Summary Report of the Informal Advisory Committee on Ways and Means Advances to State Governments

Constitution of the Committee

An Informal Advisory Committee on Ways and Means Advances to State Governmetns was constituted by the Reserve Bank Governor on August 19, 1998 under the chairmanship of Shri B.P.R. Vithal, Member, Tenth Finance Commission on August 19, 1998 to go into the existing scheme of Ways and Means (Advances) to State Governments to consider rationalisation and if warranted, to suggest revision of limits, keeping in view the needs of the State Governments as also the issues relating to fiscal and monetary management. The Committee submitted its Report on November 25, 1998.

Agreements with States : Main Provisions

A State entrusts its banking business to the RBI by voluntarily entering into an agreement under Section 21A of the Reserve Bank of India Act, 1934. Twenty-three States entered in to such agreements with the RBI to undertake general banking business in India, including payments, receipts, collection, remittance of money, management of public debt and issue of new loans. Two States - Jammu & Kashmir and Sikkim - have agreements with the RBI only for the limited purpose of managing their public debt. The RBI is not entitled to any remuneration for the conduct of ordinary banking business other than the advantages which may accrue to it from the holding of their cash balances free of obligation to pay interest thereon. Maintenance of such interest-free balances are subject to periodic agreements between the States and the RBI. The RBI advises the States about their daily cash balance at the close of each working day.

Ways and Means Advances

Under Section 17(5) of RBI Act, 1934, the RBI provides Ways and Means Advances (WMA) to the States banking with it to help them to tide over temporary mismatches in the cash flow of their receipts and payments. Such advances, are under the Act, "..repayable in each case not later than three months from the date of making that advance". There are two types of WMA - normal and special. While normal WMA are clean advances, special WMA are secured advances provided against the pledge of Government of India dated securities. The operative limit for special WMA for a State is subject to its holdings of Central Government dated securities upto a maximum of limit sanctioned. In addition, the RBI has determined limits for normal and special WMA for each State as multiples of the prescribed minimum balance required to be maintained with the RBI by that State. These limits have been revised periodically. The present limits, effective from August 1, 1996, work out to an aggregate of Rs.3,085.60 crore - Rs.2,234.40 crore (normal WMA) and Rs.851.20 crore (special WMA). At the time of the last revision in 1996, the ceilings for normal and special WMA were fixed at 168 times and 64 times of the minimum balance of Rs.13.30 crore, respectively.

The minimum balances and limits for WMA (at amounts equal to their respective minimum balances) of States were fixed for the first time on April 1, 1937. The limits were fixed on the basis of the ratio of their total revenue and expenditure to the corresponding total of the

Centre prior to the introduction of provincial autonomy. The limits became effective from April 1, 1938, when the then provincial Governments became responsible for managing their own ways and means position. After the formation of the Part B States, in 1953, the minimum balances were revised in line with the growth in revenue receipts and expenditure in the intervening period. In the same year, the WMA limits were liberalised to twice the revised balances, and a special WMA facility against the pledge of Central Government securities was introduced for the first time. The special WMA was subject to a uniform Rs. 2 crore limit for each State. After 1953, in the two successive revisions in 1967 and 1972, the minimum balances were revised upwards as a multiple of the minimum balances fixed in 1953 and the WMA limits were liberalised by increasing the multiples of the revised minimum balances. From 1976 onwards, the minimum balances were not changed but the WMA limits were increased by increasing the multiple in successive revisions.

Overdraft Regulation Scheme

Any amount drawn by a State in excess of WMA is an overdraft. As per the Overdraft. Regulation Scheme, in force from October 2, 1985, no State was allowed to run an overdraft with the RBI for more than seven continuous working days. In case an overdraft appeared in the State's account and remained beyond seven continuous working days, the RBI and its agencies stopped payments on behalf of the State. On a further review of the Overdraft Regulation Scheme in 1993, the time limit for clearance of overdraft was increased from seven consecutive working days to ten consecutive working days with effect from November 1, 1993. This position continues.

At the instance of Governments of Assam and Manipur, RBI has agreed to a ceiling on their overdrafts at Rs.252 crore and Rs.10 crore, respectively. If this ceiling is exceeded even within a time frame of ten consecutive working days as stipulated under the Overdraft Regulation Scheme, the RBI suspends payments on behalf of these State Governments.

