VII Role of the Reserve Bank in State Finances

The Reserve Bank's contribution towards shaping the State finances has progressively broadened beyond the statutory ambit of being a banker and debt manager of the State governments. As a banker, the Reserve Bank has modulated the system of Ways and Means Advances to and minimum balances from the States in consonance with their growing requirements for short-term accommodation. Simultaneously, the overdraft regulations of States were made more stringent to preserve short-term fiscal discipline and monetary stability. The Reserve Bank conducted market borrowings through an administered system of pre-determined notified amounts of borrowings and coupons thereon until 1998. Since then, the Reserve Bank has allowed States to access market borrowings through the auction route in a graduated manner before eventually migrating to a full-fledged system of auction of State government securities from 2006-07. Progressively, since the late 1990s, the Reserve Bank has been playing an advisory role whereby it formulated model fiscal responsibility legislation for the States, thereby facilitating the introduction of the rule-based medium-term fiscal consolidation in the States. The Reserve Bank has also been sensitising the States on policy issues relating to fiscal sustainability. The Reserve Bank has been organising Conferences of State Finance Secretaries since 1997. These have provided a regular platform for interaction with officials of the Central government, the Reserve Bank and other agencies on issues relating to State finances that emerge from time to time. The dissemination of information and analysis of State finances by the Reserve Bank every year have become an important reference for not only undertaking policy decisions but also facilitating research in this area.

1. Introduction

7.1 The Reserve Bank of India Act, 1934 provides that the Reserve Bank, by agreement with any State government, shall be entrusted with all its money, remittance, exchange and banking transactions in India and the management of its public debt, and shall also deposit all its cash balances with the Reserve Bank, free of interest. Accordingly, the Reserve Bank is a banker to all the State governments, except Sikkim. The Reserve Bank also manages the market borrowings of all the States. The market borrowing programme of the State governments is finalised by the Central government and the Planning Commission, keeping in view the provisions of Article 293(3) of the Constitution of India.

7.2 Apart from the statutorily mandated obligations, the Reserve Bank constituted various working groups and committees to examine matters relating to State finances and to provide guidance to States on institutional and policy reforms, such as consolidated sinking fund, guarantee redemption fund, model fiscal responsibility bills, fiscal transparency guidelines, and information disclosures relating to outstanding liabilities and guarantees.

7.3 Accordingly, this chapter presents the evolution of the Reserve Bank's role as a banker, debt manager and adviser on financial matters to the State governments and its response to the challenges in this area in terms of policy initiatives undertaken from time to time. Section 2 provides the legal framework underpinning the Reserve Bank's role as a banker and debt manager of the States. Section 3 focuses on the challenges faced by the Reserve Bank during the evolution of its role as a banker and debt manager of the States from 1935-1990. Section 4 covers the period since 1990 when the Reserve Bank started to play an important role in its advisory capacity on matters relating to the fiscal position of the States while it became more active as a banker and debt manager to State governments. Section 5 undertakes an overall assessment of the Reserve Bank's role in State finances. Concluding observations are provided in Section 6.

2. The Reserve Bank and State Finances: Legal and Institutional Underpinnings

7.4 The genesis of the Reserve Bank's role in State finances dates to its inception in 1935. The interface between the Reserve Bank and the States started when the individual States entered into agreements with the Reserve Bank. By the early 1950s, the Reserve Bank took over the function of serving as a banker to all the States (Section 21A of the Reserve Bank of India Act, 1934), whereby it undertakes all money, remittance, exchange and banking transactions of the States in India including holding their deposits, free of interest. Furthermore, the Reserve Bank assumed responsibility for providing secured and unsecured Ways and Means Advances (WMAs)/Overdrafts (ODs) to the State governments to meet temporary mismatches in their cash flows (Section 17(5) of the Reserve Bank of India Act, 1934). The limits and the interest rates applicable on such advances are, however, not specified in the Reserve Bank of India Act but are regulated by voluntary agreements with the State governments. The State governments, in turn, are obliged to maintain interest-free minimum balances in their accounts with the Reserve Bank, depending upon the relative size of their budgets and the level of economic activities in their States. Currently, the Reserve Bank acts as a banker to all the State governments in India except Sikkim. A notable feature, particularly since the introduction of fiscal rules in 2004-05, has been the reduction in fiscal imbalances of the States. As small saving collections autonomously built up the cash balances of the States while their deficits came down, managing the surplus cash balances of the Centre emerged as a challenge.

7.5 The Reserve Bank has also been managing market borrowings of the States (under Section 21A of the RBI Act) since its inception. State governments are permitted to undertake only domestic borrowings upon the security of the Consolidated Fund of the State and within limits, and they cannot raise any loans without the consent of the Central government so long as they are indebted to the Centre (Article 293 of the Constitution). Furthermore, the public debt management comes under the ambit of the Government Securities Act, 2006, effective from December 1, 2007.[16] Currently, the Reserve Bank manages the market debt of all the State governments (28 States) and the Union Territory of Puducherry. As part of this responsibility, the Reserve Bank decides the timing and issuing process, and disseminates details about the auction of State government loans to the public and investors.The method of issuance of market loans has migrated from the administratively controlled system to an auction based system for all the States since 2006-07. This was facilitated by the moderation in fiscal imbalances, following various institutional and fiscal reforms and the enactment of Fiscal Responsibility and Budget Management (FRBM) Acts by the State governments since 2004-05. The Reserve Bank conducts auctions of States' borrowings to enable price discovery.

7.6 As part of its advisory role, the Reserve Bank has been setting up several committees/working groups to examine issues concerning the State finances from time to time. The Reserve Bank also provided inputs facilitating the introduction of a rule-based fiscal consolidation by the States. Besides, the Reserve Bank has been regularly organising Conferences of State Finance Secretaries which provide a platform for their interaction with senior officials of the Central government, Planning Commission, Comptroller and Auditor General of India (CAG), Controller General of Accounts (CGA), and the Reserve Bank on issues of mutual interest. The Reserve Bank compiles and disseminates consolidated and State-wise disaggregated data in its report on State budgets, which constitutes a primary source of information on State finances for policymakers and researchers.

[16] The Government Securities Act,2006 replaced the Public Debt Act,1944 and the Indian Securities Act,1920.

7.7 International experience suggests that countries have been using a mix of approaches for appropriate management of sub-national debt (Box VII.1). While in most countries central governments play a major role, in India, the Reserve Bank, being a full service central bank, has played a unique complementary role by assisting the Central government in the adoption of an appropriate combination of approaches to debt management that remains consistent with a judicious balance between growth and macroeconomic stability.

Box VII.1: Approaches to Sub-national Debt Management: Cross-country Experiences

A growing trend worldwide is towards decentralised delivery of government services. Consequently, the expenditure obligations of sub-national tiers of governments have risen without commensurate growth in their own and devolved sources of revenue from the central government, thereby necessitating recourse to debt. Various studies have emphasised the need for transparency in the finances of sub-national governments (SNG) through establishment of appropriate institutions and processes akin to the Central government system, so as to ensure better accountability, efficiency, and governance of decentralised administrations. Considering the implications of sub-national debt for overall macroeconomic stability, the central governments across countries play a critical role in monitoring sub-national debt management (Ahmad, *et al*, 2005). In India, the Reserve Bank plays a unique role of assisting the Central government to fulfill these responsibilities by acting as the banker and debt manager of State governments as well as providing advice on issues and concerns relating to their finances from time to time.

Ter-Minassian (1996), in a cross-country survey, identified four principal approaches to managing sub-national debt. At one extreme, there are countries (United States, Canada, Japan and Switzerland) with developed capital markets that have adopted a *market discipline* approach whereby the borrowing activities of SNGs are mainly monitored and controlled by the market and/or regulated by local-level regulations. At the other extreme, there are countries (Lithuania, Columbia, Latvia, and Indonesia) which have imposed *administrative constraints,* whereby the Central government is empowered with direct control over sub-national borrowings through setting up debt limits, special treatment/prohibition of external borrowings, review and authorisation of individual borrowing operations or centralisation of all government borrowings with on-lending to SNGs. In India, while the States' annual borrowing limits are decided by the Centre, they have been allowed to approach the market directly from 2006-07 subject to their borrowings remaining within annual limits. However, for external borrowings, the States in India have to depend upon on-lending from the Centre, which passes on external assistance to the States on a 'back-to-back' basis. Between the two extremes, there are countries (Australia, Austria, Germany and Spain) that follow *co-operative approach,* whereby SNG borrowings are set as part of fiscal targets and debt ceilings through a negotiation process between Central and local governments. Finally, there are countries which have adopted *rule-based controls* on SNG borrowings imposed by the Central/upper-tiers of government for the of purpose of borrowing (Germany, Italy, Mexico and South Africa) and numerical constraints based on parameters such as fiscal balance and expenditure (Germany, Italy, France and Brazil) and also debt (Spain, Peru, Lithuania and Poland). In India, the States were incentivised to legislatively frame fiscal rules setting targets for revenue balance and fiscal balance, which work towards controlling debt.

Cross-country practices show that countries have chosen a combination of these approaches for sub-national debt management. For instance, in principle, though market discipline can be an effective approach, very few countries, particularly developing ones, can satisfy the stringent pre-conditions (free and open market, sufficient information on borrower's debt level and repayment capacity, absence of bailout expectation in the event of default and strong market sensitive institutional infrastructure). Even in Canada where provinces rely solely on market discipline and there are no constitutional/legal limits on their borrowings, there has been a mixed record. The market discipline approach, which does not stipulate any limits on SNG borrowings, is also prone to risks of uninhibited accumulation of provincial debt as was the case in Brazil from the late 1960s to the 1980s (*IMF Survey*, 1996). This necessitated a migration towards an administrative approach by setting new legal rules and Central bank regulations that prohibit states from borrowing from their own banks. However, country experiences also support the need to accord primary emphasis on the fiscal discipline of SNGs as, in its absence, Central government controls over SNG borrowings tend to be less effective. Therefore, Brazil also undertook various institutional reforms (enactment of fiscal rules, introduction of golden rule provisions, new accounting norms and transparency requirements at all levels of government) that improved the effectiveness of its administrative approach for managing SNG debt. Other countries (Australia and Scandinavian countries), where the culture of fiscal discipline is already in place, have instituted co-operative arrangements involving SNGs in formulating budgetary policies with due recognition of associated macroeconomic implications. The co-operative approach facilitates exchange of information across the various tiers of government and improves communication. However, this approach may be prone to protracted bargaining. Thus, some industrial countries (United States, Spain and Japan) have adopted rule-based controls.

