Chapter 3: Salient Features of State Government Guarantees and the Dimensions Thereof

Constitutional Provision

3.1 In terms of Article 293(1) of the Constitution of the India, the State governments can give guarantees within such limits as fixed by the legislature of the concerned State. The constitutional provision relating to raising of loans and issuing of guarantees are summarised below :

(1) Subject to the provisions of this Article, the executive powers of the State extends to borrowing within the territory of Indian upon the security of the Consolidated Fund of the State within such limits, if any, as may from time to time be fixed by the Legislature of such State by law and to the giving of guarantees within such limits, if any, as may be so fixed.

(2) The Government of India may subject to such conditions as may be laid down by or under any law made by Parliament , make loans to any State or, so long as any limits fixed under Article 292 are not exceeded, give guarantees in respect of loans raised by any State, and any sums required for the purpose of making such loans shall be charged on the Consolidated Fund of India.

(3) A State may not without the consent of the Government of India raise any loan if there is still outstanding any part of a loan which has been made to the State by the Government of India or by its predecessor Government , or in respect of which guarantee has been given by the Government of India or its predecessor Government.

(4) A consent under Clause (3) may be granted subject to such conditions if any as the Government of India may think fit to impose.

3.2 Since all the States are still indebted to Government of India, the constitutional position, therefore, is that prior consent of Government of India is necessary before a State Government raises a loan. Such prior consent is not necessary before the State government gives a guarantee. The State legislature is competent to limit the amount of guarantees which a State Government may give. It may be argued that guarantees are in the nature of a contingent liability which devolve on the State government in the event of default in repayment of loan; Article 293(3) may therefore, be stretched to extend to guarantees given by State governments. However, Article 293(1) specifically distinguishes between borrowing and guarantees. It would, therefore, be reasonable to conclude that 'loan' mentioned in Article 293(3) is intended to cover borrowing only and is not intended to apply to guarantees as well.

3.3 The constitutional position, therefore, would be that State governments do not require prior consent of Government of India before giving a guarantee. It is possible to suggest that Government of India, while giving permission to State governments to raise loans may satisfy itself about the extent of guarantees given by the State government and impose conditions thereon. In view, however, of the different constitutional provisions relating to States powers to raise finances and issue guarantees, such suggestions would need to be vetted by constitutional

experts who could limit the interpretation of conditions to be only those related to the specific loan for which consent is given.

3.4 Given the ambiguity of the constitutional interpretation , the Committee is of the view that it is in the interest of the State Government itself to have self set limits on guarantees, the parameters and basis for which are discussed in *Chapter 4*.

Assessment of State Finances

3.5 Any meaningful analysis of guarantees requires an assessment of States' finances. The emerging financial position of State governments shows an accentuation of fiscal imbalances as reflected in a growing deficit in the revenue account, increasing indebtedness, a rising interest burden, a sharp rise in expenditure on non-developmental sectors, a stagnant tax-GDP ratio and declining non-tax revenues. One of the disquieting developments in the finances of State governments is the persistence of revenue deficit since fiscal 1987-88. The level of revenue deficit which was Rs.1,088 crore or 2.4 per cent of revenue expenditure in 1987-88 witnessed substantial increase to Rs.19,672 crore or about 10 per cent of the revenue expenditure in 1997-98 and further to Rs.26,439 crore or more than 11 per cent of revenue expenditure in 1998-99. The widening of revenue deficit has also caused the gross fiscal deficit (GFD) to go up sharply from the level of Rs.11,220 crore in 1987-88 to Rs.50,885 crore in 1997-98 and further to Rs.59,776 crore in 1998-99. Furthermore, the share of revenue deficit in the total borrowing (GFD) has increased substantially over the years to 38.7 per cent in 1997-98 from 9.7 per cent in 1987-88 and 24.5 per cent on an average during the period 1990-95. The budget for 1998-99 has placed this at about 44 per cent. Given the high cost of borrowed funds the increased pre-emption of funds for consumption purpose which do not yield any direct economic returns reflects the self-attenuating nature of State Government finances.

