or public spending, one impinges upon the other. So, for efficient management of public finance, both the Centre and the States must work together.

4. The Reserve bank of India (RBI) is the banker to both the Central and State Governments. Every State Government needs to maintain a minimum cash balance with the RBI and when that limit is exceeded, the excess funds

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automatically get invested in the 14-day treasury bills of the Government of India which become liability for the Central Government. States also invest in the auction treasury bills and thereby lend to the Centre. Citizens in every State put their savings in various instruments at post offices – these money which go to the National Small Savings Fund and is used to finance the fiscal deficit of the Centre and the States.

5. If a State indulges in reckless borrowing to finance unproductive expenditure or poorly targeted subsidies, it will crowd out private borrowing from the market. This will lead to increase in the borrowing costs of private industries and adversely impact the production and supply of goods and services in the market. Increases in the State's debt servicing liabilities as a consequence of higher borrowing by it will reduce the availability of funds for development, leading to impoverishment of people and loss of State income, and hence also loss of national income. It may also engender various social and other problems. Thus, if public finance is treated as a State-specific and not a national issue, the entire edifice of federal structure in the country would collapse like a pack of cards.

Public debt and fiscal discipline is a National issue

6. Public debt is the total of all the liabilities of the Central Government contracted against the Consolidated Fund of India and of the State government contracted against the Consolidated Fund of the State concerned. Public debt forms a very important part of public finance as Governments are increasingly resorting to debt

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to meet the growing needs of the people. However, Governments should seek to ensure that both the level and rate of growth in their public debt is fundamentally sustainable, and can be serviced under a wide range of circumstances while meeting cost and risk objectives. Maintaining sustainable levels of Government debt is critical to sustained high macroeconomic outcome. As the Government cannot afford any default in servicing its debt, under Article 112(3)(C), all public debt is charged to the Consolidated Fund of India and can be redeemed without a vote of Parliament.

7. Fiscal discipline underpins macroeconomic stability in a country. Unsustainable fiscal deficits and high debt burdens can compromise both growth and stability, leading to high inflation, reduced expenditure on development, deteriorating Government services, as well as macroeconomic distress. Public finance principles articulate that the macroeconomic stabilization function rests with the central government. It is difficult for State governments to undertake independent macro stabilization policies, including the public debt management. Fiscal sustainability is therefore a crucial question which involves the coordination between Centre and State governments. Fiscal consolidation is identified as one of the primary instruments to achieve macroeconomic stability. In the context of a decentralised federal economy like India, ensuring the sustainability of fiscal policy is more challenging if the State Governments indulge in financial profligacy. This may be exacerbated by the implicit understanding that the Central Government will bail out a State Government that is in distress. Such

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State Governments pose a serious threat to fiscal sustainability and, therefore, macroeconomic stability of the country.

8. There are several examples of the close relationship between sub-national debt crises and national debt crises. Brazil suffered several sub-national debt crises in the 1980s and 1990s, with multiple provinces requiring Central Government refinancing of their debt in 1989, 1993 and 1999. Argentina's default on its sovereign debt in 1991 has been associated with sub-national debt crises in two of its provinces. Mexico's 1995 Tequila currency crisis plunged several sub-national entities into distress. Following Russia's 1998 financial crisis, more than half of its provinces defaulted on debt. In such a context, mechanisms to ensure fiscal discipline across the entire country, including State Governments, are critical to ensure growth and stability.

9. So, maintenance of fiscal discipline by State Government is of paramount importance not only from the point of view of macroeconomic stability but also to ensure adequate funding of essential social and economic services as well as building the foundations for long term economic growth. In this framework of economic governance, maintenance of fiscal discipline at the State level is significant. Therefore, to ensure India's macroeconomic stability, prudent fiscal management is needed both at the Central and State Government levels. Fiscal profligacy even at one layer of Government may cause macroeconomic instability. Moreover, default by any of the State Government in debt servicing would create

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reputation issues and will have domino effect endangering financial stability of the whole of India.

10. Debt of States also affects credit rating of the country. Sovereign ratings are about the creditworthiness of Governments. They provide a marker for investors around the world about the ability and willingness of Governments to repay debt and affect their ability to borrow and the interest rates at which they can borrow from the global markets. A good rating will make the borrowing cheap, and will also attract investments into the country from foreign investors. Institutional investors rely on sovereign ratings to qualify and quantify the general investment atmosphere of a particular country. Typically, rating agencies use various parameters to rate a sovereign. These include growth rate, inflation, Government debt, short-term external debt as a percentage of GDP, and political stability. Macroeconomic management and public financial management, both quantitatively and qualitatively, affect the ratings in a big way. Hence for good ratings, it is essential that the general Government debt which includes the debt of State, be managed properly.

11. India has long relied on the time tested provisions of Article 293(3) and 293(4) of the Constitution to control the spending and borrowing of State Governments. This constitutional mechanism has been used by the Central Government to ensure that State Governments do not exceed annual borrowing limits that are set at the beginning of every year. These limits are set by the Finance Commission in

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accordance with a formula that ensures that the fiscal deficit of no State exceeds 3% of Gross State Domestic Product (GSDP).

12. The underlying premise of the power under Article 293(4) is the outstanding debts of the State. The purpose of this provision is not only to protect the rights of the Centre in its capacity as a creditor but also there is a broader purpose of creating a mechanism to facilitate macroeconomic stability. State indebtedness negatively affects general Government debt, i.e. the fiscal health of the nation as a whole. The Expert Committee on the Financial Provisions of the Union Constitution presided over by Nalini Ranjan Sarker, appointed by the Constituent Assembly, underlined the need for a balance in powers and oversight of borrowings. Provincial autonomy in raising loans from the market, the Committee felt was essential since it creates financial responsibility and is a dependable metric to assess the credit rating of a province. At the same time, coordination between borrowings by different provinces was felt to be equally essential not only to fix priorities between borrowings inter-se but also to prevent unhealthy competition between Provinces and thereby preserve the capital market. This is also logical— the Central Government, not only by virtue of being a creditor, but also being responsible for macroeconomic stability in the country, should play a determinative part in State borrowings from the market. This is the practical working of the balance between State financial autonomy and the need for Central coordination and oversight that was drawn by the drafters of the Constitution and followed thereafter.

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13. All the States in India are indebted to the Centre and hence require the permission of the Centre to borrow from any source. While giving this permission, the Centre keeps in mind the overall objectives of macroeconomic stability of the country as a whole and fixes a borrowing limit for the State seeking its permission, under Article 293(4). The borrowing limits of States are fixed in a non-discriminatory and transparent manner guided by the recommendations of the Finance Commission. The Commission also while making its recommendations keeps in mind spirit of the FBBM Acts which strive ultimately to achieve a fiscal deficit target not exceeding 3 percent of the Gross State Domestic Product (GSDP) of a State.

14. In view of the rising debt of the States which had soared to unsustainable levels, the Union government has taken a number of initiatives in the past to promote their debt sustainability. These include Debt Write-off, Debt Swap Mechanism, Ways and Means Advances, allowing the State Governments to raise market borrowings through auction method and making the external assistance a pass through for States.

15. For ensuring that the Centre follows a prudent fiscal policy, the Fiscal Responsibility and Budget Management Act, 2003 has been enacted. It aimed to bring about prudential debt management and fiscal sustainability through limits on Central Government borrowings, debt and deficits, and greater transparency in fiscal operations of the Central Government. Inclusion of a ceiling of general

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Government debt in the definition of General Government debt was important amendment in the Act in 2018 because the databases of international financial institutions like the IMF shows the general Government debt for all the countries and credit rating agencies or investors as well as lenders to a country considers not the federal but the general Government debt for their purposes of rating, investment or lending, as it actually indicates the level of risk inherent in an economy.