Several lessons follow from the cross-country experiences on sub-national debt management. First, management of SNG debt cannot rely solely on a single institutional arrangement as none of the approaches seem to be superior. Second, SNGs cannot be given unconstrained borrowing authority. Typically, at low levels of vertical fiscal imbalances, the fiscal rules adopted by SNGs themselves improve fiscal outcomes. Widening of vertical imbalances requires the institution of Centrally imposed rules. Third, central governments need to avoid bailing out SNGs wherever possible as they reduce the effectiveness of borrowing controls (Singh and Plekhanov, 2005).

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3. Evolving Role of the Reserve Bank in the Pre-reform period (1935-1990)

7.8 The pre-reform period witnessed the Reserve Bank taking over the responsibility for managing the public debt of the Central and State governments, besides playing the role of a banker in an environment of underdeveloped financial system. With the increasing participation of both the Central and State governments in the process of planned economic development, their dependence on the Reserve Bank also increased. At the start of the planning process, an abiding objective of the Reserve Bank as a banker, was to integrate the departmental treasury operations of all the provinces/States into the banking system. The Reserve Bank also provided short-term accommodation in the form of WMA to the States with the limits usually set as a multiple of their minimum balances held with the Reserve Bank. However, it realised the need to keep a check on the tendency of the States to remain persistently in WMA/OD so as to guard against undue automatic monetisation of deficits as was the case for the Centre. As a debt manager of the States, the Reserve Bank initially had to underwrite States' borrowings. While the States were keen to directly access the market to meet their expanding funding requirements, the Reserve Bank was not only apprehensive about their capacity to raise funds directly from the market in view of the limited *clientele* but also about its unintended consequences in terms of unco-ordinated and competitive borrowings by the States. The challenges faced by the Reserve Bank in conducting its responsibilities on behalf of the State governments up to 1990 are set out below.

Deeper financial integration through Banker of Part B States

7.9 Initially, the Reserve Bank served as a banker only to Part A States[17]. The imperative of expanding the Reserve Bank's role as a banker to all the States was recognised by the V.T.Krishnamachari Committee, 1949[18] for the following two reasons. First, handling the critical operations in respect of treasury, currency chest and remittance arrangements for States in a country-wide manner provided scope in deepening the financial sector of the Indian economy. This, in turn, was required for fostering integration of all the States across the Union. Second, the nature of currency and governmental banking facilities in the former Part B States[19] was found unsatisfactory, and hence, was identified to be addressed closely as a prelude to future reforms. Accordingly, the Rural Banking Enquiry Committee, 1950 (Chairman: Purshotamdas Thakurdas) recommended that the Reserve Bank may be permitted to operate as sole banker to Part B States as well, whose banking activities were either performed departmentally or by the Imperial Bank of India/local banking institutions. The Central government took the initiative for amending the Reserve Bank of India Act, 1934 to enable it to become the banker to Part B States after executing agreements with them. Supporting this view, the Reserve Bank argued that, according to the international practice, central banks function as bankers to the government. It was pointed out that this arrangement, apart from being economical and convenient, was required for having an intimate connection between public finances and monetary affairs. This also enabled the central bank to assess financial situation at any point of time in a wholesome manner, so as to appropriately advise the government.

7.10 Some Part B States were, however, not keen on this arrangement; they felt that they would be losing a number of accommodation facilities being offered by their prevailing bankers, including the interest they earned on their cash balances maintained with these institutions which they would cease to earn once the Reserve Bank becomes their banker. While the

[17] Part A States refer to nine States which were provinces of British India.

[18] As referred in Balachandran G. (1998), *The Reserve Bank of India 1951-1967,* pp:185, Oxford University Press, Delhi.

[19] Part B States refer to eight States which were former princely States.

Central government advised Part B States in 1951 to appoint the Reserve Bank as their banker by April of the following year, the target date was subsequently shifted to July. Eventually, it was decided that some of these States can make their prevailing bankers serve as agents of the Reserve Bank under 'suitable safeguards'. Thus, the process started, with the governments of Madhya Bharat, Travancore-Cochin, Mysore and Hyderabad appointing the Reserve Bank as their banker during the curse of 1952-53.

Conflict between financial integration and monetary stability due to huge overdrafts by the States

7.11 The Reserve Bank stipulated and revised upwards the levels for the interest free minimum balances of the States during the pre-reform period, based on certain indicators reflecting expansion in State finances relative to benchmark periods. At the same time, it also had to grant Ways and Means Advances (WMAs) to the States within specified limits linked to minimum balances to tide over temporary liquidity mismatches in revenues and expenditures. Originally, in April 1937, both the limits of minimum balances and WMAs of States were fixed at the level equivalent to the ratio of their total revenue and expenditure to the corresponding total of the Centre for the period 1931-32 to 1933-34. Although the WMAs were repayable after three months, the law did not prevent renewals of WMAs after the stipulated period. Nonetheless, the Reserve Bank preferred not to allow such renewals. After the smooth working of the WMA system until 1948, there were several instances when the States were unable to repay even after being called upon by the Reserve Bank. Some of them also started running large overdrafts (ODs) on their accounts with the Reserve Bank from 1950. As the States were virtually able to draw amounts from the Reserve Bank, the State Bank of India branches and the treasuries, without any evident limit, it was recognised that such unregulated financing of budget deficits by States could pose concerns for monetary stability.

7.12 With the increasing cost of managing the government accounts, following the rising turnover in these accounts, a need for an upward revision in the minimum cash balances, which had remained fixed at 1937 levels. Furthermore, it was noticed that with interest rate downturn, the Reserve Bank's annual earnings from investment of these balances fell far short of commissions it paid to agency banks of the States. Although the Reserve Bank proposed to quadruple the aggregate minimum balances of the States, the Central government only permitted doubling of the existing limit of aggregate minimum balances to avoid pressure on the States' resources. On the other hand, WMA limit was quadrupled, thereby raising the ratio of WMA limit to minimum cash balance from 1:1 to 2:1 in 1953. Moreover, in addition to 'normal' WMA which was unsecured, each State was allowed to draw a 'special' WMA up to ₹20 million against Central government securities.

7.13 The problem of States' overdrafts re-emerged and escalated by the mid-1960s on the back of deterioration in States' fiscal conditions due to dwindling revenues, on the one hand, and a sharp increase in drought relief expenditures, on the other. Some States even began using overdrafts as 'Plan resources'. The fiscal position of the Centre was also adversely impacted, as the States' overdrawn accounts began to be settled through Central assistance to them. With the Centre enjoying the facility of automatic monetisation of Central government deficit through issue of *ad hoc* treasury bills to the Reserve Bank, the practice of settling States' ODs by the Centre through special assistance was tantamount to *de facto* unbridled monetisation of even the States' deficits, notwithstanding the fact that State government borrowings from the Reserve Bank were subject to stipulated limits.

Overdraft Regulation aimed at stricter financial discipline

7.14 State governments recorded large budgetary deficits as their outlays surged since the beginning of the Third Five-Year Plan. These deficits were financed

to a large extent by recourse to ODs from the Reserve Bank. To avoid persistence of this situation, the Reserve Bank, with the approval of the Central government, evolved a new procedure to deal with such ODs beyond approved limits with effect from March 1, 1967. With ODs becoming a serious problem by the end of the Third Plan, this issue was examined by the Fifth Finance Commission. The Commission noted that the recourse to ODs by the States reflected an uneven pattern of their receipts and expenditures, and attributed it to chronic imbalances between sources of funds and functions of the States while devolution of resources to them remained inadequate and no suitable mechanism was present to deal with unforeseen difficulties. At the same time, the Commission recommended continuous monitoring by the Reserve Bank so that the stipulated three-month period of WMA was not exceeded, the notice period was not violated in case of an OD, and payments were stopped if States failed to comply with the notice.

7.15 With the OD position becoming a concern due to its effects on the financial stability of the economy, a new policy on ODs came into force from May 1, 1972, whereby no State government could resort to unauthorised borrowing from the Reserve Bank. However, to meet the genuine needs of the States arising out of their increased budgetary operations, the limits of clean or unsecured WMAs from the Reserve Bank were raised to four-times their earlier limits. The outstanding ODs on the Reserve Bank's accounts on that date were cleared by the Centre granting special ways and means assistance and releasing the States' share in income tax and plan assistance. These measures were expected to impart considerable financial discipline by containing both Plan and non-Plan expenditures of the States within the constraints of the available resources.

7.16 As a measure to tightly regulate ODs, a system was put in place from October 1, 1978, whereby the Reserve Bank would caution the State after it exhausted 75 per cent of the authorised WMA limit and automatically suspend the payments if, despite such action, the account was overdrawn for more than seven working days. The WMA limits to States were doubled to provide them with sufficient room to manage their financial commitments within the available resources. However, the ODs continued, which led the Centre to clear the States' outstanding amount of ODs again at end-March, 1982 by granting term loans, advance release of the States' share in Central assistance and taxes, while deciding to rigidly enforce the OD regulation scheme thereafter. The WMA limit was doubled from July 1, 1982, recognising the increased budgetary expenditure of the States.