3.6 Over the years, both revenue deficit and GFD have mutually reinforced leading eventually to accumulation of debt. Reflecting this, the level of debt of State Governments has increased to Rs.2,84,942 crore in 1997-98 from a level of Rs.69,971 crore in 1987-88 and Rs.23,959 crore in 1980-81. The level of debt is placed at Rs.3,36,365 crore in the budget for 1998-99. Large increase in debt has resulted in higher interest payments which has increased to Rs.31,235 crore in 1997-98 from Rs.4,898 crore in 1987-88 and Rs.1,225 crore in 1980-81.

3.7 The weighted average interest rate on State Government market borrowings moved sharply upward to 13.82 per cent in 1996-97 from 10.28 per cent in 1990-91. Consequently, the average interest rate on public debt of the State Governments rose steadily from 9.2 per cent in 1990-91 to 12.6 per cent in 1996-97. Given the constraint on revenue raising capacity of the States, rapidly rising interest payments have led to large pre-emption of revenue receipts. The interest payments accounted for 13.0 per cent of revenue receipts in 1990-91 and rose to 16.8 per cent in 1996-97. Among the major States, the States with high interest burden (i.e., interest payments to revenue receipts ratio exceeding the States average) during the period 1990-91 to 1996-97 were Bihar, Jammu and Kashmir, Kerala, Orissa, Punjab, Uttar Pradesh and West Bengal. These States also exhibit higher public debt to NSDP ratio.

3.8 Apart from deterioration in the deficit indicators as set out above, there has been a pressure on the receipt and expenditure of the State governments as reflected in the ratio of non-

developmental expenditure to revenue receipts and capital expenditure to GFD. It may be noted that the investment expenditure as reflected in the ratio of capital outlay to GFD has declined over the years from about 75 per cent during the period 1990-95 to about 41 per cent in 1998-99. This has serious implications for the adequacy and quality reflecting larger growth of interest payments and administrative services. Consequently, the developmental outlays including social expenditure have been adversely affected. The States' tax revenue has been stagnant at less than 6 per cent of GDP since late eighties and the States' non-tax revenue has declined from 2 per cent of GDP during the late eighties to 1.7 percent of GDP in 1998-99 States' own non-tax revenues.

3.9 The latest Annual Report (Paragraph 7.18 and page 112) in the above context contains the following :

> "In regard to State finances, the quality and range of adjustment continue to present major challenges to overall fiscal management. The States' own taxes have been insufficient in relation to their growing expenditures. Apart from improving tax administration and compliance, the States would need to rationalise their tax structure and harmonise taxes (e.g., moving to VAT from sales taxation), as also to explore newer avenues for raising resources (e.g., tax on services). On the expenditure side, reduction of subsidies in non-merit goods sector is called for together with raising of user charges. Keeping in view the financial sector reforms, the States' market borrowing programme would also required to be conducted in a flexible manner, by gradually moving over from the fixed coupon rate system to an auction-based one. As of now, the States could exercise the option of borrowing 5 to 35 per cent of the amounts allocated to them through auctions. The States will also need to resist the demands on provision of guarantees, since they form part of contingent liabilities and have to be provided for to avoid defaults."

Nature and Pattern of Guarantees

3.10 The guarantees given by State governments may be broadly classified as under:

(a) Guarantees in respect of loans to public sector enterprises including co-operative enterprises engaged in commercial activity but where banks/financial institutions are unwilling to extend support to the enterprises in the absence of government guarantee. Such guarantees are generally asked for based on risk perception and the project viability but in some cases are mandated by law such as, loans given by National Cooperative Development Corporation (NCDC). Such guarantees could be in favour of commercial or co-operative banks, all India financial institutions, Khadi & Village Industries Corporation (KVIC), NCDC, Rural Electrification Corporation (REC) etc. In the agricultural sector, such guarantees cover refinance from National Bank for Agriculture and Rural Development (NABARD) to State Co-operative banks for various agricultural purposes, loans from NCDC, loans from REC etc. In the industrial sector loans raised by sugar corporations, co-operative spinning mills, silk weaver's societies and other type of industrial activities have been covered by State guarantees. Rehabilitation assistance by commercial banks and financial institutions to sick public sector enterprises is usually backed by guarantees from the government.

