

Chapter 2

Legal Framework

2.1 Introduction

The legal framework provides strategic direction, defines and clarifies powers and supports professionalism and operational focus in public debt management and also limits potential abuses of power and promotes good governance by establishing accountability for managing the government's debt liabilities. A clear and explicit legal framework could contribute much to achieve lower borrowing costs and prevent waste and inefficiency in public debt management. The legal framework comprises both primary legislation (laws enacted with approval of the legislature) and secondary or delegated legislation (rules, regulations, executive orders etc.). As per international best practices, the legal framework of public debt management should contain the following elements:

- **Authorization by Parliament to the executive:** The Parliament has ultimate power to borrow on behalf of the government arising from its power to approve government tax and expending measures. The Parliament should, therefore, authorize the executive to borrow.
- **Authorization to the debt management unit:** The legal framework should authorize the debt management unit to borrow through regular issue of government securities.
- **Borrowing purposes:** The legal framework should clearly define the borrowing purposes.
- **Debt management objectives:** Having public debt objectives in legal framework allows a country to formulate a debt management strategy to achieve the debt management objectives.
- **Debt management strategy:** The legal framework should provide for preparation of debt management strategy that is consistent with the debt management objectives.
- **Debt reporting:** There should be clear and explicit legal reporting requirements to hold debt management unit/executive accountable to legislature.

2.2 Legal Framework in India

The legal framework for the management of public debt in India is contained in Article 292 of the Constitution of India which empowers the Union Government to borrow upon the security of the CFI within such limits, if any, as may be fixed by Parliament by law, and in different primary and secondary legislations as given below:

- **The Fiscal Responsibility and Budget Management (FRBM) Act, 2003:** The FRBM Act, 2003 provided limits on the Central Government's borrowings, debt and deficits, greater transparency in fiscal operations of the Central Government and conducting fiscal policy in a medium-term framework and of matters connected therewith or incidental thereto.
- **FRBM Rules, 2004:** FRBM Rules, 2004 framed under FRBM Act, 2003 specified the annual targets for reduction of fiscal and revenue deficits, annual targets for assuming contingent liabilities in the form of guarantees and additional liabilities as a percentage of GDP.
- **RBI Act, 1934:** Under Section 20 of the RBI Act, 1934, RBI was obliged to manage the Central Government public debt.
- **Public Debt Act, 1944 and Government Securities Act, 2006:** The Public Debt Act is an Act to consolidate the law relating to government securities and the management of the public debt by RBI. With the enactment of the Government Securities Act, 2006, which amends the law relating to Government securities and its management by RBI and matters connected therewith, the Public Debt Act, 1944 ceased to apply to the government securities.

2.3 Inadequacies in the Legal Framework

The existing legal framework in India covered some of the requirements of a good legal framework. However, some aspects of an ideal legal framework for management of public debt were not present in legislations governing public debt in India as discussed below.

2.3.1 Definition of Public Debt

Under the Indian budgetary classification; three sets of liabilities constituted Central Government liabilities, namely, internal debt, external debt and other liabilities. In the budget documents, internal debt and external debt were together termed as public debt. However, it was observed in audit that the term 'Public Debt' had not been defined in the existing legal framework.

RBI stated (July 2015) that though public debt had not been explicitly defined, all the liabilities of government were listed and reported on a regular basis through Finance Accounts / Status Paper of Government debt. In the Exit Conference, DEA stated that the term public debt had

been defined in the Indian Government Accounting Standard (IGAS) which could be adopted after its notification.

DEA may consider adopting the definition as well as the components of public debt given in the proposed IGAS.

2.3.2 Objectives, Purposes of Public Debt and Formulation of Debt Management Strategy

As mentioned in the preceding paragraphs, the legal framework should ideally indicate the public debt objectives, the borrowing purposes and should require the preparation of a debt management strategy.

Audit observed that though the debt management objectives were mentioned in the Status Paper prepared by the DEA, the existing legal framework did not indicate debt management objectives explicitly. Further, while it can be construed from the Annual Financial Statement passed by Parliament that borrowing was for financing the fiscal deficit, Audit observed that borrowing purposes had not been mentioned in the existing legal framework of public debt management in India. Moreover, the legal framework did not necessitate the formulation of a debt management strategy.

RBI stated (July 2015) that the debt management objectives were implicit in FRBM Act and Budgets and added (September 2015) that the overall objective of the Government debt management policy was to meet Union Government's financing need at the lowest possible long term borrowing costs and also to keep the total debt within sustainable levels. Additionally, it aimed at supporting development of a well-functioning and vibrant domestic bond market. RBI stated (July 2015) that the main purpose of borrowing by the GOI was for financing the fiscal deficit. RBI added that the mandate to manage public debt implicitly imposed strategy formulation on the debt management agency. RBI further added that the international sound practice clearly mentioned debt management objectives and the executive in India had adopted those objectives.