Enhancement in WMA, OD in the wake of drought

7.17 The fiscal conditions of the States worsened during the 1980s, with drought conditions impacting revenue collections while their expenditures grew. Consequently, the States continued to overdraw their accounts with the Reserve Bank, which had to be cleared by the Centre through medium-term loans. The WMA limits were enhanced during 1986-87. Consequent to another drought during 1987-88, which affected the liquidity position of several States, the Reserve Bank further enhanced the limits for normal WMA in March 1988. Nonetheless, as fiscal stress in the States continued in the 1990s, the time limit for clearing ODs was raised (from seven to ten consecutive working days) in November 1993, and limits under normal and special WMA were further doubled in August 1996.

Gradual upward revisions in minimum balances and sharper hikes in WMA in consonance with growing stress in State Finances

7.18 As already mentioned, the minimum balances were periodically revised by the Reserve Bank during the pre-reform period, in the light of expansion in the State finances relative to benchmark periods. Beginning with a stipulated minimum balance level of ₹19.5 million for Part A States in April 1937, the Reserve Bank enhanced the level to ₹39.4 million for all States in April 1953 when its role as a banker was extended to Part B States as well. The stipulated minimum level was increased gradually to ₹133 million in 1996. Up to August 1996, minimum balances were

revised upwards on 11 occasions, taking into account expansion in State finances and formation of new States from time to time. The pace of upward revision of stipulated minimum balances to be maintained by the States, however, lagged behind the upward revisions in their WMA limits. Thus, the ratio between minimum balance and the normal WMA limit worked out to 1:168 in August 1996 as compared with 1:1 in 1938. The Special WMAs began to be linked to minimum balances from March 1967. The ratio between minimum balances to Special WMA worked out to 1:64 in August 1996 as compared with 1:6 in March 1967 (Table VII.1).

Interest Rates on WMA and ODs made more progressive to restrain use of temporary advance from the Reserve Bank as a normal budgetary resource

7.19 The interest rates on normal and special WMAs, and ODs did not exceed the Bank Rate before May 1976. In particular, interest rates on normal WMA and ODs were kept at one per cent below the Bank

Table VII.1: Minimum Balances and Limits of WMAs

(Amount in ₹ million)

Date	Minimum Balance Total for States	Ways and Means Limits (Expressed as a Multiple of the Minimum Balance)	
		Normal / Clean	Special / Secured
1	2	3	4
1. April 1, 1937 (effective April 1, 1938) Provincial Governments/Part A States)	19.5	1 (19.5)	#
2. April 1, 1953 (Part A and Part B States)	a) 39.4 on Friday b) 33.8 on days other than Friday c) 45.0 before repayment of Ways and Means Advances	2 (78.8)	20.0 for each State
3. March 1, 1967	62.5	3 (187.5)	6 (375.0)
4. May 1, 1972	65.0 +	12 (780.0)	6 (426.6)
5. May 1, 1976	130.0	10 (1300.0)	10 (1300.0)
6. October 1, 1978	130.0	20 (2600.0)	10 (1300.0)
7. July 1, 1982	130.0	40 (5200.0)	20 (2600.0)
8. October 1, 1986 a) April-September b) October-March	 130.0 130.0	52 (6760.0) 48 (6240.0)	20 (2600.0) 20 (2600.0)
9. March 1, 1988	133.0	56 (7448.0)	20 (2660.0)
10. November 1, 1993	133.0	84 (11172.0)	32 (4256.0)
11. August 1, 1996	133.0	168 (22344.0)	64 (8522.0)
12. March 1, 1999	##	## (36850.0)	++

Figures in parentheses in Columns 3 and 4 are the total monetary limits for all States.

: Secured ways and means advances were occasionally granted on an *ad hoc* basis.

+ : The increase of ₹2.5 million over the figure for 1967 was due to the fixation of minimum balances for four States, *viz.*, Himachal Pradesh, Manipur, Meghalaya and Tripura. There was no revision for other States.

: The minimum balance was revised upwards, linking it to the same base as for WMA. The base for the revised WMA limits will be the three-year average of revenue receipts plus capital expenditure.

++ : The limit for special WMA was liberalised; no upper limit on Special WMA. Special WMA was to be provided against actual holdings of Government securities.

Source: Informal Advisory Committee on Ways and Means Advances to State Governments, Reserve Bank of India, 1999.

Rate and at the Bank Rate, respectively. The interest rate on special WMAs, after having a graduated structure based on the size of the advance, was made uniform and equal to the interest rate of normal WMA, *i.e.,* one per cent below the Bank Rate, between March 1967 and April 1976. However, from May 1976 to August 1996, a graduated scale of interest rates was charged based on the duration of the advance to discourage states from using the WMA as a normal budgetary resource. While interest rates on special and normal WMAs continued to remain equal, they became progressively based on the duration of use of the WMA facility. While the interest rate of normal and special WMA up to 90 days was kept unchanged at one per cent below the Bank Rate, higher interest rates (up to two per cent above the Bank Rate) were applied when these advances were availed of beyond the 90-day period. In respect of ODs, while the interest rate up to seven days was kept unchanged at the Bank Rate, it was raised to three per cent above the Bank Rate for ODs of 8-10 days, reflecting sharper progressivity and the need to address the problem of the States' ODs during this period.

Ensuring success of States borrowing programme primarily through Reserve Bank's underwriting system in the initial period

7.20 The Reserve Bank continued to undertake responsibility for the management and issue of debt of the provinces even after their legislatures were granted autonomy to do the same in 1937. The provinces delayed enacting the laws that would enable them to issue and manage debt on their own, pending lack of clarity about whether their legislatures could bypass the power granted to the Reserve Bank in this regard. Furthermore, under the British laws, the prevailing system of the Reserve Bank undertaking debt management of the provinces had to continue till their legislatures were found 'competent' to take over this responsibility. The system remained in force even after the Republic's inauguration in 1950. Initially, the Reserve Bank followed the practice of underwriting provincial loans. Some States, however, felt that this system prevented them from coming directly to the market through 'straight public issues' and advocated that they should be allowed to access the market directly to mobilise 'realistic amounts' at 'reasonable rates'. Although some views favoured discontinuing the system of underwriting State loans and arrangements were also made for the State governments to float 'straight loans in the market', the Reserve Bank had to ensure the success of the market borrowing programme of the States, in case public subscriptions fell short of the issued amounts in the early 1950s.

Balancing the States' aggressive approach for market loans with imperatives of sound monetary management and absorptive capacity of investors

7.21 Amidst the easing of monetary conditions during the latter half of the 1950s and the dearth of State loans, the market response to State borrowings improved, which drove down the coupon rates. The success of State loans prompted the Reserve Bank to consider lengthening the tenor and narrowing the spreads between State and Central loans. The Reserve Bank, however, cautioned against the States against pressurising involuntary subscriptions. Another concern, notwithstanding a positive market response, emerged in the wake of reports that commercial banks were financing their subscriptions to State loans through borrowings from the Reserve Bank and the State Bank of India. During the Third Five-Year Plan, States adopted aggressive practices to mobilise funds from the market by paying higher coupon rates and accepting deposits from potential subscribers/investors even before the loan issuance date. However, as the policy stance became disinflationary by the mid-1960s, the Reserve Bank could not extend any support to State loans in keeping with its overall responsibility of sound monetary management. With the State loans being under-subscribed against the backdrop of lack of support from the Reserve Bank and weak investor appetite, the States were persuaded to set modest targets at more attractive terms to investors.

Deterioration in State finances and growing recourse to captive institutional investor base

7.22 The fiscal conditions of the States improved from the mid-1970s to the mid-1980s as they recorded surpluses in their revenue account in the wake of improved buoyancy in both own tax and non-tax revenues, while revenue expenditures increased moderately. State government securities generally having a maturity of 10 to 15 years were issued at coupon rates slightly higher than the coupon rates of comparable maturities of Central government securities. A rising proportion of State government securities were held by commercial banks, followed by the Life Insurance Corporation of India and Provident Funds. The Reserve Bank did not subscribe to the State government securities during this period.

7.23 The fiscal conditions of the States, however, deteriorated significantly from 1987-88, with the revenue account turning into deficit on account of droughts/floods, which not only entailed additional expenditure on relief work but also affected States' revenue collections. There was also a sharp deterioration in the financial performance of State public enterprises with a bearing on the finances of States. The implementation of the revised pay structure across States also contributed to deterioration in the fiscal position of the States during the late 1980s. Reflecting the impact of the increasing recourse to borrowed funds by the States, interest payments shot up, pre-empting 11.0 per cent of their revenue receipts during the second half of the 1980s as compared with 8.1 per cent during 1980-85. A few States curtailed their plan outlays to contain fiscal deficits. The co-existence of both revenue and gross fiscal deficits during the second half of the 1980s implied that a large portion of borrowing was used to meet the revenue gap. As a result development prospects suffered and debt accumulated. It may be noted that the Central government's revenue and fiscal deficits had also expanded significantly during the 1980s, leading to the enlargement of debt servicing obligations. To contain the bulging debt servicing obligations, the Central and State governments tapped the financial surpluses of the household sector through statutory pre-emptions stipulated for financial intermediaries at lower than market clearing rates. Mandatory investments in government and other approved securities by banks under the statutory liquidity ratio (SLR) requirement was steadily raised from 26 per cent of their net demand and time liabilities in 1970 to 38.5 per cent in 1990.