How Public Finances are managed in India

16. Management of public finances in India, both at the Union and the State level is governed by the Constitution, related Statutes, and institutions. Schedule VII to the Constitution outlines the division of legislative powers between the Union and the States. Taxing entries in the Union and the State lists in the Schedule define their powers to levy and collect taxes. Non-tax revenues and expenditure are also guided by the Schedule VII entries. The relevant Articles of the Constitution and Statutes concerning PFM are as given below:

i. Article 112 to 117: Union Budget

ii. Article 148 to 151: Comptroller & Auditor General of India

iii. Article 202 to 207: State Budget

iv. Article 246 of the Constitution distributes the legislative powers including taxation, between the Union and the State Legislature. Schedule VII provides the subject matters in three lists.

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v. Article 266: Consolidated Fund of India and Public Account

vi. Article 267: Contingency Fund

vii. Article 268: Taxes levied by the Union, collected & appropriated by the states (Stamp Duty)

viii. Articles 268 to 273 lay down the principle of sharing taxes between the Union and the States. The taxes that Union government can levy and retain, levy and share with States and levy to be collected by the States to be retained by them are given in these articles

ix. Article 269: Taxes levied and collected by the Union but assigned to the States

x. Article 269A: Levy and collection of IGST in course of inter-state trade and commerce

xi. Article 270: Taxes levied and distributed between the Union and the States (All taxes and duties in the Union list except in 268, 269, 269A)

xii. Article 271: Surcharge by the Union

xiii. Article 275: Grants from Union to Certain States which are in need of assistance

xiv. Article 279: Net proceeds to be sharable between the Union and the states

xv. Article 279A: GST Council

xvi. Article 280: Constitution of Finance Commission by the Union every five years to review the Centre State finances and to give recommendations on the basis of sharing the net proceeds of the shareable taxes levied by the Central government. The Finance Commission is also required to

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recommend the principles of grant in aid to the States under Art 275 of the Constitution. The Central Finance Commission studies finances of the both Union and States and it recommends suitable measure to overcome the fiscal stress like recommending Post Devolution Revenue Deficit Grant to the States to overcome projected Revenue shortfall in their Revenue

xvii. 73rd and 74th Amendments to the Constitution have given a legal basis to the third tier of government in Panchayati Raj Institutions (PRI) and Urban Local Bodies (ULB). States must constitute a State Finance Commission under Article 243 every five years to recommend devolution from the States to the PRIs and ULBs. In addition, Central Finance Commissions are now being tasked by the Government of India to make recommendations for Central assistance to the third tier from the Central funds.

xviii. Article 282: Enables the Union to transfer funds to the States on as needed basis. This provision is principally used to fund the plan schemes which are not covered by the Finance Commission.

xix. Article 292: Borrowing by the Union

xx. Article 293: Borrowing by the States

xxi. Article 301: Freedom of trade & Commerce - Common market promised; trade shall be free.

xxii. Article 302: Power of Parliament to impose restrictions on trade, commerce in public interest

xxiii. Article 303: Restrictions on the legislative powers of Union & States in respect of trade and commerce: No law giving preference to any state.

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xxiv. Article 360: Provisions as to financial emergency: If the President is satisfied that a situation has arisen whereby the financial stability or credit of India or of any part of the territory thereof is threatened, he may, by a Proclamation, make a declaration to that effect. During the period any such Proclamation as is mentioned in Clause (1) is in operation, the executive authority of the Union shall extend to the giving of directions to any State to observe such canons of financial propriety as may be specified in the directions, and to the giving of such other directions as the President may deem necessary and adequate for the purpose.

Architects of the Constitution have assigned more powers to the Union

17. The Indian Constitution, in its Seventh Schedule, assigns the powers and functions of the Union and the States. The Schedule specifies the exclusive powers of the Union in the Union list; exclusive powers of the States in the State list; and those falling under the joint jurisdiction are placed in the Concurrent list. All residuary powers are assigned to the Union. The nature of the assignment of powers to the Centre is typical of federal nations. The functions of the Central Government are those required to maintain macroeconomic stability, international trade and relations and those having implications for more than one State.

18. Study of the division of subjects between the Union and the States, makes it clear that there is an asymmetry between the taxation powers and the functional responsibilities. While the Centre is assigned with taxes with higher revenue

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potential, States are assigned with more functional responsibilities. By constitutional design, the Union of India is on a different footing and is vested with key powers on financial matters for reasons of monetary stabilization and distribution. It is because of the asymmetry in financial powers that the Finance Commission is constituted every five years and makes recommendations regarding vertical and horizontal distribution of tax proceeds, principles governing grants-in-aid, etc. The constitution makers also provided for instruments in the form of taxes to be shared and grants-in-aid. Accordingly, there are both mandatory and enabling provisions in the Constitution for transfer of resources from the Union to the states namely,

a) duties levied by the Union but collected and appropriated by the States (Article 268);

b) taxes and duties levied and collected by the Union but assigned to the States (Article 269);

c) mandatory sharing of proceeds of income tax (Article 270);

d) permissible participation in the proceeds of Union excise duties (Article 272);

e) statutory grants-in-aid of revenues of States (Article 275);

f) grants for any public purpose (Article 282); and

g) grant of loans for any public purpose (Article 293)

19. Therefore, although the institutional structures for managing the finances may look similar, the Constitution makers have consciously granted wider powers to

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the Union considering its higher responsibilities in managing the finances of the country. For example:

i. The Union can borrow from outside India while the States can borrow only within the territory of India.

ii. The Union can borrow within any limit fixed by the Parliament but States' power to borrow is subject to both the limit set by the Legislature of the State as well as the consent of the Government of India in case there is outstanding loan or guarantee given by the Government of India.

iii. While the State Governments are not required to share any revenue with the Union, the Union Government shares a major part of its taxes and duties (41%) with State Governments besides providing them grants & loans.

iv. The Centre alone is constitutionally empowered to regulate the money supply, contract foreign loans, charge income tax on non-agricultural income and on services, or collect import and export duties.

v. The President, on the advice of the C&AG, has the power to prescribe the form of accounts of both Union & States.

vi. Union Government also has a regulatory role in managing the country's economy both directly as well as through its designated agencies such as RBI, SEBI etc. There can be no unnatural symmetry between regulator and

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regulated as the functions domains and roles of regulator and regulated are totally different.

vii. In case the financial situation in State is allowed to deteriorate beyond a point and if the President is satisfied that a situation has arisen whereby the financial stability or credit of India or any State is threatened, the President may under Article 360, proclaim financial emergency in a State.

20. Central FRBM Act, 2003: The Central Fiscal Responsibility Legislation (FRL), titled the Fiscal Responsibility and Budget Management Act, was passed in 2003. It aimed to bring about prudential debt management and fiscal sustainability through limits on Central Government borrowings, debt and deficits, and greater transparency in fiscal operations of the Central Government.