(b) Guarantees in respect of advances to State enterprises for specific projects of a non commercial nature such as housing for weaker sections, corporations for scheduled caste/tribe, municipal bodies, housing boards, transport corporations and other projects involving social or economic infrastructure and urban development. Such guarantees could be given in favour of Housing and Urban Development Corporation (HUDCO), Life Insurance Corporation (LIC), KVIC, LIC apart from banks and financial institutions.

(c) Guarantees in respect of loans taken by State Electricity Boards (SEBs) from Power Finance Corporation (PFC), LIC, General Insurance Corporation (GIC), Unit Trust of India (UTI), Rural Electrification Corporation, etc., for financing capital works, rural electrification etc.

(d) Guarantees in respect of bonds issued by public utilities and other *special purpose vehicles* such as, Water and Sewerage Boards, road transport corporations, irrigation corporations, housing development agencies and corporations. The guarantees usually cover the repayment of principal and interest on such bonds. Such guarantees have been on the rise of late as States have been trying to increase capital expenditure on infrastructure while trying to adhere to the hard budget constraint.

(e) More recently, States have been giving guarantees favouring World Bank, Asian Development Bank (ADB) and other parastatal bodies in respect of large project loans sanctioned by them to the State.

(f) Private units in the power sector are being provided payment assurances which are as good as guarantees. For fast track power projects these arrangements involve escrow account mechanisms which authorise the automatic debit of the State government account in the event of shortfall in the escrow account for payments covering not only repayment of debt but also the guaranteed return as also the exchange risk. The quantification of such arrangements is not so easy.

Magnitude of Guarantees

3.11 The magnitude of government guarantees extended by all the State governments has not been compiled in a systematic way although the budget document of each State government compulsorily requires inclusion of statement regarding all the subsisting guarantees extended by the State governments. Data on guarantees are available in *Statement 6* of the State Finance Accounts prepared by the office of the Comptroller and Auditor General. The data are, however, available only with a lag. The 1997-98 accounts contain the data on guarantees for the period ended March 1997. The data do not capture the entire gamut of explicit contingent liabilities of the State Governments as they do not, for example, include the likely devolvement on account of IPP arrangements, letters of comfort having the same legal obligation as guarantees or structured payment arrangements which provide for assured payment to the investors.

3.12 The trend in guarantees as compiled from the *Statement 6* of the Comptroller and Auditor General's (CAG's) accounts and data provided by the finance secretaries as also data available on the issuances of guaranteed bonds in the market in the last two years either through public issue or private placement is presented in *Table 1*.

3.13 In absolute terms, the outstanding guarantees increased from Rs 40,318 crore at end March 1992 to Rs 79,625 crore at end September 1998 representing a compound rate of growth of 12.01 per cent per annum. The aggregate guarantees outstanding of 18 major States at end-March 1992 accounted for 10.3 per cent of their Net State Domestic Product (NSDP). As at end-March 1997, the aggregate outstanding guarantees as a ratio of NSDP was 9.1 per cent. In terms of share of revenue receipt guarantees constituted 46 per cent in March 1997 and 30 per cent in terms of share of consolidated fund in March 1996. As NSDP data are only available upto 1997, the relevant ratios could not be worked out for later periods. The growth in guarantees particularly since 1995 has been significant; the annual growth rate between March 1995 and September 1998 was 13.1 per cent. State-wise, the absolute amount of outstanding guarantees were higher for Andhra Pradesh, Gujarat, Karnataka, Maharashtra, Rajasthan and Punjab. These six states alone accounted for nearly 63.6 per cent of the total outstanding guarantees during 1998-99 (April-September).