4. Role of the Reserve Bank in the Post-Reform Period since 1990

7.24 The unsustainable level of fiscal deficits of the Centre and State governments during the 1980s eventually triggered a balance of payments crisis by the early 1990s, necessitating fiscal reforms as a pre-condition for restoring macroeconomic balances in the Indian economy. As fiscal adjustments occurred initially at the Central government level, the Reserve Bank reduced the statutory pre-emption ratios of the banks, introduced the auctioning system in the Central government securities market and phased out automatic monetisation of the Centre's fiscal deficits by 1997-98. The deterioration in State finances, however, persisted up to the mid-1990s. The situation became acute during the second half of the decade, following the implementation of the Fifth Pay Commission awards for State government employees and significant losses incurred by State Public Sector Undertakings. The fiscal deterioration of States was further exacerbated by the growing size of interest payments, the inability to levy adequate user charges and falling buoyancy in Central transfers to States. While the focus of fiscal reforms was initially on the Central government finances, the continued deterioration of State finances prompted the Reserve Bank to play a more proactive role in instituting reforms at the State government level by the late 1990s.

7.25 As part of its proactive approach to State finances during the post-reforms period, the Reserve Bank assumed responsibilities beyond its traditional role of serving as a banker and debt manager to the

States. Among its several initiatives, the Reserve Bank examined the implications of States' contingent liabilities/guarantees on their finances and set up funds to build cushions for repayments of loans and guarantees. It also played an active role in designing 'Model Fiscal Responsibility Legislation' for the States, which paved the way for the introduction of fiscal rules at the State government level under their FRBM Acts. Several of these initiatives were the outcome of intensive discussions at the interactive platform provided by the Reserve Bank in the form of Conference of State Finance Secretaries. Various facets of the Reserve Bank's role in State finances during the post-reform period are discussed below.

Volume of Budgetary Transactions becomes determinant of stipulated level of minimum balances and normal WMA Limits

7.26 The Reserve Bank revised the WMA Scheme for the State governments from time to time, taking into account their fiscal situation, financial and institutional developments, and the objective of co-ordinating monetary and fiscal policies. The persistent recourse to WMAs/ODs by the States necessitated re-examination of the practice of linking normal WMA limits to stipulated levels of minimum balances, when the latter had remained unchanged since 1976. Persistent WMAs reflected a combination of liquidity mismatches and underlying structural imbalances. The Informal Advisory Committee on Ways and Means Advances,1999 (Chairman: Shri B.P.R. Vithal) (Vithal Committee) noted that the size of WMA expressed as a multiple of minimum balances did not capture the differing needs of the States as evident from the size of their budgetary transactions. Accordingly, the Vithal Committee recommended that the normal WMA limits be linked to the sum of revenue receipts and capital expenditure. It also recommended increasing the level of minimum balances by linking it to the same base as was applicable to normal WMA limits, *albeit* with a lower ratio. These recommendations were accepted by the Reserve Bank. As the States continued their demand for a higher quantum of WMAs, normal WMA limits were further revised upwards by a similar magnitude across non-special and special category States based on the recommendations of the Informal Group of State Finance Secretaries in 2001 and 2002. It may, however, be noted that while the minimum balances of the States continued to remain at the absolute level stipulated by the Vithal Committee, the normal WMA limits were revised over the years. Subsequently, the Advisory Committee on WMA to State governments (Chairman: Shri C.Ramachandran, 2003) pointed out that the inclusion of capital expenditure in the base for linking normal WMA limits caused distortions. It, therefore, recommended linking of normal WMA limits exclusively to revenue receipts, as this proxy indicator was considered relatively transparent, simpler to calculate and also a proper measure of the repayment capacity of the States. Accordingly, its recommendations were accepted (Table VII.2).

7.27 The year 2004-05 marked a turning point in State finances against the backdrop of the incentivised process of rule-based fiscal consolidation at the State government level, guided by the recommendations of the Twelfth Finance Commission (TwFC) and the implementation of the Debt Swap Scheme (DSS). In the wake of improved State finances, the Advisory Committee to review the WMA Scheme (Chairman: Shri M. P. Bezbaruah, 2005) recommended that total expenditure could be used as the base for fixing normal WMA limits for revenue surplus States. Total expenditure was found to be a suitable proxy to capture total budgetary transactions, which would not be affected by computational differences in classifying capital expenditures across States. The total expenditure was to exclude repayments, lottery expenditure and one-time *ad hoc* expenditure. For States that had a revenue deficit, the Committee recommended that the base should also exclude the revenue deficit.

Table VII.2: Salient Features of WMA Scheme of the State Governments

Item	Just Prior to Vithal Committee (1998)	Vithal Committee (1999)	Group of Finance Secretaries (2002)	Ramachandran Committee (2003)	Bezbaruah Committee (2005)
Methodology for Computation of Limit	Expressed 168 times the minimum balances of the States	Average of revenue receipts and capital expenditure of the latest three years multiplied by a ratio of 2.25 for non-special category States and 2.75 for special category States	Average of revenue receipts and capital expenditure of the latest three years multiplied by a ratio of 2.4 for non-special category States and 2.9 for special category States	Average of only revenue receipts of latest three years multiplied by a ratio of 3.19 for non-special category States and 3.84 for special category States	Multiplying ratios of 3.1 per cent and 4.1 per cent to the average of the total (revenueplus capital expenditure excluding repayments and adjusted for onetime*ad hoc* expenditures and lottery expenditure) expenditure for the three years in respect of Non-Special Category States and Special Category States, respectively a State has revenue deficit, the base should exclude the revenue deficit.
Aggregate Normal WMA Limits	₹22.34 billion	₹39.41 billion	₹60.35 billion	₹71.70 billion	₹98.75 billion @
i) Non-Special Category States	₹20.33 billion	₹35.89 billion	₹53.85 billion	₹64.45 billion	₹88.20 billion @
ii) Special Category States	₹2.01 billion	₹3.52 billion	₹6.50 billion	₹7.25 billion	₹10.55 billion @
Rate of Interest	Bank Rate	Bank Rate	Bank Rate	Bank Rate for the period of 1-90 days and 1 per cent above the Bank Rate for the period beyond 90 days.	Repo Rate for the period of 1-90 days and 1 per cent above the Repo Rate for the period beyond 90 days.
Special WMA					
Computation of limits (Margin)	Limits were placed at 64 times the minimum balances	15 per cent* 10 per cent**	15 per cent* 10 per cent**	5 per cent uniformly	5 per cent uniformly (no change)
Rate of Interest	Bank Rate	Bank Rate	Bank Rate	1 per cent below the Bank Rate	1 per cent below the Repo Rate
Use of Special WMA	This is availed of after Normal WMA	This is availed for after Normal WMA	This is availed of after Normal WMA	To be availed of before utilising Normal WMA limit	To be availed of before Normal WMA
Overdraft Regulation Scheme					
No. of consecutive Working Days a State can be under OD (excluding holidays)	10	10	12	14	14 (No change)

Table VII.2: Salient Features of WMA Scheme of the State Governments *(Contd.)*

Item	Just Prior to Vithal Committee (1998)	Vithal Committee (1999)	Group of Finance Secretaries (2002)	Ramachandran Committee (2003)	Bezbaruah Committee (2005)
No. of working days in a quarter a State can be in OD	-	-	-	36	36 (No change)
No. of consecutive working days OD can be in excess of the Normal WMA limit	-	3	5	5	5 (No change)
Rate of Interest	Bank Rate *plus* 2 per cent	Bank Rate *plus* 2 per cent	Bank Rate *plus* 2 per cent	OD up to 100 per cent of Normal WMA at 3 per cent above the Bank Rate and for OD exceeding 100 per cent of Normal WMA at 6 per cent above the Bank Rate	OD up to 100 per cent of Normal WMA at 2 percentage points above the Repo Rate and for OD exceeding 100 per cent of Normal WMA at 5 percentage points above the Repo Rate

@ Present limits of Normal WMA for all States (including U.T. of Puducherry), for non-Special Category States and for Special Category States were fixed at ₹102.4 billion, ₹88.2 billion and ₹13.7 billion, respectively, effective April 1, 2011.
* For securities with residual maturity of more than 10 years.
** For securities with residual maturity of less than 10 years.
Source: Report of the Advisory Committee on Ways and Means Advances to State Governments, 2005 (Chairman: M.P. Bezbaruah).

Liberalisation of upper limit on Special WMA to encourage building up of reserves

7.28 The limits under the special WMA scheme during the period 1967-1998 were linked to the minimum balances instead of the underlying collateral of Central government securities held by them. Consequently, although the limits were raised, the States could not fully utilise the sanctioned limits, since their holding of underlying collaterals remained at a much lower level, thereby restricting their operative limits. Accordingly, Vithal Committee argued in favour of States' investing in Central government securities up to the permissible amounts which could be liquidated for meeting unforeseen contingencies. Therefore, the Committee recommended linking special WMAs to actual holding of Central government securities and liberalisation of upper limits, thereby encouraging the States to build up reserves in the form of these securities. However, the Committee stipulated provision for margins (10-15 per cent on the market price) against price risk, with a higher margin for securities of residual maturity in excess of 10 years. Subsequently, the special WMA scheme was further liberalised in accordance with the recommendations of the Ramachandaran Committee, whereby a lower and uniform margin (5 per cent) was stipulated, based on investments in unencumbered securities, with the condition that special WMA be availed of before utilising the normal WMA limit. The Bezbaruah Committee further liberalised the scheme by making available net incremental investments in CSF and GRF eligible for availing of special WMA. However, this required that the necessary provisions in this regard be incorporated by the States in their CSF/GRF schemes.

OD regulation restricting longer period borrowings without disrupting essential operations

7.29 To strengthen financial discipline at the State level, the overdraft regulation scheme was made

stringent over the years through restrictions such as stopping payments in case the State remains in OD beyond the stipulated number of working days. However, in the 1990s, considering the representations from certain State governments, the Reserve Bank had enhanced the period for which a State government could run OD so that the essential operations of the States do not get unduly disrupted. Nonetheless, the Advisory Committees on WMAs/ODs continued to work towards stipulating new restrictions to check the extent and frequency of States' recourse to ODs so that the use of OD by the States remains under control. Accordingly, the additional stipulation relating to the number of consecutive working days that States can remain in OD in excess of normal WMA limits as well as the permissable number of days for ODs during a quarter were introduced.