21. State FRBM Acts: Article 293(1) provides that State legislatures have the power to limit, by law, the State's executive powers of borrowing and giving guarantees. The 12th Finance Commission had recommended that each State should enact FRLs prescribing specific annual targets with a view to eliminating the revenue deficit by 2008-09 and reducing fiscal deficits to 3% of GSDP based on a path for reduction of borrowings and guarantees. The enactment of such FRLs was a precondition for availing the Debt Consolidation and Relief Facility (DCRF) as outlined by 12th Finance Commission. Accordingly, by 2010-11, all States had passed their FRBM Law.

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Institutions involved in the management of public finances and their roles

22. Several institutions are involved in the management of public finances in India at the Union and the State level. These institutions and their brief roles are outlined below:

(i) **Parliament, State Legislatures, Parliamentary and Legislative Committees:** The Parliament and the State Legislatures exercise their oversight powers through the respective Fiscal Responsibility and Budget Management Acts, Budgetary process and through various committees. The important Committees are the Estimates Committee Departmentally Related Standing Committees, Public Accounts Committee (PAC) and Committee on Public Undertakings (COPU).

(ii) **Finance Ministry at the Centre and Finance Departments in the States:** They are responsible for consolidation of budget estimates demands for grants given by different ministries/ departments, preparation and presentation of Annual Financial Statements before the Legislatures; monitoring of the economy in general and taking necessary steps in consultation with various Ministries/ Departments.

(iii) **Central Board of Direct Taxes (CBDT), Central Board of Indirect Taxes and Customs (CBIC), and Tax Departments of the States:** They are responsible for tax administration for the Union and the States respectively.

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(iv) **Ministries/ Departments and their subsidiary offices/ Units:** They are responsible for execution of the budget and its monitoring through Internal Audit.

(v) **Finance Commissions:** Besides making recommendations regarding vertical and horizontal distribution of tax proceeds, principles governing grants-in-aid, etc, Central Finance Commissions have focused on increasing fiscal discipline in sub-national borrowing through aggregate borrowing caps and a shift from discretionary lending or on-lending by the Centre to more market-mediated borrowing by the States. Finance Commissions have also recommended the annual borrowing limit for States as certain percentage of Gross State Domestic Product (GSDP). Consultation with State Government and Union Government and stake holders in the States has been an essential feature of the Finance Commission. Accordingly, before arriving the final recommendations, Commission makes extensive consultation with stake holders. It has been observed that fiscal roadmap provided by successive Finance Commissions has helped in maintaining the fiscal stability in the country thereby contributing towards strengthening the fabric of fiscal federalism in the country.

(vi) **Comptroller & Auditor General of India:** The CAG, an authority established by Article 148 of the Constitution of India, is supposed to be the 'guardian of the public purse'. It audits all the receipts and expenditure

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of the Government of India and State Governments, including those of bodies and authorities substantially financed by the Government. It also performs vital functions of accounting for Union Receipts and Expenditure; accounting for State Receipts and Expenditure. Independence and constitutional protection to the Comptroller & Auditor General of India is an essential attribute of the monitoring of public finances, since the CAG is to highlight the inefficiencies and irregularities in the PFM system of the country.

(vii) **Reserve Bank of India (RBI):** The Reserve Bank of India (RBI) is India's central bank, established in 1935. It serves as the custodian of India's monetary and financial system and plays a pivotal role in the country's economic development. The RBI also serves as the banker to both the Union and State governments. It manages government funds, facilitates transactions, and manages public debt. The RBI is statutorily mandated to manage the public debt of the Central Government. In case of States, the RBI may, by agreement with State Governments undertake the management of their public debt. The Internal Debt Management Department of the RBI performs various functions in this regard, including floating State Government loans, facilitating investment of surplus cash balances of State Governments in dated securities under various funds, etc. It is also authorised to make Ways and Means Advances (WMAs) to the Centre and States, and to fix the limits thereof. Apart from acting as a

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banker to State Governments as discussed above, the RBI also has regulatory power over the Government securities market. The RBI in consultation with the respective State Governments and Government of India decides on the timing, tenure and notified amount of State Development Loans (SDLs) keeping in view the borrowing requirements of State Governments and market conditions. Since 2006-07, the market borrowings of State Governments have also been conducted entirely through auction method. The SDLs carry practically no risk of default. As a result, all government bonds get subscribed irrespective of the fiscal performance of the state.

(viii) **NITI Aayog** : NITI Aayog (National Institution for Transforming India) from 1 January 2015. NITI Aayog serves as a Think-Tank of the government and provides both the Union and State Governments with relevant strategic and technical advice across the spectrum of key elements of policy.

(ix) **Inter-State Council (ISC) :** Article 263 of the Constitution of India provides for the establishment of an Inter-State Council. The duties of the Council includes:

a) inquiring into and advising upon disputes which may have arisen between States;

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b) investigating and discussing subjects in which some or all of the States, or the Union and one or more of the States, have a common interest; or

c) making recommendations upon any such subject and, in particular, recommendations for the better co-ordination of policy and action with respect to that subject.

(x) **GST Council**: As per Article 279A (4), the Council will make recommendations to the Union and the States on important issues related to GST, like the goods and services that may be subjected or exempted from GST, model GST Laws, principles that govern Place of Supply, threshold limits, GST rates including the floor rates with bands, special rates for raising additional resources during natural calamities/disasters, special provisions for certain States, etc. GST Council was, thus established to make decisions on various aspects of GST, including tax rates, exemptions, and administrative procedures. It plays a crucial role in shaping the GST framework in India.

23. There are parameters to measure whether the Central or a State Government's PFM system is performing adequately. Some of the important parameters are as under:

i. **Revenue deficit:** Revenue Deficit is the excess of revenue expenditure over revenue receipts. It implies increase in the liabilities of the State without corresponding increase in the assets of the State. It points towards

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Government's dissaving and using up the savings of the other sectors of the economy to finance a part of its consumption expenditure.

ii. **Fiscal deficit**: Deficit or simply Fiscal Deficit is the resource gap in the budget and equals the total expenditure of the Government on both revenue and capital accounts less the total non-debt receipts. Non-debt creating capital receipts are those receipts, which are not borrowings, and, therefore, do not give rise to debt. Examples are recovery of loans and the proceeds from the sale of PSUs. Fiscal Deficit is reflective of the total borrowing requirements of Government from all sources. It arises if the Government spends more than it collects in revenue. Gross Fiscal Deficit is financed by borrowings from internal and external sources. It is desirable to fully utilize borrowed funds for the creation of capital assets and to use revenue receipts for the repayment of principal and interest. But this is not the case with many of the State Governments in India.

iii. **Primary Deficit:** Primary Deficit equals the fiscal deficit less interest payments and indicates the additional debt created by the Government during the year. This is an important parameter for determining the sustainability of public debt, which means the stability or decline of the Debt Ratio.

iv. **Capital Expenditure:** The expenditure made on creation of capital assets besides repayment of principal amounts of loans.

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v. **Revenue Expenditure**: The expenditure made on administration (General Services), on social services like public health, education etc, and economic services like agriculture, industry, powers, transport and communication, etc.

vi. **Committed Expenditure:** The expenditure on interest payment, salaries and wages and pension, besides subsidies which are also in the nature of committed expenditure though often not included in calculations, accounts for the major part of revenue expenditure, leaving little leeway for spending on actual maintenance of assets.

vii. **Contingent Liability**: Liability that will arise in future, contingent on an event. For example, guarantees given by the State to its public sector enterprise for borrowing, which will be invoked if the enterprise defaults in repayment of the loan, and then it becomes an actual liability of the State.