Monitoring of WMA Overdrafts and Enforcement of Stoppage of Payments

The position of WMA actually utilised and overdrafts of various States is closely monitored in the Internal Debt Management Cell (IDM Cell), RBI, on a daily basis on receipt of the position from Central Accounts Section (CAS), RBI, Nagpur. When a State avails of WMA in excess of ***75 per cent*** of the aggregate limit (aggregate = normal ***plus*** operative limit for special WMA), the State is cautioned to take remedial measures to avoid emergence of overdraft in its account. Whenever a State, after availing of normal and special WMA, emerges in overdraft the Reserve Bank of India (IDM Cell) conveys, by facsimile message, the position of its overdraft to the concerned State on a daily basis, with a request to clear it within a period not exceeding ten consecutive working days. If the account of a State continues to be overdrawn on the eleventh continuous working day, the RBI suspends payments on behalf of the State until the overdraft is cleared.

Interest Rate on WMA and Overdrafts

The interest rate charged on WMA and overdrafts at present are the Bank Rate (9 per cent) and the Bank Rate plus two percentage points (11 per cent), respectively.

Surplus Investments

The RBI acts as the sole agent for investment of the State's surplus funds. Surplus cash balance of a State beyond a level indicated by it is automatically invested in 14-day intermediate Treasury bills, on which, the rate of interest at present is 6 per cent. The States are also free to participate in 14-day and 91-day Treasury bills auctions as non-competitive bidders for investment of their durable surplus.

Growing fiscal stress

The use of WMA facility and emergence of overdrafts by States have become more frequent over time reflecting a persistent stress on liquidity management and the underlying structural imbalances in their finances. The continuing problems in the budgetary operations of the State Governments for 1998-99 have been described in the RBI Annual Report for 1997-98 (Paragraph 4.23, PP 63-66) as follows :

"A preliminary analysis of the consolidated budgetary position of twenty three State Governments reveals a rise in almost all the major deficit indicators. The deterioration in the State finances emanates from a lower growth of 14.6 per cent in revenue receipts in 1998-99 than that of 16.8 per cent in the previous year, and a sharp rise of 16.2 per cent in revenue expenditure on top of an increase of 17.4 per cent in 1997-98. As a consequence, there would be a marked rise in the revenue deficit to Rs.24,861 crore (1.5 per cent of GDP) in 1998-99 from Rs.19,053 crore (1.3 per cent of GDP) in the previous year. The widening of the revenue deficit would, in turn, cause the gross fiscal deficit (GFD) to go up sharply to Rs.56,660 crore (3.5 per cent of GDP) in 1998-99 from Rs.49,708 crore (3.5 per cent of GDP) in 1997-98. The sharp rise in revenue expenditure in 1998-99 would be mainly on account of the additional burden emanating from the implementation of the Fifth Pay Commission awards and the rising interest burden."

During 1997-98, of the ***sixteen*** States that resorted to overdrafts, there were ***ten*** States which frequently resorted to overdrafts. Out of these ***ten*** States, ***five*** (Assam, Himachal Pradesh, Manipur, Mizoram and Nagaland) belonged to the special category, while the other five (Andhra Pradesh, Madhya Pradesh, Orissa, Punjab and Rajasthan) were in non-special category States. In three States (Assam, Manipur and Mizoram), payments were stopped as they could not clear their overdrafts with the RBI within the stipulated time limit of ten consecutive working days. The problem was quite severe in Assam, with payments being stopped on as many as eight occasions.

During the first seven months (April-October) of 1998-99, ***sixteen*** State Governments were in overdrafts with ***ten*** States taking frequent recourse. Of these ten, five (Assam, Himachal Pradesh Manipur, Mizoram and Tripura) belonged to the special category and five (Andhra Pradesh, Madhya Pradesh, Orissa, Punjab, and Uttar Pradesh) were in the non-special category. In four States (Assam, Manipur, Mizoram and Nagaland), payments were stopped as they could not clear their overdrafts with the RBI within the stipulated time limit of ten consecutive working days.

An analysis of average levels of normal WMA, special WMA and overdrafts availed by the States indicates that during 1997-98, the peak level, on an average, was Rs.1,207 crore with variations of the peak between Rs.289 crore in June and Rs.2,337 in April. The peak level increased in the first seven months of 1998-99, with the peak varying between Rs.536 crore in May and Rs.2.660 crore in October and the average considerably higher at Rs.1,675 crore.