Move towards Interest Rates more reflective of short-term market conditions and policy rates

7.30 The interest rates on WMA (both special and normal) and OD were protected from changes in the Bank Rate by varying their spreads over the Bank rates during the late 1990s. Subsequently, in order to use interest rate as a deterrent for persistent WMA, the interest rates on normal WMA were applied on a graduated scale and were charged based on the duration of the advance, with normal WMA beyond 90 days attracting a rate higher than the Bank Rate. The interest rates in respect of ODs were charged based on the magnitude of these advances and their spreads over the Bank Rate were made more progressive. On the other hand, the interest rate on special WMA was lowered below the interest rate on normal WMA to encourage the States to build up reserves in the form of investment in Central government securities. With the repo rate becoming an indicator of short term policy rate and more reflective of market conditions, the interest rates on WMA (normal and special)/ODs were linked to the repo rate.

Transition in liquidity positions of States from deficit to surplus cash balances pose new challenges to monetary management

7.31 The commencement of a rule-based fiscal consolidation from 2004-05 onwards engendered a shift in the short-term liquidity position of the State governments. The improvement in State government finances was due to several factors. First, the incentivised fiscal roadmap recommended by the TwFC made the States eligible for availing the Debt Consolidation and Relief Facility (DCRF) scheme as and when they enacted their FRBM Acts. Second, the Debt Swap Scheme (DSS), operative between 2002-03 and 2004-05, helped the States to swap their high cost debt owed to the Central government with low cost market borrowings/NSSF so as to benefit from the interest rate downturn. Third, pension expenditures of the States also moderated reflecting, *inter alia*, the implementation of the new pension scheme by most of the States. Fourth, tax buoyancy of the States – both own taxes and tax devolution from the Centre – improved, supported by the acceleration in economic growth. The improvement in States' own tax buoyancy was further aided by the implementation of VAT in *lieu* of sales tax. These factors enabled a turnaround in the revenue account from a deficit to a surplus position by 2006-07, both at the consolidated level as well as at the individual state level for most States. This improvement in revenue account of the States coincided with large autonomous inflows from NSSF collections, resulting in an accumulation of cash balances by the States as opposed to their earlier practice of taking frequent recourse to WMAs/ODs to meet their expenditure requirements. The cash balances of the States continued to build up since 2004-05, despite a shortfall in NSSF inflows in 2007-08 and 2008-09, reflecting the tendency of States to avoid recourse to WMAs/ODs. The surplus cash balances of the States stood at ₹852 billion as at March 11, 2012. These cash balances get automatically invested in the Central government's 14-day intermediate treasury bills as well as in auction treasury bills (ATBs) where States

are non-competitive bidders, without any ceilings/ limits. Consequently, there is a spillover of the surplus position of the States to the liquidity position of the Centre. The build-up (and volatility) of the Central government's cash surplus, in turn, reflects the unintended absorption of liquidity from the banking system which poses a challenge to the Reserve Bank's monetary management. The ThFC, therefore, advised the State governments to first utilise their cash balances before taking recourse to fresh borrowings, to finance their deficits so as to reduce the interest burden. Nonetheless, as advised by the Reserve Bank from time to time, there is no substitute for adopting an effective forecasting and monitoring mechanism of cash flows by the States to address the issue of negative carry[20] on their surplus cash balances.

Focus on greater market access for resources: Sequential Evolution of Market borrowings

7.32 The Reserve Bank's conduct of market borrowings of State governments has evolved sequentially from a completely administered system (traditional tranche method) prevailing till 1998, whereby the market borrowings of all the States were generally completed during the year in two or more tranches through issuances of bonds with pre-determined coupon and pre-notified amounts for each State. During 1998-99, the States were permitted to access the market individually through the auction method (with a predetermined notified amount but without predetermined coupons) to raise between 5-35 per cent of allocated market borrowings, or the tap method (with predetermined coupons but without a predetermined notified amount), thereby providing scope for better managed States to raise resources at market rates. Nonetheless, some States continued to prefer the traditional tranche method. To address the risk of under-subscription faced by some States, 'umbrella tranche' method was introduced during 2001-02, whereby the total targeted amount at pre-determined coupons was indicated without notifying the amounts for individual States. The limit for utilising the auction option was raised to 50 per cent in 2002-03, before the States were eventually allowed to raise their entire market borrowings through auctioning of State Development Loans (SDLs) from 2006-07. After having a system of fixed coupon spreads (raised from 25 basis points to 50 basis points in 2001), the complete switchover to the auction system enabled the market determination of spreads.

Operation of Debt Swap Scheme enabled substitution of existing high cost loans with fresh low cost market borrowings and small savings

7.33 In view of the mounting interest burden and also to supplement the efforts of States towards fiscal management, the Central government formulated the DSS allowing States to prepay the high cost loans from the Central government, contracted at interest rates of 13 per cent and above, through the low cost borrowings such as small savings and market loans. Accordingly, these loans were swapped through additional market borrowings (allocated under the DSS in addition to the normal borrowing allocations of the States) and net small savings proceeds at the prevailing administered interest rates, over a period of three years ending in 2004-05. The total debt swapped during 2002-03 to 2004-05 amounted to ₹1,020.34 billion, of which ₹535.66 billion (52.5 per cent) was swapped through additional market borrowings at interest rates below 6.5 per cent, *i.e.,* at less than half the earlier cost.

Introduction of innovative practices aimed at wider base of investors and reduction in cost of borrowings

7.34 During recent years, for the States' debt management the Reserve Bank has enabled the use of various innovative practices aimed at minimising interest burden and widening the investor base for State government securities. Towards effective cash management, the Reserve Bank introduced the buy-back scheme for State government loans. Under the

[20] The rate of discount on ITBs is one per cent less than Bank Rate, which is lower than the interest paid out on market borrowings and small savings.

Scheme, States were allowed to prepay their outstanding SDLs through buy-back auctions to reduce their future coupon payment liabilities. The buy-back auctions were conducted for two State Governments during 2006-07. Second, to widen the scope of participation of retail investors in SDLs, the non-competitive bidding facility was introduced in August 2009. Third, embedded derivative options in the issuance of SDLs, which is an innovative way of price discovery and reducing the States' cost of borrowings, was introduced in September 2009. Finally, based on the recommendation of the Working Group on Liquidity of State Government Securities (Chairman: Shri V.K. Sharma), SDLs have been made eligible for repo transaction under the liquidity adjustment facility.

Discontinuance of Centre as intermediary for State market borrowings necessitated measures for better planning and transparency in issuance of SDLs

7.35 The TwFC marked a turning point in the borrowing arrangements of the States by discontinuing the system of the Centre acting as an intermediary in raising loans for the States. However, this transition called for an additional responsibility for the Reserve Bank to develop a market for State government borrowings so as to enable them to raise funds from the market directly in a smooth manner. Accordingly, as recommended by the Technical Group (Chairperson: Smt. Shyamala Gopinath), the Standing Technical Committee on State government borrowings was constituted in December 2006 to make annual projections of the borrowing requirements of the State governments, taking cognisance of evolving macroeconomic and financial conditions, the sustainability of debt, and the provisions of fiscal responsibility legislations. It may, however, be noted that the traditional role of the Centre in intermediating the external assistance by multilateral agencies for the States has been continued, although it is being passed to the States on a back-to-back basis since April 2005, whereby States bear the foreign exchange risk. In this regard, the Reserve Bank also organised a workshop in May 2007 to sensitise the States on the management of foreign exchange risk. The Reserve Bank has also been working towards issuance of indicative calendars for State governments to improve transparency and for better planning of their market borrowings. So far, indicative calendars were announced in September 2007 and June 2008 detailing net allocation, maturities, amount raised and the amount that could be raised during the remaining period of the year.

Reserve Bank's initiatives in developing deep, wide and secured government securities market facilitated the States' smooth switch over to direct open market borrowings

7.36 In line with other countries, the Reserve Bank has been taking a series of initiatives to develop the government securities market since the early 1990s when it had deregulated the system of administered price and quantity controls. The landmarks in fiscal-monetary coordination, such as phasing out the automatic monetisation of Central government's fiscal deficits from April 1997 and prohibition of the Reserve Bank's participation in primary government securities market from April 2006, acted as key catalysts in developing this segment of the financial market. Over the years, the measures have led to deepening of government securities market, leading to a significant transformation in various dimensions, *viz*., market-based price discovery, widening of the investor base, introduction of new instruments, establishment of primary dealers (PDs), and setting up of electronic trading and settlement infrastructure. With the various market development measures, the market has witnessed entry of smaller entities, such as co-operative banks, and small Pension and other Funds. To increase awareness about the government securities market amongst small investors, the Reserve Bank has arranged workshops on the basic concepts relating

to fixed income securities/bonds, existing trading and investment practices, and the related regulatory aspects and guidelines. The non-competitive bidding facility, which was introduced for auctions of Central government securities in 2002, was extended to auctions of State government securities in 2009 to facilitate the participation of retail investors, thereby widening the investor base. The investment limit on government securities for Foreign Institutional Investors (FIIs) has been enhanced to accommodate greater foreign participation.