Public Account

24. All other public moneys than those credited in the Consolidated Fund, received by or on behalf of the Government of India, are credited to the Public Account of India in terms of Article 266 (2) of the Constitution. Similar provisions are there for State Public Account. The funds in Public Account do not belong to the Government/ they are the moneys in respect of which the Government acts more as a banker. For instance, provident funds, small savings and so on. They have to be paid back at some time to their rightful owners. Because of this nature of the fund, expenditure from it is not required to be approved by the Parliament.

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25. Borrowing by a State to bridge its fiscal deficit includes borrowing from the market through State Development Loan (SDL) bonds and financial institutions as well as loans from the Centre. When borrowing from these sources do not meet the meet the requirements of the GFD, States can utilise its net accruals to the Public Account, which anyway, willy-nilly, are always available to the State. Public account is an integral part of Government finances. They constitute liability for the Government on many public account balances, for example provident fund or small savings, the Government has to pay interest which is paid from the Consolidated Fund of India. Excluding public account balances from the scope of liabilities will hide the actual liability and enhance the financial vulnerability of the Union and the State. The Hon'ble Delhi High Court in Shri Vashist Bhargava v. ITO, Salary Circle held that moneys in the public account of India do not belong to the Central Government unlike money in the Consolidated Fund of India. Thus, Inclusion of transfers from public account within the scope of total fiscal deficit, both at the Centre and in the States is consistent with economic and legal principles.

26. To meet their rising needs for funds, both for capital and revenue expenditures, many State Governments have come up with innovative ways of borrowing circumventing the limits imposed on their fiscal deficit and both by the Centre and by their own FRBM Acts. These borrowings are not reflected in their budget and are thus termed as Off-Budget borrowings. Such borrowings supress their fiscal

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deficit artificially makes their accounting opaque. Consequently, the structure of transparency and accountability which is an essential attribute of good PFM cannot function optimally. This in turn enhances the risk of an impending fiscal crisis. The dangerous practice of off-budget borrowing has been flagged both by the Comptroller and Auditor General of India as well as successive Finance Commissions.

Poor Financial Management in Kerala

27. Kerala has been one of the most financially unhealthy States and its fiscal edifice of Kerala has been diagnosed with several cracks. While commenting on the debt situation of the States, the 12th Finance Commission classified Kerala among the States with deteriorating debt situation reflected both in terms of the Debt- GSDP ratio and the ratio of interest payments to revenue receipts. The Commission also observed that Kerala had one of the lowest percent of capital expenditure at 1.1%. 14th Finance Commission also noted that there were only three States with revenue deficits in 2007-08 namely, Kerala, Punjab and West Bengal. The 15th Finance Commission designated Kerala to be a "highly debt stressed" State. It observed that Kerala had largely failed to limit its fiscal deficit to 3% of GSDP for almost all of the past decade. "*The State has been breaching its FRBM targets with unhealthy levels of Revenue Deficit-Fiscal Deficit ratio (65% in 2018-19). This implicitly explains why the State has resorted to borrowing to finance its Revenue Deficit,*" the Commission had noted. The Reserve Bank of India has also categorized Kerala among the five highly stressed States with high indebtedness

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requiring urgent corrective measures. The report said Kerala, Rajasthan and West Bengal are projected to exceed the debt-GSDP ratio of 35% by 2026-27. "These States will need to undertake significant corrective steps to stabilize their debt levels" it said.

28. The Government of Kerala had published a white paper on State finances in June 2016 which informed that the State was facing an acute fiscal crisis, entire borrowing was just sufficient to meet the day to day expenditure, no funds were left for capital expenditure and schemes in the budget had no resources to finance them. It warned that Kerala is heading for a financial crisis owing to a failure both on expenditure control and resource mobilisation. The CAG report on State finances of Kerala for the year 2016-17 noted that the fiscal crisis became more worse in 2016-17. There was an increase in revenue deficit, fiscal deficit and debt GDP ratio. The fiscal crisis continued and the government was forced to impose severe restrictions on treasury payments during the major part of the year 2017-18. In addition to the existing treasury restrictions, new restrictions were imposed in December 2018. Since February 15, 2019, all the bills exceeding rupees one lakh were stopped from making payments. The only exemptions given are the bills on salaries and pensions.

29. A study on State Finances of Kerala conducted by the Indian Institute of Management Kozhikode in the year 2027 also pointed towards poor public finance management in the State. This observation was based on a high Debt-

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GDP ratio, high interest payments to revenue receipts ratio, high gross fiscal deficit, high revenue deficit, high share of provident funds in its outstanding liabilities, high current expenditure, large expenditure commitment on salaries, pension and interest payment, decline in expenditure on capital formation, decline in revenue receipts as percentage of GSDP. Another study published in the September 11, 2021 issue of the Economic and Political Weekly titled "Utilisation of Government Borrowings in major Indian States" has also noted that Kerala has shown poor and unproductive utilisation of its debt receipts.

30. The Kerala Public Expenditure Review Committee constituted under section 6 of the Kerala Fiscal Responsibility Act 2003 (29 of 2003) has also in its Report published on April 2019 observed that major expenditure items of the State like salaries, pension and interest payment recorded high growth. As the gap between Revenue receipts and Revenue expenditure has been widening continuously, expenditure management practices should go beyond direct expense by the State. It is also noted that "*growing debt levels are in contrast to the situation witnessed by other States excluding Punjab and West Bengal.*" It is further stated that "*Public Account Liabilities shall be reduced in order to bring about consistency in the repayment schedule of debt". Excess borrowing except for prudential level of buffers should not be kept so as to avoid negative carry of interest".*

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31. An analysis of financial situation of Kerala has revealed that the State still has poor financial indicators pointing towards a lack of proper management of its public finances. This is discerned from the following indicators:

(i) **High level of outstanding liabilities:** As per the Reserve Bank of India Report on State Finances 2023-24, outstanding liability as a percentage of the Gross State Domestic Product (GSDP) of Kerala is increasing consistently from 31% in 2018-19 and reached a high level of 39% in 2021-22. The average of all States for this indicator was 29.8% in 2021-22. One of the major consequences of having a high outstanding liability ratio is enhanced outflow in terms of interest payments which in turn increases the deficit of the State and may result in a debt trap. Interest payment of the State has already climbed to 19.98% as against the 14th Finance Commission's recommended level of 10 per cent. However, what is remarkable about Kerala is the huge Provident funds component of outstanding liabilities. Share of Provident funds in total outstanding liabilities is close to 10.70% in 2021-22.

(ii) **High level of committed expenditure:** The Committed Expenditure of Kerala as percent of Revenue Receipts has increased from 74% in 2018-19 to 82.40% in FY 2021-22. This is the highest among all States. The average of all States was 55.29% in FY 2021-22. High levels of committed expenditure squeeze out the space for productive Government spending which negatively impacts the growth of the State in the long run.

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(iii) **High revenue deficit:** The revenue deficit of Kerala as % of the Gross State Domestic Product (GSDP) has increased from 2.41% in 2017-18 to 3.17% in FY 2021-22. The average of all States was 0.46% for FY 2022-22. A high RD-FD ratio implies that the State Government is borrowing not to invest in productive schemes but to meet its day to day expenses such as salaries and pensions. Not surprisingly, the capital expenditure has suffered and is "very low. This lop sided composition of fiscal deficit can have serious consequences for capital formation in the State and its long term productivity and growth.

(iv) **High Fiscal deficit:** The fiscal deficit of Kerala as percent to the Gross State Domestic Product (GSDP) was high at 4.94% for FY 2021-22 as compared to the all State average of 2.80%.