Under the existing system of WMA and overdrafts, there is no requirement to vacate the WMA drawn/overdrafts at the end of the financial year. This has encouraged some States to use WMA and overdrafts as a resource and has also led to difficulties in distinguishing between a temporary mismatch between cash receipts and cash expenditure and a manifestation of the underlying structural deficit. In the above context, the amounts held by the States in the public account also assumes critical importance. It is pertinent to note that the States receive public account funds in a role as a banker. It is, therefore, important that these funds are not used for financing a fiscal deficit. The public account funds do, however, provide a cushion to tide over temporary liquidity mismatches.

Liquidity mismatch *vis-a-vis* the underlying structural deficit

A liquidity mismatch is by definition an ***ex ante*** concept and hence, difficult to estimate. A Government can only spend as much cash as it has. Thus, even when the ***desired*** expenditure is in excess of the available funds, the observed outflow will only be equal to the cash revenues, including loan proceeds. In the WMA context, when a State is not in overdraft and has fully utilised its WMA limit, the mismatch between inflows and outflows will appear to equal the WMA limit, but this does not indicate that the ***true*** mismatch was exactly equal to the limit. The observed mismatches are not, therefore, the indicators of true mismatches.

Cash flow problems are inevitable in day-to-day budgetary transactions. States without any deficit can and do face liquidity problems during the year. However, in the case of States with deficits, the problems get aggravated because it is difficult to distinguish between a genuine temporary mismatch and a mismatch arising out of a deficit. A deficit implies that receipts falls short of expenditure at the end of the year. More often than not, this year-end shortfall reveals itself during the course of the year.

If a State has shown in its Budget a year ending revenue deficit, this has to be covered by borrowings so that there is no overall budgetary deficit. States like the special category ones have a revenue surplus arising out of the fact that 85-90 percent of Central Assistance is by way of grants. Yet, both types of States have run into overdrafts. Furthermore, with borrowings financing revenue deficits, no distinction remains between revenue and capital receipts. With no capital asset generating income even to meet its interest liability, the distinction between revenue and capital expenditure has also disappeared. In such a situation the States have become insensitive to the costs of overdrafts. When a State remains in overdraft for such long periods as 200 days in a year, WMA becomes a resource and the overdraft becomes the WMA. The only difference is that the constraint is no longer a financial limit but a time limit. The peak level is no longer determined as a financial limit that can be brought down within the WMA limit within ten consecutive working days. The WMA, which was expected to be the safety net to bridge the gulf between the timing of receipts and payments becomes the safety net between two spells of overdrafts. The crux of the matter is, therefore, not WMA, but the elimination of overdrafts. With the progressive deterioration in the fiscal balances of States over the years, there is a concern that the WMA limit, which is to meet temporary liquidity mismatches, is being used as a resource. This problem gets exacerbated by the growing differences between the Budget Estimates, Revised Estimates and Accounts in the Budget.

After considerable deliberations, the Committee came to the conclusion that in a situation of pervasive deficit problem, the identification of true mismatches, as distinct from the underlying deficit problem, is one without any easy solutions. Furthermore, given the important role played by the WMA limits and overdraft regulation in the enforcement of a hard budget constraint, the optimum solution is to assume a less than proportionate growth in the mismatches relative to some suitable measure of transactions volumes.

Asymmetry between Central and State Governments

The problem of liquidity management of the Centre and State is similar. Both of them maintain minimum balances with the RBI and avail of WMA from the RBI to tide over the mismatches between their receipts and expenditure. The State Finance Secretaries pointed out that there are two important asymmetries in the system of minimum balances, WMA and overdrafts operated by the RBI with Centre on the one hand and the States on the other. First, until March 1997, RBI did not have any formalised system of WMA for the Centre. The issue of ***ad hoc*** treasury bills and their placement with the RBI automatically made up any shortfall in the Centre's minimum balance although limits were placed on net creation of ***ad hocs*** during the fiscal years 1994-95 through 1996-97. This asymmetry has ended with the discontinuation of the ***ad hoc*** treasury bills from March 1997 and the announcement of specific WMA limits for the Centre for the two halves of the fiscal year. Second, the WMA limits for the Centre are higher than those for the States taken together although the size of their budgets are roughly the same.