7.37 A fast, transparent and efficient clearing system constitutes the basic foundation of a well-developed secondary market in government securities. Towards this goal, during the initial phase, the Reserve Bank introduced dematerialisation of government securities in the form of Subsidiary General Ledger (SGL) to enable holding of securities in an electronic book entry form and operationalised the Delivery *versus* Payments (D*v*P) system (in 1995) to synchronise the transfer of securities with cash payments, thereby eliminating settlement risk in securities transactions. Under the present system, banks, financial institutions, insurance companies and PDs are allowed to hold twin accounts, *viz.*, security accounts (SGL) and current accounts for cash. For these participants, the settlement is done through the D*v*P system. Other participants, who are not allowed to hold direct SGL accounts with the Reserve Bank, can operate *via* the constituents' SGL account maintained by SGL account holders. A landmark initiative in developing market infrastructure to ensure guaranteed settlement was taken when Clearing Corporation of India Limited (CCIL) was established on February 15, 2002 to act as the clearing house and as a central counterparty through novation for transactions in government securities, thereby seeking to impart considerable stability to the government securities market. Through the multilateral netting arrangement, this mechanism has reduced funding requirements from gross to net basis, thereby reducing liquidity risk and greatly mitigating counterparty credit risk. All transactions in government securities concluded or reported on Negotiated Dealing System (NDS) as well as transactions on the NDS-OM have to be necessarily settled through the CCIL. As a step towards introducing the National Settlement System (NSS) to centrally settle the clearing positions of various clearing houses, the integration of the integrated accounting system (IAS) with the real time gross settlement system (RTGS) was initiated in August 2006. This facilitated the settlement of various CCIL-operated clearing through multilateral net settlement batch (MNSB) mode in the RTGS in Mumbai.

Reserve Bank's Advisory Role on guarantees and pension liabilities helps to contain their adverse impact on State finances

7.38 The Reserve Bank in its advisory capacity has been sensitising the States to various issues of contemporary concerns that have a bearing on their finances. The genesis of concern with respect to guarantees dates back to 1999 when their magnitude rose substantially in the wake of the poor fiscal position of the States which hampered the provision of direct financial support to the State PSUs. Accordingly, the Reserve Bank constituted a *Technical Committee on State Government Guarantees* to examine all aspects of the issue of State government guarantees. The Committee stipulated a ceiling on the guarantees and recommended setting up of a Guarantee Redemption Fund (GRF) to provide a cushion to service contingent liability arising from invocation of guarantees. As per the scheme introduced in 2001, the States had to contribute an amount equal to 1/5th of the outstanding invoked guarantees and likely invocation as a result of incremental guarantees issued during the year. In line with the recommendations of the TwFC and Bezbaruah Committee, the scheme was revised from 2006-07 to make the net incremental annual investment in GRF eligible for availing of the special WMA. Accordingly, several State governments

stipulated a ceiling on their guarantees and set up GRFs. This resulted in a reduction in outstanding guarantees for States from 8.0 per cent of GDP in 2000-01 to 2.8 per cent in 2009-10. By February 2012, 10 State Governments, including five continuing with the old scheme, had notified the GRF scheme. The outstanding investment under the GRF scheme stood at around ₹40 billion in February 2012.

7.39 Following the recommendations of the Tenth Finance Commission (1995) and subsequent discussions with the State governments, the Reserve Bank also enabled the creation of a Consolidated Sinking Fund (CSF) in 1999 to provide the States with a cushion for repayment of open market loans, whereby the States were to contribute 1-3 per cent of their outstanding open market loans as at the end of the previous year. Subsequently, based on the recommendations of the Bezbaruah Committee, the ambit of the CSF was expanded in 2006-07 to include amortisation of all the liabilities with the stipulated contribution of minimum 0.5 per cent of the outstanding liabilities of the State as at the end of the preceding financial year. By February 2012, 20 State governments, including U.T. of Puducherry (including four continuing with the old scheme) had notified the CSF scheme. The revised CSF scheme also stipulates a 5-year lock-in period. The aggregate outstanding investments in CSF were placed at ₹415 billion in February 2012. Both the CSF and the GRF are being administered by the Central Accounts Section of the Reserve Bank at Nagpur.

7.40 The implementation of the Fifth Pay Commission at the State level resulted in a considerable fiscal stress on the States, not only through an increase in expenditure on wages and salaries but also through significantly higher expenditure on pensions. The consolidated pension expenditure for all States doubled to 1.2 per cent of GDP between 1990-91 and 1999-2000, thereby increasing the pre-emption of revenue receipts for meeting pension liabilities to 11.2 per cent from 5.4 per cent in 1990-91.

7.41 Recognising the unfunded and non-contributory nature of the prevailing pension scheme and its implications for State government finances, a *Group to Study Pension Liabilities of the State Governments* (Chairman: Shri B.K. Bhattacharya) was constituted in 2003. The group recommended a contributory pension scheme for new employees based on a mix of defined contribution and benefit schemes as also funding of pension obligations. Subsequently, 20 States introduced the New Pension Scheme (NPS) for their employees. Consequently, the pension liabilities, relative to GDP, have remained under control, notwithstanding the implementation of the Sixth Pay Commission award unlike the situation experienced during the Fifth Pay Commission award.

7.42 In view of the substantial differences in the definition and coverage of liabilities in the publications presenting States liabilities and the need for reliable and credible statistics on public debt comparable across States, the Working Group on Compilation of State Government Liabilities was constituted in the Reserve Bank in 2006. Based on the recommendations of this Group, the coverage of liabilities of the State governments has become more comprehensive, as data were culled out from various sources while ensuring that the compilation of States' liabilities was consistent with gross fiscal deficit.

Reserve Bank facilitated introduction of Fiscal Responsibility and Budget Management Acts by the States

7.43 The Reserve Bank also catalysed the introduction of rule-based fiscal consolidation at the State government level by providing technical guidance under the aegis of the Group on Model Fiscal Responsibility Legislation (FRL) at the State Level constituted in October 2003. The Group provided guidance for enacting the FRLs of the States by designing a model FRL bill based on international best practices. The Group's FRL Bill was quite comprehensive in setting out the objectives and principles of sound fiscal management. It

recommended the elimination of revenue deficit and containment of fiscal deficit to sustainable levels. It suggested that the bill should reflect the policies being pursued by the State for raising non-tax revenues and prioritising capital expenditure to provide impetus for economic growth. It placed emphasis on key fiscal management principles pertaining to transparency, stability and predictability, responsibility and integrity, fairness and efficiency. It suggested that the FRL bill should also include fiscal policy statements on the macroeconomic framework, medium-term fiscal policy and fiscal policy strategy. The Group recommended disclosure statements on key fiscal indicators. The model bill took into account the disclosure requirements which were recommended by the *Core Group on Voluntary Disclosure Norms* for State governments. The model bill facilitated the State governments in formulating their FRBM Acts. All the State governments have enacted their FRBM Acts.

Reserve Bank's Conference of State Finance Secretaries provides regular platform of interaction on issues of State finances

7.44 The Reserve Bank has been organising Conferences of State Finance Secretaries in a structured manner since 1997, where a consensual approach among the Central Government, State governments and the Reserve Bank has evolved on issues relating to State finances. Over the years, the Conference has provided a very useful forum for interactions among State Finance Secretaries, senior officials of the Government of India, the CGA, the Planning Commission, the Finance Commission, the Comptroller and Auditor General and the Reserve Bank.

Reserve Bank's dissemination of information on State Finances has progressively become more comprehensive

7.45 The Reserve Bank disseminated data on State finances as an article in the RBI Monthly Bulletin from 1950-51 to 1998-99. However, from 1999-2000, this has been replaced by an annual publication *'State Finances: A Study of Budgets'*, which provides as analytical presentation of State finances at the consolidated as well as at the individual State level. The analysis, orientation, coverage and format of the report have been restructured periodically to make it more contemporary. The overall purpose has been to present a detailed and critical assessment of various developments and other issues that have a significant bearing on the finances of State governments. Since 2005-06, the analytical content of the report has been further improved by incorporating a theme-based chapter that covers specific aspects of State finances from a medium-term perspective. Such special theme-based chapters covered in the past five years include 'Outstanding Liabilities of State Governments', 'Social Sector Expenditure', 'Fiscal Transfers to State governments', 'Revenue Receipts of State Governments: Trend and Composition', 'Expenditure of State Governments: Trend and Composition' and 'Finance Commissions in India: An Assessment'. To facilitate research in the area of State finances, the Reserve Bank provided access to all the articles published from 1950-51 to 2010-11 by releasing 'Compendium of Articles on State Finances (1950-51 to 2010-11),' in the form of a CD.

7.46 To provide time series data on State government finances, the Reserve Bank brought out a publication titled *'Handbook of Statistics on State Government Finances'* in 2004, which was revised/expanded in 2010. This publication, which provides time series disaggregated data on consolidated as well as State-wise transactions in the revenue and capital accounts of 28 State governments and two Union Territories, is a major initiative by Reserve Bank to improve data dissemination on the finances of State governments. The Handbook has been released in CD and web versions as well as in print form for wider dissemination.

5. Impact of Reserve Bank's role on State Finances: Overall Assessment

Improvement in short term fiscal management of States

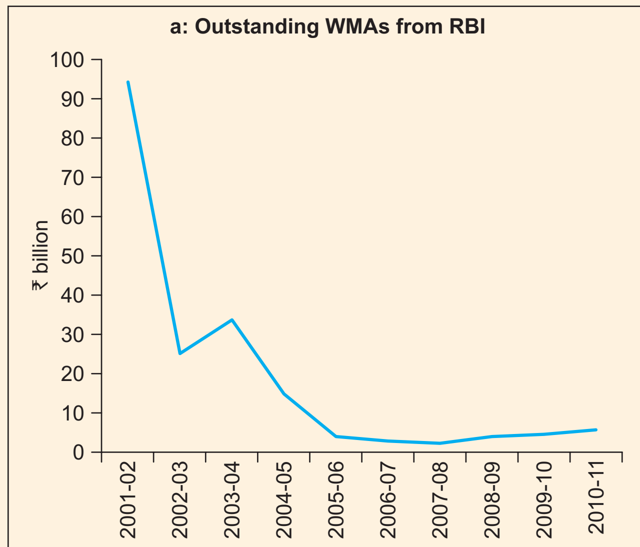
7.47 Systematic reforms in the conduct of financial arrangements of States initiated by the Reserve Bank, based on the recommendations of advisory committees as also the introduction of the rule-based fiscal consolidation, have led to a structural improvement in the short-term fiscal management of the States. The occasions of temporary liquidity mismatches have progressively reduced particularly, from 2005-06 onwards. On the contrary, an improvement in the fiscal position of States as reflected in their surplus cash balances, posed a challenge for managing these cash balances which were invested in 14-day intermediate treasury bills and auction treasury bills (Chart VII.1a & b).