3.14 The rising deficits on revenue account have pre-empted financial resources from investment projects. In such a situation, the issue of guarantees as a compensatory measure for maintaining the existing level of public investment is significant. In most cases guarantees have been issued in favour of Special Purpose Vehicle (SPV) to raise resources and it is very clear that the assurance of repayment is out of State's budget. Thus guarantees are thus are not very different from debt. The compound growth rate of debt between 1995 and 1998 was 7.5 per cent whereas the compound growth rate of guarantees was 13.1 per cent. *Table 2* shows the net/gross market borrowing since 1992-93 and incremental guarantees issued since then.

3.15 State-wise analysis of the levels of guarantees in relation to NSDP as given in *Table 3* broadly reveals that during 1991-92 to 1996-97, Andhra Pradesh, Gujarat, Haryana, Himachal Pradesh, Jammu and Kashmir, Karnataka, Meghalaya, Punjab and Rajasthan had higher levels of guarantees than the States average. Furthermore, the composite burden of interest bearing public debt and guarantees together as a ratio of NSDP is high for the States of Assam (43.07 per cent), Bihar (50.12 per cent), (Himachal Pradesh (80.70 per cent), Kerala (47.37 per cent), Orissa (55.93 per cent), Punjab (54.00 per cent), Rajasthan (47.85 per cent) and the ratio for Jammu and Kashmir being at the top at 86.54 per cent.

3.16 Since the guarantees are extended upon the security of the Consolidated Fund of the State these liabilities could be analysed in relation to the receipts accruing to the Consolidated Fund of the State. As evident from *Table 4*, State wise analysis of guarantees to Consolidated Fund ratio exhibits that during 1995-96, Gujarat (62.9 per cent), Haryana (38.6 per cent), Karnataka (46.4 per cent), Kerala (31.8 per cent), Maharashtra (41.0 per cent), Punjab (32.0 per cent) and Rajasthan (39.2 per cent) recorded a proportion above the States' average of 30 per cent. These high levels of guarantees may not imply immediate obligation but could imply a large burden on State finances in future.

3.17 In view of the above, it is clear that guarantees are growing and are extensively used in mobilising funds by the State governments for capital expenditure, in the context of growing revenue deficit and diversion of borrowing towards financing such deficit.

3.18 An attempt was made to collect data on guaranteed loans made by banks and financial institutions. The data thus collected were, however, not complete and also did not include investments in guaranteed bonds. Nevertheless, NABARD, NCDC, LIC and HUDCO accounted for a major part of guaranteed advances as can be seen from the table below.

	(Rs. Crore)
Name of the Institution	Amount of Guarantees
Banks	1278
LIC	4952
NHB	302
NCDC	1988
NABARD	14431
HUDCO	6419
REC	1063

Reason for increasing trend of guarantees

3.19 The reasons for increasing trend in guarantees being given by the State governments are as under:

(a) Till 1993-94, the public sector enterprises (PSEs) were getting a separate share of market borrowing (SLR linked). They were also getting substantial amount of budgetary support for their capital requirements. Since 1994-95, a separate allocation of market borrowing for PSEs has been stopped. The governments have also been facing decreased budgetary support for the capital works of such organisations. The utilities and other PSEs therefore turned to banks and financial institutions for a substantial part of their financing requirements through guaranteed bonds.

(b) The rising deficits on revenue account have pre-empted financial resources from investment projects. In such a situation, the guarantees as a compensatory measure for maintaining level of public investment assumes significance.

(c) The growing need for infrastructure at the State level and the participation by the private sector in such projects requiring huge investments has put further pressure on State governments to stand guarantee for such projects.

Guarantee Fee

3.20 Most State governments charge guarantee fee on a per annum basis. There is however, no uniformity in the charging of such fees. In a circular issued by the Ministry of Finance in April 1992, the guarantee fees to be charged on guarantees given by the Central government was prescribed. Borrowings under the market borrowing program were to be charged fee of 0.25 per cent per annum whereas in case of guarantees covering public sector borrowings the fee was were fixed at 1.00 per cent and for other sectors it was 2.00 per cent. Problems associated with timely payment of guarantee fees are common. Instances of lack of proper management of guarantee fees have also been reported.