(v) **Low capital expenditure as percentage of GSDP:** Capital expenditure to Gross State Domestic Product (GSDP) of Kerala is considerably low at 1.52% for FY 2021-22 whereas the all-State average stands at 2.25%. Lower public spending on capital works may have serious repercussions on capital formation in the State and its long-term productivity and growth. Capital expenditure as percent to total expenditure of Kerala is low at 8.85% for FY 2021-22 as compared to all State average of 13.76%. The fact that only a very small portion of State's overall budgetary resources are allotted for capital formation (capital outlay) do not augur well for the State

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economy as it is this expenditure that really affects the growth process in an economy.

(vi) **High proportion of interest payment:** The 14th Finance Commission recommended that interest payments should be less than or equal to 10% of the revenue receipts in order to qualify for enhanced borrowing limit. The interest payments as percentage of revenue receipts (IP/RR) for Kerala has been rising and is at 19.98 per cent. This is a more serious concern since Kerala does not provide enough for capital expenditure to sustain this high level of interest payments. Such high outflows on account of interest payments are bound to squeeze out the space for productive Government spending over the next few years. Interest payments absorb resources and limiting their availability for other economic and social purposes. Debt has grown faster than revenue receipts and own tax revenues.

(vii) **High contingent liabilities:** Another kind of liability is contingent liability that takes the form of guarantees extended by the Government on loans raised by PSEs or other Government bodies. Contingent liabilities as a percentage of GSDP were found to be the highest for Kerala as compared to the comparable States.

(viii) **Revenue Expenditure to Revenue Receipt:** The Revenue Expenditure to Revenue Receipts Ratio % was very high at 125.33% for FY 2021-22 and consistently higher than all State averages. The all-State average was

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103.39% for FY 2021-22.

(ix) **Revenue Deficit to GSDP:** The revenue deficit of Kerala as % to the Gross State Domestic Product (GSDP) was the highest at 3.17% among all States for FY 2021-22. The all-State average was 0.46% for FY 2022-22.

(x) **Fiscal Deficit to GSDP:** The fiscal deficit of Kerala as % to the Gross State Domestic Product (GSDP) was also high at 4.94% for FY 2021-22 and consistently higher than all States average. The all-State average was 2.80% for FY 2022-22.

32. Squeezed for funds for Capital expenditure and to circumvent the borrowing limits imposed by its own FRBM Act and similar limits prescribed by the Central Government, Kerala has resorted to substantial off-budget borrowing through the Kerala Infrastructure Investment Fund Board (KIIFB).

(i) In the State Finance audit Report of Kerala for the year ended 31st March, 2019, C&AG has said that:

"*Kerala Infrastructure Investment Fund Board (KIIFB) has no source of income and has borrowed a substantial sum of money which is to be repaid from the petroleum cess and part of motor vehicle tax set apart by the Government of Kerala from its own revenue resources for transfer to KIIFB.*"

(ii) CAG in the State Finance Audit report of Kerala for the year ended 31st March 2021 has reiterated that:

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"Off-budget borrowings by the State Government have the effect of bypassing the Net Borrowing Ceiling (NBC) of the State by routing loans outside State budget through Government owned or controlled Companies/ statutory bodies despite being responsible for repayment of such loans. Such borrowings naturally have impact on the Revenue Deficit and Fiscal Deficit and thus, have the effect of surpassing the targets set for fiscal indictors under 'The Kerala Fiscal Responsibility Act, 2003' (as amended from time to time). Creating such liabilities, without disclosing them in the budget, raises questions both of transparency, and of inter-generational equity.

These off-budget borrowing will have an impact of increasing the liabilities of the State Government, leading to a debt trap over a period of time. As these borrowings are not disclosed in the budgets the Legislature is unaware of creation of such liabilities."

The CAG observed that such off-budget borrowing by SOEs amount to borrowing by the State.

33. KIIFB and KSSPL have no revenue sources of their own. For example, as per the financial statement of KIIFB for 2021-22, out of its total revenue of Rs.6,401.3 crore, 93.6% was by way of contribution from the State Government. The remaining 6.40% was from interest income from its deposits & investment and

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outstanding of loan given to other Government agencies. A minuscule 0.04% was its other income. KIIFB receives revolving/ corpus fund on annual basis from Government of Kerala (GoK) by way of statutory contribution being share of KIIFB from cess on Petrol and Motor Vehicle Tax. An amount of Rs.12,896.73 crore was received as revolving/ corpus fund by KIIFB from GoK from 2019-20 to 2021-22. This amount is used for discharge of its Principal and interest liabilities.

34. Apart from devolution of Central taxes and duties, Government of Kerala has received substantial Post Devolution Revenue Deficit Grant from the Union as per recommendations of the Finance Commission. An amount of Rs. 9,519.00 crore was released to the State Government during the 14th Finance Commission period 2015-16 to 2019-20. Similarly, in the 15th Finance Commission period from 2020-21 to 2023-24, an amount of Rs. 52,345 crore has been released to the State Government upto January, 2024. It is pertinent to mention that the Post Devolution Revenue Deficit Grant recommended to the State of Kerala is 16.07% of the total Post Devolution Revenue Deficit Grant recommended by the Commission to all the States taken together for the period 2020-21 to 2023-24, far more than its share of population or GDP. In addition to allowing higher borrowing limit of 4% of GSDP and 3.5% GSDP during FY 2021-22 and FY 2022-23 respectively, substantial financial resources have been provided by the Government of India to the Government of Kerala from year 2020-21 to 2023-24

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over and above the amount recommended by the 15th Finance Commission are as below:

(i)	Assistance under the scheme **'Special Assistance to States for Capital Expenditure'**	Rs. 2,223 Crore
(ii)	Additional borrowing for employer and employees' share contributed to **New Pension Scheme**	Rs. 3,543 Crore
(iii)	Benefit of additional borrowing on account of **repayment of off-budget borrowings**	Rs. 3,523 Crore
(iv)	**Back to back loan to meet GST compensation shortfall**	Rs. 14,505 Crore
(v)	Additional Borrowings under **Atam Nirbhar Bharat (i.e. 2% of GSDP)**	Rs. 18,087 Crore

35. Further, additional borrowing of Rs.4,060.00 crore and Rs.4,263.00 crore has also been allowed to the State of Kerala for meeting certain performance criteria in power sector for the year 2021-22 and year 2022-23 respectively.

36. Despite the devolution of substantial resources from Central taxes and duties, highest share of post devolution Revenue Deficit Grant, financial support extended by the Union Government over and above the recommendations of the Finance Commission and substantial transfer of resources to the State Government under the Centrally Sponsored Schemes, any financial stress that the Government of Kerala is facing is purely due to its own financial mismanagement.

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A Brief Note on Critical Role of Sound Public Financial Management

1. Public finance encompasses financial activities of the Government including revenue mobilization, expenditure, capital formation and debt management. Its objectives are to increase revenue, enhance resource-allocation and operational efficiency and facilitate transparency and accountability in financial activities. It also aims at ensuring macro-economic stability of the country, controlling inflation, and reduction of inequality and regional imbalances. Performance of a Government's Public Financial Management (PFM) system is measured using certain financial indicators and ratios.

2. In India, the Union and the State governments manage public finance through various institutions functioning under the provisions of the Constitution, Statutes, Rules and Policies. Many Articles of the Constitution deal with management of public finances. Seventh Schedule of the Constitution outlines the division of legislative powers, including power to levy and collect taxes, between the Union and the States. Many institutions like Finance Commission, Comptroller & Auditor General of India (CAG) and Reserve Bank of India (RBI) play a critical role in PFM.