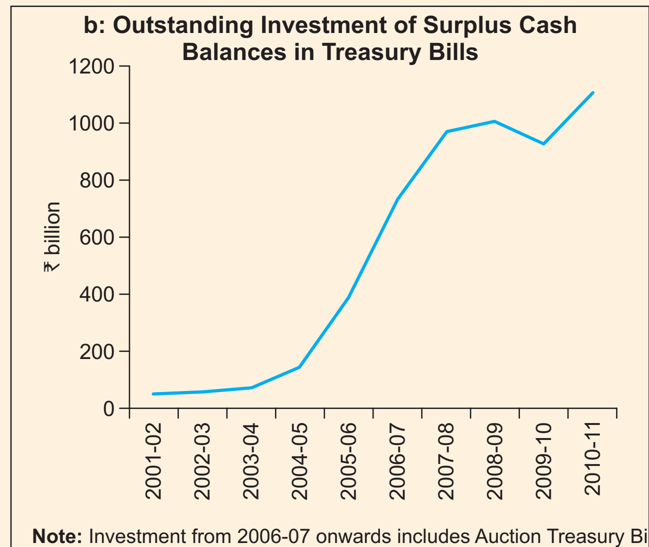
Reducing fiscal imbalances and rising proportion of market borrowings

7.48 The evolution of State government finances since the 1990s can broadly be divided into four phases, *viz.,* (i) 1990-91 to 1997-98, (ii) 1998-99 to 2003-04, (iii) 2004-05 to 2006-07 and (iv) 2007-08 to 2011-12(BE). During the first phase (1990-91 to1997-98), fiscal imbalances persisted, although the consolidated fiscal deficit-GDP ratio remained contained marginally below 3 per cent. The fiscal deficits of States were essentially financed through loans from the Centre and small savings collections earmarked for the States were also intermediated through these loans. Market borrowings played a subordinate role and its share in the fiscal deficit of the States remained quite low. Consequently, the Reserve Bank completed the market borrowings of all the States in a combined fashion, generally in two or more tranches through issuance of State Development Loans at pre-determined coupon and notified amounts for each State.

7.49 During the second phase (1998-99 to 2003-04), the fiscal deficit-GDP ratio of the States reached a historical peak, crossing 4 per cent, on account of higher expenditures related to the implementation of the Fifth Pay Commission award and deceleration in State government revenues due to economic slowdown. The National Small Savings Fund (NSSF) was established in 1999 to mobilise small savings and direct them to the Central and the State governments through investments in their

Chart VII.1: Outstanding WMAs and Investment in Treasury Bills (as at end-March)





Note: Investment from 2006-07 onwards includes Auction Treasury Bills.

special securities. Consequently, small savings collections, instead of being intermediated by the Centre, were channelised through NSSF's investments in special securities issued by the States for financing their fiscal deficits[21]. During this phase, the NSSF's investments became the dominant source of financing fiscal deficit. The States were allowed to use the auction mode, *albeit* to a limited extent, for accessing market borrowings. Market borrowings, as a source of financing fiscal deficit for the States, increased in importance by 2003-04.

7.50 The third phase (2004-05 to 2006-07) saw operationalisation of fiscal rules by most of the States which led to a decline in their fiscal deficit-GSDP ratios. There was an increase in small saving collections during this phase and the States had to absorb the predominant share[22] of small savings collections earmarked to them, regardless of the cost of borrowings. As a result, the States' recourse to market borrowings for financing fiscal deficits declined during this phase (Chart VII.2). By 2006-07, the States were allowed to raise market borrowings completely through the auction route so as to allow market determination of yields on their SDLs.

7.51 With market access for States switching completely to the auction-mode, market borrowings steadily grew in importance for financing fiscal deficits during the fourth phase [2008-09 to 2011-12(BE)]. Consequently, the States were able to meet the enhanced requirements during 2008-09 to 2009-10 for implementing the Sixth Pay Commission award and fiscal stimulus measures, particularly in the wake of shortfall in small savings collections. Even after the States reverted to fiscal correction from 2010-11 the importance of market borrowings continued, as small saving collections remained low. During this

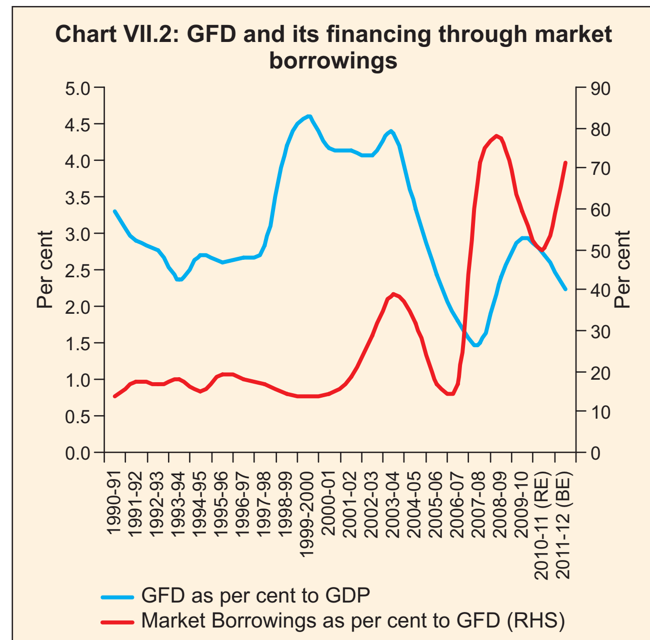


Chart VII.2: GFD and its financing through market borrowings

phase, market borrowings have emerged as a dominant source of financing and, on an average, accounted for around 65 per cent of GFD (Chart VII.2).

Comparative cost advantage of market borrowings relative to administered cost of NSSF loans

7.52 Cost minimisation has continued to remain a key objective of the Reserve Bank in the management of market borrowings of the States. The States have benefited in terms of lower interest cost on market borrowings, as the timing of the issuance of state government securities was modulated in line with market conditions to minimise interest costs during the first half of the decade of the 2000s. However, the interest rate on securities issued to the NSSF remained quite rigid and turned out to be higher than the weighted average interest rate on market borrowings (Chart VII.3). The interest rate on securities issued to the NSSF declined from 13.5 per cent in 1999-2000 to 9.5 per cent in 2003-04. While the interest rates on SDLs

[21] Since 1999-2000, the erstwhile loans received by the States from the Centre against small savings collections are substituted by investments made by the NSSF in special State Government securities and continue to form a part of the internal debt of the respective State governments.

[22] Investments by NSSF in special securities of the State and Central Governments were in the ratio of 80:20 between April 1999 and March 2002; 100:0 between April 2002 to March 2007 (part of the proceeds were used by the States to prepay their loans to the Centre under the debt swap scheme during 2002-03- 2004-05); at least 80 per cent from April 2007 and minimum 50 per cent from April 2012.

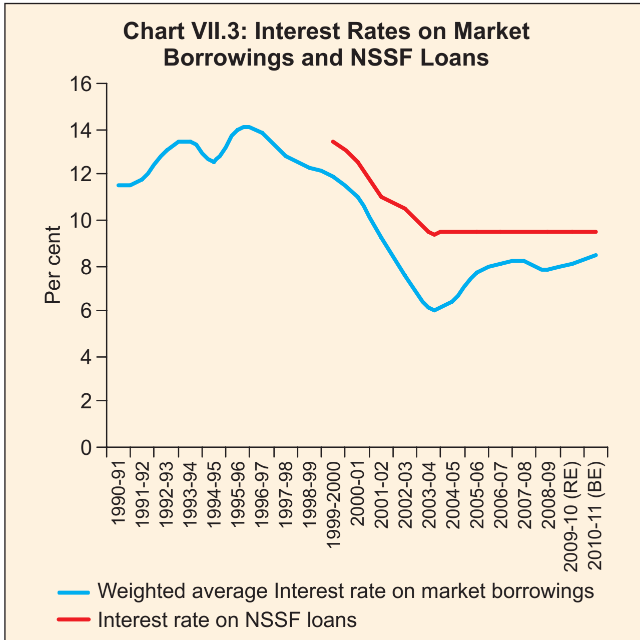


Chart VII.3: Interest Rates on Market Borrowings and NSSF Loans

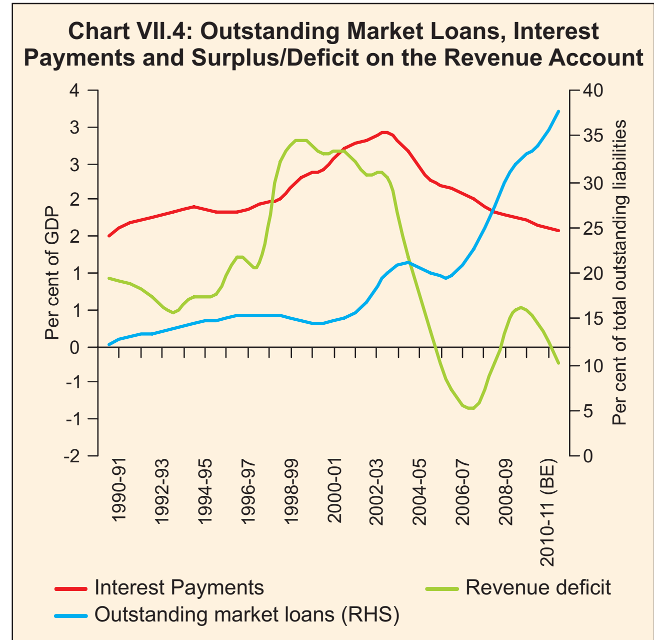


Chart VII.4: Outstanding Market Loans, Interest Payments and Surplus/Deficit on the Revenue Account

rose after 2005-06 in tandem with market conditions and enhanced market borrowings, the level remained much lower than that on securities issued to the NSSF. The weighted average interest rate on market borrowings declined from 11.9 per cent in 1999-2000 to 8.4 per cent during 2010-11.