DEA replied (September 2015) that borrowing was for the financing of fiscal deficit which has Parliamentary approval. It was added that the purpose was dynamic and varied over time depending on the priority of the nation and general socio-economic environment. It was opined by DEA that such legal provisions might either create rigidities and/or require frequent legal amendments.

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In the Exit Conference, DEA stated that the inclusion of objectives of debt management, borrowing purposes and the need for debt management strategy into the existing legal framework such as Public Debt Act/Government Securities Act, etc. might not be desirable as it could infuse elements of rigidity into debt management activities.

The reply of DEA should be viewed in light of the following:

- The FRBM Act, 2003 did not specify the objective of public debt management but placed a ceiling on the Government's borrowings while the budget shows the gap in funding and requirement of debt. In no primary or secondary legislation were the objectives of public debt management specified.
- It is to be noted that the FRBM Act, 2003 mandated submission of three reports to the Parliament on an annual basis which *inter alia* contained information on debt management activities. However, in the absence of stated objectives or requirement of a strategy as indicated above, there was no evaluation of outcomes.
- While it is true that the borrowing purposes may be dynamic, the broad contours may be prescribed in the legal framework.
- Though RBI stated that the mandate to manage public debt implicitly imposed strategy formulation on the debt management agency, a debt management strategy had been brought out only in December 2015 by DEA which covers the period from 2015 to 2018. Inclusion of the requirement to prepare a debt management strategy in the legal framework would assure timely and regular preparation of the said strategy.
- The international best practices recommend that the legal framework should contain the debt management objectives, borrowing purposes and formulation of debt management strategy for effective debt management.

2.4 Inconsistency in the Provisions of FRBM Rules

Rule 3 (4) of FRBM Rules, 2004 framed under FRBM Act, 2003 provided:

“The Central Government shall not assume additional liabilities (including external debt at current exchange rate) in excess of nine *per cent* of GDP for the financial year 2004-05 and in each subsequent financial year, the limit of nine *per cent* of GDP shall be progressively reduced by at least one percentage point of GDP.”

Rule 3 (2) of FRBM Rules, 2004 as amended by FRBM (Amendment) Rules, 2015 provided:

“The Central Government shall reduce the fiscal deficit by an amount equivalent to 0.4 *per cent* or more of the GDP at the end of each financial year beginning with the financial year 2015-16, so that fiscal deficit is brought down to not more than 3 *per cent* to GDP at the end of 31st day of March 2018.”

As per Rule 3 (4) above, it is clear that no additional liabilities could have been assumed in 2013-14 or thereafter which is inconsistent with the fiscal deficit target of 3 *per cent* of GDP as per Rule 3 (2) above as amended.

In the Exit Conference, DEA noted the inconsistency between Rule 3(2) and Rule 3(4) of the FRBM Rules for corrective action.

2.5 Management of External Debt

As per section 20 of the RBI Act, 1934, it is the obligation of RBI to undertake the management of public debt. As stated above, the budget documents termed internal and external debt together as public debt. However, it was observed that RBI was managing only internal debt and DEA was managing external debt.

RBI, in their reply (July 2015), stated that Government of India (Allocation of Business) Rules framed under the powers conferred by clause (3) of Article 77 of the Constitution of India; allocated ‘management of external debt’ to DEA, Ministry of Finance (MOF); giving them necessary legal authority to manage the debt. RBI, while stating that the MOF might be managing the external debt due to sovereign – sovereign / multilateral relationship, added that they managed the debt whenever it was issued in international capital markets like GBP¹ denominated Indian Government bond in UK in 1935 and a Sterling loan in 1949.

DEA replied (September 2015) that considering more than 90 *per cent* financing of the fiscal deficit was funded by domestic market borrowings which was being managed by RBI, as also that external borrowing was largely concessional (and not market linked), it might be said that legal provisions were being followed in spirit and to a substantial extent.

It is true that the Government of India (Allocation of Business) Rules provided sufficient legal authority to DEA for management of external debt. However, it is pertinent to mention here

¹ Great Britain Pound

that the requirement of RBI managing public debt is in the RBI Act, 1934. It is felt that these two legislations need to be in consonance with each other.

Recommendation:

- 1. Legal framework, consisting of both the primary as well as secondary legislation, may include the definition of public debt, debt management objectives, borrowing purposes and requirement of debt management strategy. DEA may consider doing this in a phased manner.*