3. Although the institutional structures for managing the finances may look similar for the Union and the States, the architects of the Indian Constitution have consciously granted wider powers to the Union considering its higher responsibilities in promoting macroeconomic stability and mobilizing financial resources. It is because of this inherent asymmetry in financial roles and powers that the Constitution has made provision for a Finance Commission under Article 280 of the Constitution every five years to make recommendations on vertical and horizontal distribution of tax proceeds of the Union to the States and for grants-in-aid by Centre to States under Article 275. No corresponding responsibility exists in the Constitution for States to part with any portion

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of their revenue to the Union. Union Government also has a regulatory role in managing the country's economy both directly as well as through its designated agencies. Moreover, Article 360 of the Constitution provides for proclamation of a financial emergency by the President in a situation which threatens the financial stability or credit of India or any part of its territory and has a provision for directions by the Union to any State during such an emergency.

Public Finance Management is a National Issue

4. Even though there is clear distinction between the taxing and legislative powers of the Union and the States, the public financial management does not work in isolation. The finances of the State and Centre are intertwined at every stage and actions of one impinge upon the other. For example, the grants made by the Centre become revenue for the States. The expenditure out of the Consolidated Fund of India benefits the States and generate income and hence taxes for the State. Every State Government needs to maintain a minimum cash balance with the RBI and when that limit is exceeded, the excess funds automatically get invested in the 14-day treasury bills of the Government of India which become a liability for the Central Government.

5. If a State indulges in reckless borrowing to finance unproductive expenditure or poorly targeted subsidies, it will increase the interest rates on borrowings of the Union and the States and also crowd out private borrowing from the market. This will lead to increase in the borrowing costs and adversely impact the production and supply of goods and services. Increases in the State's debt servicing liabilities as a consequence of higher borrowing will reduce the availability of funds for development, leading to impoverishment of its citizens, engender social problems and cause loss of income.

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National Importance of Fiscal Discipline and Public Debt

6. Public debt is the total of all the liabilities of the Central Government contracted against the Consolidated Fund of India and of the State government contracted against the Consolidated Fund of the State concerned. As the Government cannot afford any default in servicing its debt, all public debt is charged to the respective Consolidated Fund and can be redeemed without a vote of Parliament/State Legislature. Governments are increasingly resorting to debt to meet their growing needs. However, for sustained growth and high macroeconomic outcome, Governments should ensure that both the level and rate of growth in their public debt is sustainable.

7. Unsustainable fiscal deficits and high debt burdens can compromise both growth and stability, leading to high inflation, reduced expenditure on development, deterioration in Government services and macroeconomic distress. Maintaining fiscal sustainability and macroeconomic stability is more challenging in a federal economy like India if States indulge in financial profligacy. There is an implicit understanding that in distress, they will be bailed out by the Union. It is due to this implicit understanding that the interest rate on borrowings of financially weaker and stronger States is almost the same.

8. Moreover, debt of States also affects credit rating of the country. A good rating makes the borrowing cheap, and also attracts investments into the country. Moreover, debt servicing default by any one State would create reputational issues endangering financial stability of the entire country. So, maintenance of fiscal discipline by States is of paramount importance for the country's fiscal health, macroeconomic stability and long-term economic growth.

9. The Union government has relied on the provisions of Article 293 (3) and 293(4) of the Constitution to ensure that the lendings of the Union to States using taxpayer's funds are

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safe and that the debt of States remains within sustainable limits. These two purposes are intertwined. These limits are fixed in a non-discriminatory and transparent manner for all States. There have been instances of default by States in meeting obligations to the Centre. For example, the Kochi Metro Rail Ltd. and the Government of Kerala had failed to make payments for loan from Agence Française de Dévelopement (AFD) since 2014 and the amount was paid to the creditor by the Centre to avoid any default.

10. To meet their rising needs for funds, States borrow heavily from their Public Account, which contains all public money received by or on behalf of the Government other than those credited in its Consolidated Fund. However, the Government is more like a banker as the funds in Public Account, like provident funds, deposits and small savings, do not belong to the Government and has to be paid back to its rightful owners. There are instances when States have purported to release Central grants to implementing agencies & then credited the amount to public account thus showing utilisation with no additional expense. Therefore, net increase in liabilities is considered a part of fiscal deficit of both the Union and the States.

11. Some of the States, facing financial stress due to their financial extravagance, have come up with innovative ways of borrowing through the State Owned Entities (SOEs). However, in many cases the burden of servicing the principal and interest of such loans is on the Consolidated Fund of the State. Such borrowings constitute Off-Budget borrowings and are simply an attempt to bypass the fiscal deficit targets. Such borrowings are opaque, not reflected in the budget, supress the fiscal deficit artificially, and enhance the risk of a fiscal crisis. This non-transparent practice of off-budget borrowing has been flagged both by the CAG and successive Finance Commissions prompting the Centre to include such borrowing in the borrowing space of States.

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Poor Public Financial Management in Kerala

12. Kerala's financial health and debt situation has attracted adverse observations from successive Finance Commissions (12th, 14th and 15th) as well as the CAG. The RBI has also categorized Kerala among the five highly stressed States requiring urgent corrective measures. Acute financial crisis faced by Kerala was also recognized in its own Government's white paper published in June 2016. The paper had noted that the entire borrowing was just sufficient to meet the day to day expenditure, no funds were left for capital expenditure and schemes in the budget had no resources to finance them. A study on State Finances of Kerala conducted by the Indian Institute of Management, Kozhikode in 2017 also pointed towards poor public finance management in the State. Moreover, the Kerala Public Expenditure Review Committee constituted under its FRBM has in its report published on April 2019 pointed towards high committed liability and widening revenue deficit.

13. An analysis of current financial situation of Kerala through various financial indicators reveals poor public financial management in the State. Outstanding liabilities of the State as a percentage of Gross State Domestic Product (GSDP) have increased from 31% in 2018-19 to 39% in 2021-22 as compared to the all State average of 29.8%. Committed Expenditure of Kerala as percent of Revenue Receipts has increased from 74% in 2018-19 to 82.40% in FY 2021-22 as compared to all State average of 54.98%.

14. Revenue expenditure of Kerala was 125.33% of revenue receipts in 2021-22 as compared to the all-State average of 103.39%. The revenue deficit of Kerala as percent of the GSDP which has increased from 2.41% in 2017-18 to 3.17% in FY 2021-22 as compared to all State average of 0.46%. A large expenditure of the State consists of current expenditure due to high commitment on salaries, pensions and interest payment. Consequently, the State is

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mainly borrowing to meet its day to day expenses. This is reflected in a very low ratio of 1.52% for capital expenditure to GSDP in FY 2021-22 as compared to all State average of 2.25%.

15. Interest payment as percentage of revenue receipts of Kerala has climbed to 19.98 percent in 2021-22 as compared to the 14th Finance Commission's recommendation of 10 percent. Its seriousness increases due to the fact that Kerala does not provide enough for capital expenditure to sustain this high level of interest payments. Buoyancy of own tax revenue has been lower and total revenue of Kerala as percentage of GSDP has registered the highest decline in the country.