A straightforward comparison of the WMA of the Centre and the States, however, can be misleading. Almost as much as forty per cent of total Central Government revenues are passed on to the States as shared revenues, grants and loans through devolution and transfers under the dispensations of the Finance and the Planning Commissions. Furthermore, the Central Government also provides ***ad hoc*** grants as well as temporary WMA to States. The nature of transactions of the Centre are not exactly similar to those of States. Therefore, a complete similarity of treatment is not possible.

The Committee would, however, like to emphasise that given the undeniable fact that the Centre has greater scope for managing its liquidity problem, it should be in a position to set an example to the States. Furthermore, it is understood that RBI is considering a proposal to further lower the WMA limits and have Overdraft Regulation Scheme for the Centre which is more or less similar to the existing one for States, thus, removing the anomaly between the two. The Committee commends this for early implementation.

Limiting overdrafts

The problem of unauthorised overdrafts has gradually worsened over time. During 1997-98, as many as sixteen States got into such overdrawn position, and the average peak level of overdraft alone was Rs.474 crore. In the current year upto October 1998, the same number of States, i.e., sixteen, were overdrawn and the average peak level was Rs. 784 crore.

The WMA itself is an overdraft facility designed to help the States to tide over temporary mismatch as between revenues and expenditures. With the objective of freeing States which were prudent, from the problems of overdrafts WMA limits were repeatedly enhanced in the past. But, the problem of overdrafts has persisted. The success achieved has been limited on account of deterioration in the State finances and worsening financial management. A mere revision of WMA limits alone, therefore, is no remedy to the problem of overdrafts. With effect from November 1, 1993, the increase in time limit for clearing overdrafts from seven to ten working days as against fourteen days recommended by the Sarkaria Commission was granted to allow for delays in reporting transactions and arrange for funds for clearing overdrafts. This, however, resulted in some States being encouraged to remain in overdrafts for longer period. In this context what is required are improvements in the information system, smooth release of Central assistance to States and enhanced efficiency of the banking and payments system. Furthermore, what is of paramount importance is that the States ensure good financial management and discipline.

Monetary implications of WMA and overdrafts to States

It is important to recognise that enhancement of WMA limits increases the potential for their utilisation. Furthermore, utilisation of WMA - both normal and special - and overdrafts has monetary implications. WMA and overdrafts represent RBI credit to Governments. Even the special WMA, where the RBI provides money to States against their holdings of Central Government securities, signifies an inter-Government loan which gets replaced by RBI credit. WMA or overdraft should only provide ***intra-year*** liquidity support without making any resources available for financing a deficit at the end of the year. Nevertheless, Committee would like to underscore that the average level of the money stock or reserve money has its impact on prices and output in an economy, and persistent use of WMA or overdrafts during the year has a monetary impact.

In the above context, it may, however, be observed that all the States combined together have not contributed much to monetary expansion in the economy. According to the available information, at end-March 1998, RBI credit to Government (both Central and States) amounted to Rs.1,35,160 crore with credit to Central Government at Rs.1,33,617 crore and States accounted for only the residual Rs.1,543 crore. The latest data indicate that net RBI credit to States as on October 30, 1998 amounted to Rs.766 crore. Furthermore, during the past five years, the monetised deficit (i.e. loans given to the States by the RBI net of their deposits with RBI) of States has varied between Rs.16 crore (1995-96) and Rs.898 crore (1996-97). In aggregate the States did not have any monetised deficit in 1997-98.

Recommendations of the Committee

The recommendations of the Committee broadly relate to the rationale for revision in WMA, liberalisation of special WMA limits, stricter measures for regulating overdrafts, investment of surplus balances, and the need for complementary measures such as improvement in banking transactions.

RATIONALE

Base for Revision

Although for the reasons discussed earlier, there is a continuing need to impose a hard budget constraint on all levels of Government and pursue prudent financial policies, growing need for financing temporary liquidity mismatches of States in line with the growing volume of transactions can not be denied. Fixing the WMA limits as multiples of an unchanged minimum balance, as in the past, does not capture the differing needs of the States in line with the different growth in their budgetary transactions. This has resulted in wide ***inter-State*** variations in the WMA limits in relation to the size of the Budget and this needs to be corrected.

WMA limits should normally be fixed taking into account (a) the cash flows, (b) the variation in the rate of flow of revenues and expenditure and consequent mismatches, and (c) the capacity of a State to raise resources on its own to cover such mismatches. Ideally, such an exercise should be done for each State and should be adjusted to seasonal conditions. However, with twenty three States, and different seasonal variations in different States, it is not practical to evolve any scheme taking all these factors into account. Furthermore, if the RBI has to deal with the WMA problems of States concurrently, taking all these factors into account, it would have to do so on the basis of its own judgement which could become arbitrary.