Higher proportion of outstanding market loans reduced interest burden and led to revenue account correction

7.53 The share of market loans in the outstanding debt of the States increased by almost three times over the past two decades, as market borrowings emerged as the major source of financing their GFD. During 2002-03 to 2004-05, the sharp increase in the share of market loans in total debt of the States was attributable to DSS which was operational during this period (Chart VII.4). In recent years, market loans have increased due to four factors. First, there was a complete switchover to the auction route for market borrowings by the States from 2006-07 onwards. Second, the borrowing requirements of the States increased in 2008-09 due to higher GFD on account of the implementation of the Sixth Pay Commission award and fiscal stimulus expenditure undertaken to offset the impact of the global economic slowdown. Third, the smooth conduct of the market borrowing programme of the States at competitive rates encouraged the States to increase their access to the market. Fourth, market borrowing allocations were enhanced (2008-09 and 2009-10) due to the shortfall in net collections of small savings.

7.54 With the lower interest cost on market loans and the increasing share of market loans in total debt of the States, their interest burden declined from 2005-06 (Box VII.2). The swapping of high cost Central loans through market borrowings provided an additional benefit to the State governments. Furthermore, the conditional debt relief provided under the debt consolidation and relief facility recommended by the TwFC helped had to reduce the interest burden of the 26 States that had enacted their FRBMs. Consequently, the interest burden of the States declined from 2.9 per cent of GDP in 2003-04 to 1.6 per cent in 2011-12 and accounted for more than 100 per cent of the reduction in revenue expenditure. Thus, it contributed to 54 per cent of the correction in revenue account over the same period.

6. Concluding Observations and the Way Forward

7.55 An analysis of the Reserve Bank's role in the finances of State governments brings forth a number

Box VII.2: Recourse to Market Borrowings by the State Governments and Interest Burden

The Reserve Bank has pursued the development of the government securities market in a progressive manner beginning with the Central government securities market in the early 1990s and followed by State Development Loans (SDLs) from the late 1990s. One of the principal components of the financial liberalisation was the deregulation of interest rates. Interest rate deregulation was aimed at developing an efficient and competitive financial system to achieve allocative efficiency of available resources (Chakraborty, 2002). *As interest rates on SDLs became market determined and the States were allowed to switch to auction-based issuances of the SDLs, the share of market loans in their overall liabilities rose, thereby enabling them to vary their overall interest burden in tandem with market conditions. Apart from developing various segments of financial markets, conducive macroeconomic conditions as well as the Reserve Bank's appropriate management of liquidity in the face of capital flows during the greater part of the first decade of 2000s contributed to a softer interest rate structure, including a reduction in the weighted average yields of both Central and State government borrowings. Against this backdrop,* an exercise was conducted to assess whether softer interest rates have enabled the States to control their interest burden since 1990-91.

The total liabilities of the State government comprise market loans (ML) and rest of liabilities (RoL) including bonds, loans from banks and other financial institutions, small savings and various items relating to the public account. The share of ML in total liabilities for all States increased from 12.2 per cent during 1990-91 to 33.2 per cent during 2010-11. Correspondingly, the share of interest payments on ML in the overall interest payments rose from 15.5 per cent to 34.1 per cent. Accordingly, an exercise was conducted to study the relationship among total liabilities, total interest payments, MLs and interest payment on the MLs across 15 States within the non-special category over the period 1990-91 to 2010-11 with three new States being subsumed in their parent States so as to retain comparability. Special category States were omitted from the exercise as they remain largely dependent on resource transfers from the Centre. The period of study was divided in to three sub-periods, *viz.*, 1990-91 to 1999-2000, 2000-01 to 2005-06, and 2006-07 to 2010-11. While the first period saw the introduction of a deregulated interest rate environment, the second phase was characterised by prevalence of the debt-swap scheme, and the final phase covered a period of auction-based issuances of SDLs in a full-fledged manner.

The empirical analysis brings out several features relating to trends in interest payments across the three periods. First, in respect of all non-special category States, the effective interest rates on ML (ratio of interest outgo on ML to outstanding amount of ML) (at 9.7 per cent and 9.3 per cent) were higher than the effective interest rates on RoL (ratio of interest outgo on RoL to outstanding amount of RoL) (at 8.1 per cent and 8.4 per cent) during the first two sub-periods, respectively. By the third sub-period, however, the effective market interest rate on ML (at 7.2 per cent) became lower than that rate on remaining liabilities (7.3 per cent). Second, the dispersion of effective market interest rates across States was found to be lower than the dispersion of effective interest rates on remaining liabilities in all three sub-periods. Third, an analysis of the relationship between the share of ML in total liabilities and the effective rate of interest on total liabilities reveals that as the share of market liabilities rose during the first two sub-periods, it also led to an increase in overall effective interest rate per unit of liabilities. By the third sub-period, however, declining interest rates enabled the growing share of market loans to bring down the overall effective interest rate. Thus, as the share of ML increased from 14.2 per cent to 17.9 per cent and further to 25.9 per cent during the three sub-periods, the effective overall interest rate of all States considered in this exercise, after increasing marginally from 8.4 per cent to 8.5 per cent during the first two sub-periods, respectively, came down sharply to 7.2 per cent during the last sub-period. To sum up, the relationship between the share of market loans and effective interest rate thereon reveals a positive relationship for the first two periods as evident from the coefficient of correlation (r = 0.32 and r = 0.50), which, however, turns negative in the last period (r = - 0.52).

An OLS regression[23], based on pooled data for the States, was undertaken to assess the impact of the share of market loans in total liabilities (ML/OL ratio) on the effective rate of interest payment per unit of total liabilities (IP/OL ratio). It revealed that while the impact of increasing share of market loans to total liabilities was positive in the first two sub-periods, its impact became negative by the third sub-period. Thus, this exercise further strengthens the finding that although increasing recourse to market loans led to an increased interest burden in the administered regime, market development and implementation of rule-based fiscal discipline enabled the rising share of market loans to reduce the interest burden during the third sub-period.

The above findings corroborate the success achieved through the Reserve Bank's policy of progressively facilitating the access to the market for resources, thereby enabling them to address the critical pressure on their finances emerging from a rising interest burden. Furthermore, less dispersion of effective market interest rates across States as also narrowing of yield spreads of SDLs over Central government securities point to the significance of market factors in determining of effective interest rates for State government liabilities.

References:

Chakraborty, Lekha S.(2002**), '**Fiscal Deficit and Rate of Interest : An Econometric Analysis of the Deregulated Financial Regime', *Economic and Political Weekly*, May 11.

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of features. First, in its role as a banker to the States, the major landmarks over the years included extension of banking services to all the States; introduction of the secured advances in the form of special WMA, and modulation of the WMA limits and OD regulations by developing appropriate proxies of

[23] Estimated Equations:

First sub-period (1990-91 to 1999-2000): $IP/OL = 7.29 + 0.07*ML/OL$ $(3.62)^{\#}$

Second sub-period (2000-01 to 2005-06): $IP/OL = 8.01 + 0.04*ML/OL$ $(1.87)^{\#\#}$

Third sub- period (2006-07 to 2010-11) $IP/OL = 8.09 - 0.02*ML/OL$ $(-1.53)^{\#\#\#}$

Figures in parentheses indicate t-statistics whereby # represent significance at 1 per cent level, ## at 10 per cent level, and ### at 13 per cent level.

short-term resource requirements while ensuring that the fiscal discipline and monetary stability objectives were also achieved. These initiatives worked towards bringing about structural improvements in short-term fiscal management of the States. Second, as a debt manager of the States, the Reserve Bank became more active as it guided the gradual switch-over to auction-based market borrowings. This was, supported by structural reforms, liberalisation of the financial markets, the phasing out of automatic monetisation of Centre’s fiscal deficit and the introduction of a rule-based fiscal framework at both the Central and State government levels. The interest burden on State liabilities, as a consequence, declined, contributing to an improvement in the revenue account and the fiscal position of the States. Third, apart from its mandated roles, the post-reform period also saw the Reserve Bank playing an active advisory role in addressing fiscal concerns emerging from time to time.

7.56 Going forward, the Reserve Bank would progressively face new challenges in the area of State finances. First, with market borrowings becoming the predominant instrument of financing the fiscal deficits of the States, the Reserve Bank would assume a greater role in the management of overall debt. The Reserve Bank would, therefore, have to sensitise the States to build cushions for timely repayments of their future liabilities as also for unforeseen contingencies, which would be essential to maintain the confidence of investors in State government securities in a market-driven system. Second, with the increasing responsibilities of local governments, there would be a need to assess the likely impact of the developments in local finances on the health of the State governments. Furthermore, the financial health of State level undertakings including power utilities could impact not only the State finances but also increase the exposures of banks and financial institutions to these units. Third, with the growing demand for domestic credit by the private sector, the higher market borrowings of the States over and above that of the Central government may generate crowding-out pressures for undertaking private investment. In addressing these new challenges, the Reserve Bank's responses are expected to be guided by the primary objective of preserving monetary and financial stability in the coming years.