16. Squeezed for funds for Capital expenditure and to circumvent the borrowing limits, Kerala has resorted to off-budget borrowing of Rs 42,285 crore from 2016-17 to 2021-22 through the Kerala Infrastructure Investment Fund Board (KIIFB) and Kerala Social Security Pension Limited (KSSPL). Since these two State Owned Entities (SOEs) have no sources of income and the borrowings are to be repaid not from their revenue resources but from funds transferred from the Consolidated Fund of the State, CAG has termed it as an attempt to bypass targets set in Kerala FRBM Act and Net Borrowing Ceiling (NBC) prescribed by the Centre. CAG has observed that "*These off-budget borrowing will have an impact of increasing the liabilities of the State Government, leading to a debt trap over a period of time.*" The CAG has also observed that such off-budget borrowings by SOEs amount to borrowing by the State.

17. KIIFB and KSSPL have no revenue sources of their own. For example, as per the financial statement of KIIFB for 2021-22, out of its total revenue of Rs.6,401.3 crore, 93.6% was by way of contribution from the State Government. The remaining 6.40% was from interest income from its deposits & investment and outstanding of loan given to other Government

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agencies. A minuscule 0.04% was its other income. KIIFB receives revolving/ corpus fund on annual basis from Government of Kerala (GoK) by way of statutory contribution being share of KIIFB from cess on Petrol and Motor Vehicle Tax. An amount of Rs.12,896.73 crore was received as revolving/ corpus fund by KIIFB from GoK from 2019-20 to 2021-22. This amount is used for discharge of its Principal and interest liabilities.

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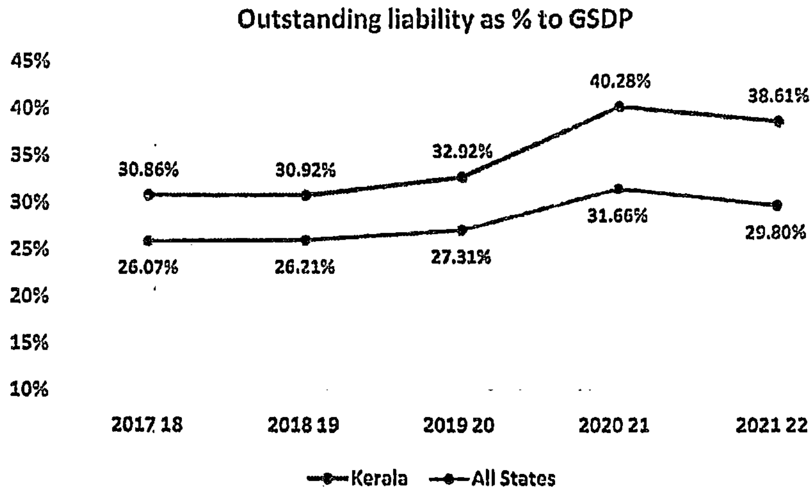
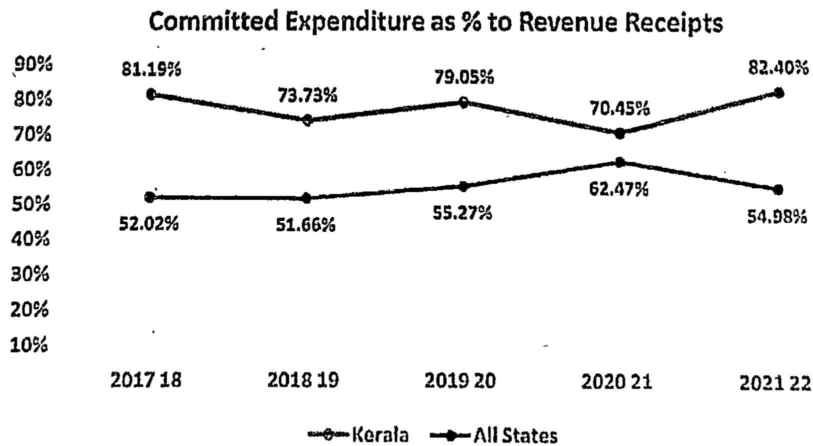
Fiscal indicators of State of Kerala vs All States average

1. Outstanding liability as % to GSDP



2. Committed Expenditure as % to Revenue Receipts



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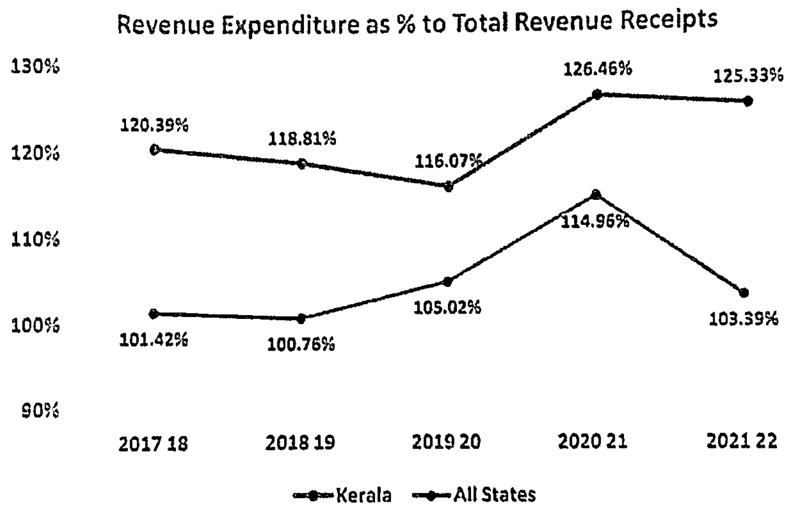
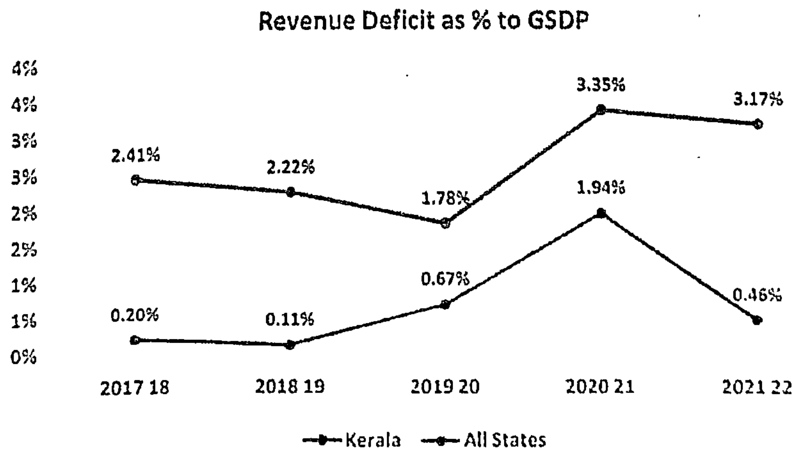
3. Revenue Expenditure as % to Total Revenue Receipts