The WMA limits for States have, therefore, to be evolved on the basis of some general principle. This may also appear arbitrary, but, it will at least be transparent and will be known ex ante. The RBI will have to provide a space within which legitimate mismatches can reasonably be expected to be handled. It should be the job of the financial manager, and not the RBI to fine tune flows of revenues and expenditures through the year within such space.

In view of the above, for fixing WMA limits, a logical surrogate for cash flows will be the total expenditure as a base. However, a justifiable fear has been expressed in the past that, linking of WMA limits to expenditure may provide an incentive for larger and more imprudent expenditures. The Committee has, therefore, modified this base so as to omit revenue deficit. Revenue expenditure minus the revenue deficit, which equals the revenue receipts, is the recommended base.

In the case of capital expenditure, similar consideration do not apply. Capital expenditure has to be matched by a revenue surplus or capital receipts. A revenue surplus financing capital expenditure is a welcome development. Borrowings by the States are regulated by the RBI and the Government of India. Therefore, till such time as the States have free access to the market, the risks involved in accepting revenue expenditure as a base would not apply to capital expenditure to the extent that it is within the approved borrowing programme. The Committee has accordingly adopted ***revenue receipts plus capital expenditure*** as the base. The impression gathered from the discussions with the Finance Secretaries was that none of them had objection to such a base.

Split Level of WMA

While discussing with the Finance Secretaries, the Committee noted that some of the Finance Secretaries wanted a split level of WMA, as had been determined in the case of the Centre. It was observed that the States do not have a regular seasonal pattern of this type in the mismatch of their revenues and expenditures. However, there are two periods in which they all seem to be facing an acute liquidity problem. One is in the month of April, in which pending bills spill over from the previous year. This problem is further accentuated by the fact that the releases from the Government of India come late in this month. The other period is later in the year when States made advance payments of salaries for major festivals; this period is also one in which there are natural calamities. At the time of major festivals, States disburse salaries in advance of the first of the next month which means that, generally in September or October, many States have two salaries to be paid in one month. This happens also at the time of Christmas in some north eastern States. Natural calamities can also create a difficult liquidity situation. This may be the monsoon season in some States, and the summer season in some others.

The Committee recognises these specific problems. However, there are practical difficulties in recommending a split level of WMA limit for such periods. At present, these situations are being met by the States by advance release of funds by the Government of India or by curtailment of other expenditures. If a higher WMA is available, the tendency will be to continue to draw the WMA at this higher level even thereafter. If, therefore, there has to be confining pressure on the States to meet such short-term exigencies by putting in efforts to mobilise resources within the existing budgetary allocations, it would be advisable not to have any split level of WMA. As it is, many of them are not taking the necessary prudent steps, like carrying balances in the calamity fund from good years for use in bad years, etc. The Committee has, therefore, not recommended any seasonal variations in WMA.

Special Category States

The Committee recognises that the special category States have problems of their own. They have a very small resource base which reduces their flexibility in planning receipts and expenditures. The Planning Commission and Finance Ministry of the Central Government fix most of the parameters. This existing small base of State resources can also be severely affected from time to time. The impact of seasonal conditions and natural calamities is even more severe in their case. In addition, these States have law and order problems. Furthermore, inaccessibility and terrain add to their problems. Therefore, the Committee has, in making its recommendations, dealt with their case separately.

REVISION OF WMA LIMITS AND LIBERALISATION OF SPECIAL WMA

Normal WMA

For the reasons discussed above, the Committee recommends the ***delinking of the WMA limits from the unchanged minimum balances.*** The Committee recommends that the ***sum of revenue receipts and capital expenditure*** should be the base to which the WMA limits are linked.

Non-special Category States

For fixing the normal WMA limits for the fifteen non-special category States, the Committee adopted the following methodology :

(a) The average of the total of revenue receipts and capital expenditure was calculated from the accounts for the years 1994-95, 1995-96, 1996-97, as published in the Budgets of the States. In non-tax revenues receipts, the receipts on lotteries were taken on a net basis.

(b) Among these States, the maximum ratio of the existing normal WMA limit to the three year average worked out as at (a) above is 2.25 per cent for Goa.