Honouring of Guarantees

3.21 As per the practice in banking industry, the guarantees are invoked when the borrower does not pay the interest on principal on due date after giving required notices and following the recall process. The information on invoking of guarantees by banks is being regularly collected by

Reserve Bank of India. Other institutions such as, NABARD, HUDCO, NCDC and Co-operatives have also invoked guarantees. A rough estimate shows that guarantees of about Rs.700 crore have been invoked. This does not however reflect the default position correctly as banks and financial institutions might not resort to invocation of guarantees or approaching Court of Law even when there is default of interest and or principal. This is due to several reasons. The banks and financial institutions want to maintain cordial relations with the State government and would use persuasion for honouring guarantees rather than go to court. Secondly, there may be cases where the unit is before BIFR and any recovery proceedings are under suspension. Thirdly, till recently the banks could classify such accounts where principal and interest was not being paid as standard accounts and were not required to make provisions for such accounts.

3.22 The RBI obtains periodic reports from banks on the arrears of interest and principal in respect of guaranteed advances as also bonds. These are compiled State wise and given in *Table 5 and 6*. The data show that non payment of interest and principal in respect of guaranteed advances amounted to Rs.252 crore as at end of March 1998. Non payment of interest and principal in respect of guaranteed bonds amounted to Rs 363 crore as at end of June 1998. Similar data are not available in respect of other financial institutions and neither were the State governments in a position to furnish the data.

3.23 Non-payment of interest and the principal by State Governments results in accumulation of arrears causing concern to the banks and also financial institutions and banks have been representing to the Reserve Bank on these issues. Apart from the interest arrears the banks and financial institutions have suffered an opportunity loss and, therefore, there has been demand for overdue interest for the delay in payments of regular interest.

3.24 The position is, however, changing. With financial liberalisation, loans are being increasingly given on commercial basis. Most of the banks today insist on guarantees only where there is need to provide holding on operations to weak or sick units under rehabilitation. Increasingly, financial institutions such as, IDBI and ICICI are making decisions on basis of commercial judgement and the availability of guarantee does not influence them to provide finance to what is intrinsically a non viable project. This trend would get further strengthened with the prudential norms introduced by the Reserve Bank in its Mid-Term Review of Monetary and Credit Policy for 1998-99 (Credit Policy 1998-99) announced in October 1998 in keeping with the recommendations of the Narasimham Committee. These measures will not only impact on the taking of guarantees as a good collateral but also expedite recovery proceedings where there is default in honouring of guarantees.

Prudential norms for State government guaranteed investments and advances.

3.25 The RBI norms relate to capital adequacy and provisioning. For purposes of capital adequacy, different categories of assets have been assigned different risk weights. Till recently, investments in Central and State government securities as also Central and State government guaranteed securities carried zero risk weight. In the Credit Policy 1998-99, RBI has introduced a uniform risk weight for all government securities of 2.5 per cent. Furthermore, in case of

investments in government guaranteed securities which do not form part of market borrowing program a higher risk weight of 20 per cent has been prescribed.

3.26 Similarly, till recently, loans and advances guaranteed by the Central and State governments carried zero risk weight. The recent credit policy 1998-99 has introduced 20 per cent risk weight for such advances where guarantee has been invoked and the concerned State Government has been in default as on March 31, 2000. Where the advance continues to be in default in respect of invoked guarantees even after March 31, 2001, a risk weight of 100 per cent will be assigned.

3.27 Presently, State government guaranteed advances in respect of which guarantee has been invoked are treated as standard assets for provisioning purposes though income on such asset is not permitted to be recognised. Some banks have represented that a few States are delaying honouring their commitments under the guaranteed advances . In order to strengthen bank's efforts in recovery of such dues and to discourage such practices by State Government, RBI has introduced provisioning norms in respect of guaranteed advances, where guarantee is invoked and has remained in default for more than two quarters. Such provisioning would have to be made by banks in stages.

Funded and Unfunded Liabilities

3.28 Most of the States have been taking the guarantee commission into the general pool and no fund has been created or provision made for honouring guarantees in the event of invocation. Normally, the guarantee commission itself should be so structured to reflect the risk and ensure that receipt of fees would be enough to take care of devolvement under the guarantees.