Economics of Government Guarantee: How to void Fiscal Pressure!

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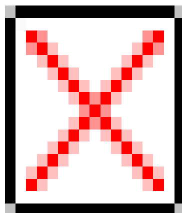**BETWEEN** two sets of numbers in the Union Budget documents for FY 22-23 (a) Notes on Demand for Grants for Department of Economic Affairs (DEA) under "Guarantee Redemption Fund" (GRF) stating four sets of numbers - actuals of 20-21 of Rs 1,600 crore, budget estimate for 21-22 of Rs 600 crore, revised estimate of 21-22 of Rs 939 cr and budget estimate for 22-23 of Rs 1,000 cr, and (b) statement no 13 of CGA's ***'Statement of Receipts, Disbursement and Balances under Heads of Account relating to Debt, Deposits, Remittances and Contingency Fund'*** disclosing the balance of GRF of Rs 5,229.6 crore as on 1-4-20 and Rs 6,829.6 crore as on 31-3-21, lies the overall outcome of union government's guarantee policy and the manner in which this policy instrument has been leveraged for public good.

Using government guarantees to address infrastructure gaps, when governments having the need and commitment to critical national projects opt for greater availability of technology, expertise and efficiency of an experienced co-partner while not directly burdening its budget to additional pressures, has long been a feature of large-size project finance structure. In India, Article 292 of the Constitution authorises the government to borrow ***'upon the security of the consolidated fund of India within such limits, if any, as may be so fixed.'*** As a follow-up, section 4 of the Fiscal Responsibility and Management (FRBM) Act, 2003 laying down the fiscal management principles enjoins upon the central government not to ***'give additional guarantees with respect to any loan on security of the consolidated fund of India in excess of one-half percent of gross domestic product in any financial year â€¦'*** States too have the authority and demarcated ceiling for extending government guarantees. Article 293 of the constitution provides that the executive power of the state ***'extends to borrowing within the territory of India upon the security of consolidated fund of the state within such limits, if any, as may be so fixed.'*** States thus have under the overarching constitutional mandate enacted state specific policy, strategy and guarantee limits for ensuring fiscal discipline through their own legislations.

Section 5 of the Gujarat Fiscal Responsibility Act, 2005 enumerating the fiscal management targets restricted outstanding guarantees within the limit as laid down in the Gujarat State Guarantees Act, 1963. Section 4(3)(e) of Karnataka Fiscal Responsibility Act, 2002 enumerating the fiscal management principles enjoins upon the state not to give guarantees for any amount exceeding the limit stipulated under Karnataka Ceiling to Guarantees Act, 1999. Section 9 of Telengana's Fiscal Responsibility and Budget Management Act, 2005 stipulates to limit the amount of incremental risk weighted guarantees to 90% of total revenue receipts in the year preceding the current year. Section 9 of Madhya Pradesh Fiscal Responsibility and Management Act, 2005 limits the annual incremental guarantees to 80% of the total revenue receipts in the year preceding the current year. The West Bengal Ceiling on Government Guarantee Act, 2001 stipulates that the total outstanding guarantee as on first day of April of any year shall not exceed 90% of state revenue receipts of the second preceding year.

Government guarantees, be they of the Centre or of the state, being explicit sovereign obligations under binding written documents, have been widely perceived as critical policy tools to close infrastructure deficits of national and sub-national governments, by shifting the underlying project risks from the participating investors and promoters thus making long gestation and finance heavy projects more fundable. Rule 276 of General Financial Rules (GFR), 2017 delineates the 3 purposes of government guarantee: (a) improve viability of projects or activities undertaken by central entities with significant social and economic benefits (b) enable central public sector companies to raise resources at

lower interest charges or on more favourable terms and (c) to fulfil the requirement in cases where sovereign guarantee is a precondition for concessional loans from bilateral/multilateral agencies to central public sector companies/ agencies.