4. Revenue Deficit as % to GSDP



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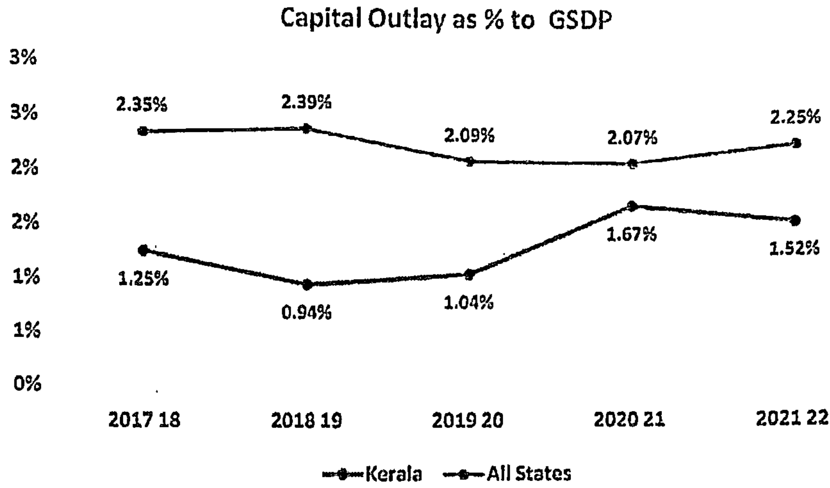
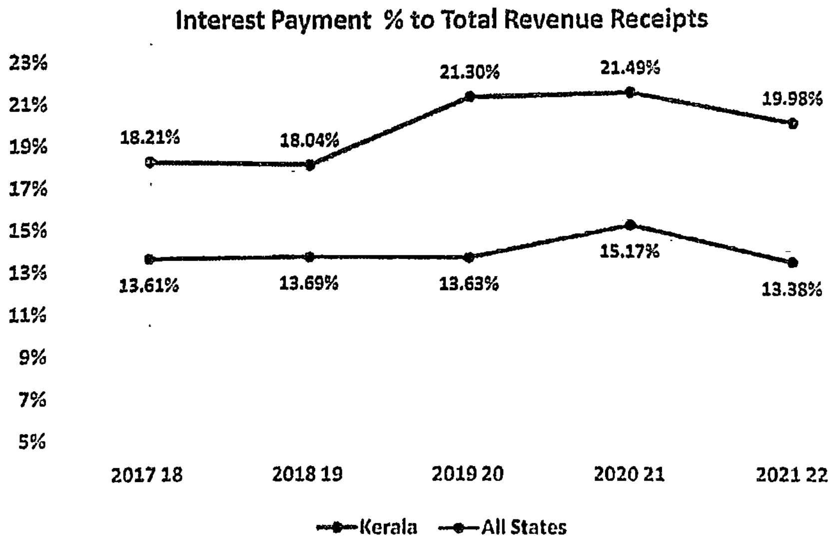
5. Capital Outlay as % to GSDP



6. Interest Payment % to Total Revenue Receipts



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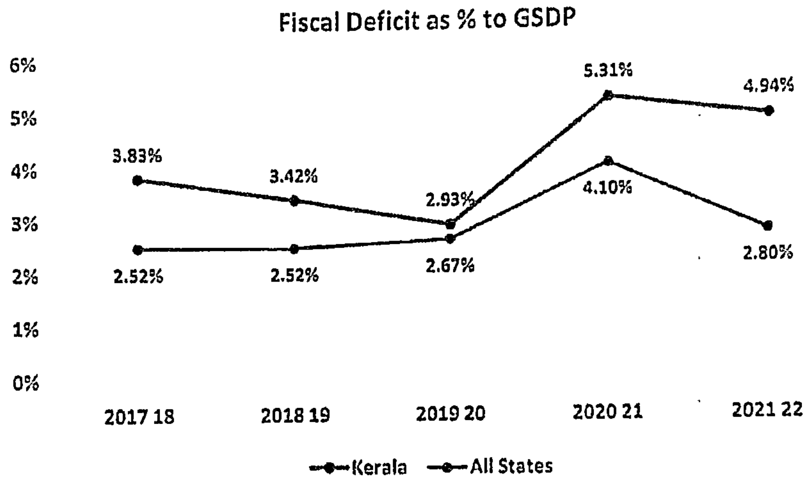
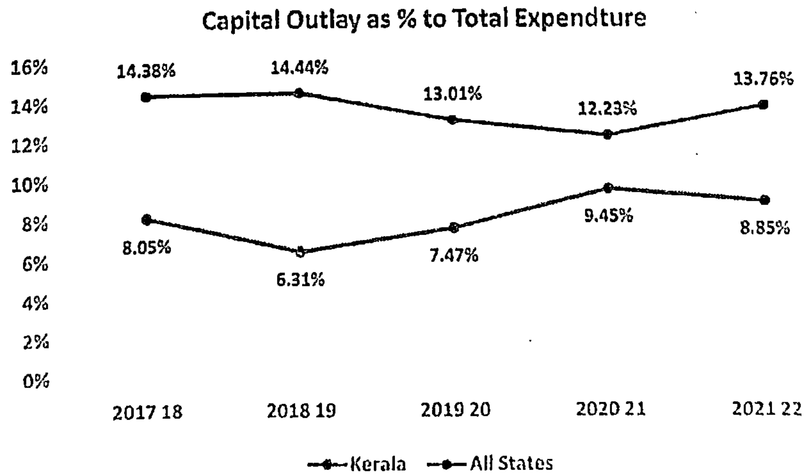
7. Fiscal Deficit as % to GSDP



8. Capital Outlay as % to Total Expenditure



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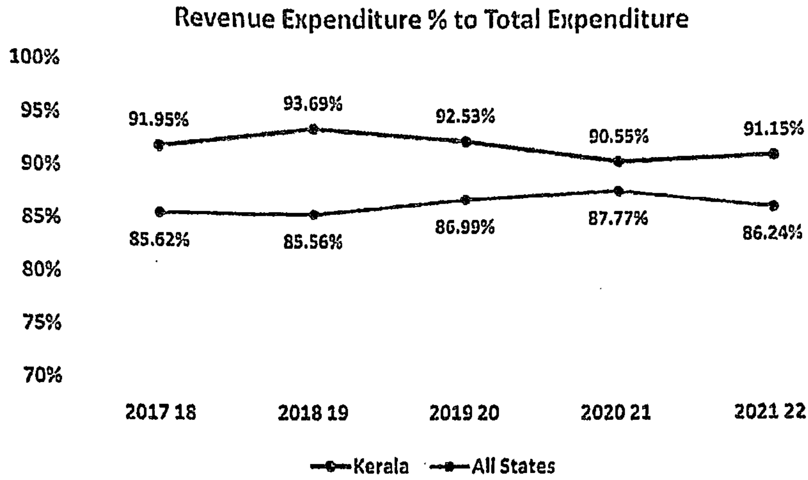
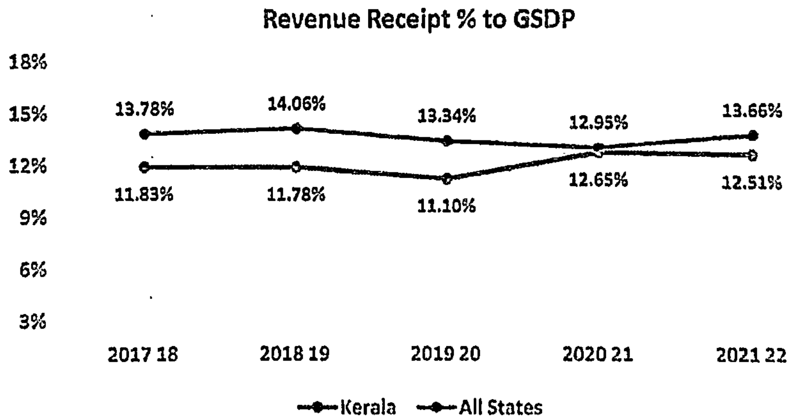
9. Revenue Expenditure % to Total Expenditure



10. Revenue Receipt % to GSDP



Source: RBI Report *"State Finances: A Study of Budgets of 2023-24"*