While risk mitigation features of a government guarantee for a funder or a promoter are the bedrock around which 443 union government's guarantees worth Rs 4.97 lakh crores have been drawn across many ministries, departments and central PSUs under their administrative control (statement under Rule 6 of FRBM Rules for the year ended 31-3-21); and state government guarantees worth Rs 4.48 lakh crores issued as on 31-3-21 (RBI's statement 28: outstanding guarantees of state governments), risk mitigation counter measures also for the guarantor in the most appropriate manner are also apparent in the policy and strategy design, fully cognizant of the risk-benefit parameter on assumption of large contingent liabilities, and in what manner and measure that risk cover for the guarantor in the complete project life can be ensured. Government Guarantee Policy, 2022 enumerates a few of these, for example, tighter review and control on period of guarantee, a guarantee fee to cover risk, representation for the government on the board of management, mortgage or lien on the assets, right to get the accounts audited, right to verify the continued credit worthiness of the borrower, guarantee generally on 80% of the project loan, right to discharge the guarantee only after the primary lender discharges his portion of exposure etc. Even the notification dated 20-12-10 of DEA for disclosure standards for guarantees given by the government is a step in setting out the disclosure requirements to the form of accounts of the union and the states.

That apart, a guarantee redemption fund (GRF) has been established in the public account for redemption of guarantees given to central public sector enterprises, financial institutions by the central government whenever such guarantees are invoked. Rule 283 of GFR, 2017 lays down the accepted route for funding to the GRF through budgetary appropriations in the demand for grants of DEA. In the event of invocation of a guarantee, the rule says, obligation may be discharged by sanctioning loan to the borrowing entity equal to the amount of guarantee outstanding with the approval of the budget division of ministry of finance, and finally charged to GRF maintained in the public account.

Provisioning for a government guarantee, recognised and reported as a liability, though seen as unquantifiable and contingent, would have depended so much on an accurate prediction of outflow of resources at some future time, which are neither timely nor data driven. The Government Guarantee Policy 2022 however has a cautionary advice to the administrative ministries to report any case of ***'impending/ likely invocation well in advance, to the Budget division along with proposed corrective measures'***. For want of a binding proportion of government guarantees to be transferred to GRF under any executive instructions, in actuality therefore on the union side of accounts, the GRF size of Rs 6,829 crores would be seen as a counter balance to outstanding guarantee of Rs 4.97 lakh crores or a little over 1.3% of outstanding guarantee load.

On the contrary, under the revised scheme of RBI, guarantee redemption fund (GRF) for the states would have an initial contribution of minimum 1% of outstanding guarantee at the end of previous year and thereafter minimum 0.5% every year to reach a minimum level of 3% in next 5 years, and eventually to a desired level of 5%. Going by RBI's laid-out trajectory of amping up the GRF to a minimum 3% and a desirable 5% level of absolute exposure of outstanding guarantees, no state as on date is anywhere remotely close to the desirable target. State of Andhra Pradesh for example for the year ended 3021 has a GRF of Rs 892 crores against outstanding guarantees of Rs 91,330 crores (0.97%). Telengana has a GRF of Rs 1,350 crores against outstanding guarantee of Rs 1,05,006 crores (1.28%). A disproportionately high outstanding guarantee compared to gross state domestic product (GSDP) in cases of some states reaching in excess of 9% coupled with underfunding of GRF as a proportion to open outstanding guarantees would be a definite risk to economic and institutional integrity of sub national governments sufficiently potent to create major upheavals to government functioning at critical and recessionary times.

Suffice it to say that government guarantees which have been issued with a less than satisfactory viability assessment of projects and specifically those projects who have known and inherent weakness to generate a steady and definite revenue stream for their debt servicing would have originally contributed to the on-coming fiscal pressure in recessionary times. What would exacerbate is insufficiency of provisioning to meet challenges in the likely events of invocation of guarantees. Adherence to prudential risk management norms, financial regulation and supervision over open guarantees including provisioning thereof, all safe and sound advices at all times, would still be the most consistent response in periods of economic uncertainty, both as a temporary containment measure and a long term protection cover against financial and reputational catastrophes.