(c) To work out the increase in normal WMA limits, when the ratio of 2.25 per cent is applied to the three year average of revenue receipts plus capital expenditure of the remaining States.

The increase in the limits worked out at (c) above is the lowest for Goa (0 per cent), followed by Orissa (9.8 per cent), West Bengal (27.9 per cent) and Punjab (33.7 per cent). Given the problems of adjustment in the short run it was considered desirable that for no State the increase in normal WMA limit should be less than forty per cent over the existing limits.

In view of the above, the revised normal WMA limits the Committee recommends for the fifteen non-special category States as follows :

REVISED WMA

(Non-Special Category States)

(Rs. Crores)

Sl. No.	*State*	*Existing Normal WMA*	*Revised Normal WMA*
1.	Andhra Pradesh	168.00	288
2.	Bihar	117.60	189
3.	Goa	16.80	24
4.	Gujarat	117.60	243
5.	Haryana	50.40	99
6.	Karnataka	134.40	228
7.	Kerala	100.80	144

8.	Madhya Pradesh	134.40	232
9.	Maharasthra	252.00	483
10.	Orissa	100.80	141
11.	Punjab	100.80	141
12.	Rajasthan	100.80	202
13.	Tamil Nadu	184.80	281
14.	Uttar Pradesh	285.60	422
15.	West Bengal	168.00	235
	TOTAL	**2032.80**	**3352**

Special Category States

As discussed in the rationale, there is a case for giving special category States a more preferential treatment in view of their facing chronic problems of liquidity. In the case of non-special category States, the average ratio of existing normal WMA to the ***base*** worked out to 1.39 per cent and the ratio of the revised WMA to the ***base*** worked out 2.25 per cent. This represents an average increase of 62 per cent. In the case of special category States, the average ratio of the existing WMA to the ***base*** worked out to 1.70 per cent. Applying the same order of increase (62 per cent) as in the case of non-special category States, the revised ratio will work out to 2.75 per cent. By this method, the percentage increase for Meghalaya and Mizoram are 33.2 and 25.76, respectively. For the reasons given for the four non-special category States in para 4.10 above, and taking into account the peculiar problems of the special category States, the Committee recommends that as a transitional provision, the revised normal WMA for special category no State should be less than 50 per cent over the existing normal WMA. In view of the above, the Committee recommends the following revised normal WMA limits for the special category States.

Special WMA

Special WMA are secured advances and are provided against pledge of Government of India dated securities. Depending on the securities held by the States, operative limits for Special WMA are worked out. The operative limits at present are at a much lower level than the prescribed limit, indicating that the States have not invested even upto the present permissible limits for special WMA. Some of the Finance Secretaries were not keen on continuing these arrangements. The Committee is, however, of the view that a scheme which encourages the States to build up reserves in the shape of Government securities should not be discontinued only because the enthusiasm for it is lacking. If the States have to create sinking funds in the Budgets for purposes like natural calamities or even liquidating a part of their debt, such a scheme should continue and in fact should be liberalised to encourage such building up of reserves.

REVISED WMA

(Special Category States)

(Rs. Crores)

Sl.	*State*	*Existing*	*Revised*

No.		*Normal WMA*	*Normal WMA*
1.	Arunachal Pradesh	16.80	28
2.	Assam	67.20	114
3.	Himachal Pradesh	33.60	59
4.	Manipur	16.80	25
5.	Meghalaya	16.80	25
6.	Mizoram	16.80	25
7.	Nagaland	16.80	26
8.	Tripura	16.80	31
	TOTAL	**201.60**	**333**

The Committee is of the view that while a formula based approach may be adopted in the case of normal WMA, special WMA may be liberalised. Thus, while the RBI may continue to assure the States special WMA at pre-specified terms and conditions upto the currently operating limits, the States should be eligible for additional special WMA against their holdings of Government securities over and above the current limits on terms determined and announced by the RBI from time to time.

OVERDRAFT REGULATION SCHEME - REVISION OF

With regard to the Overdraft Regulation Scheme, the Committee observes that the scheme is working well at present as a disciplinary mechanism. The Committee does not recommend any relaxation in this scheme. However, it is found that some States, which are persistently in overdrafts, are defeating the purpose of the scheme by so adjusting their finances that they clear the overdrafts within the time limit and again emerge into overdrafts. There are States that have remained in overdrafts for as many as 200 days in the year. There are also States which overdrew to a very large extent and in some cases beyond several times the WMA limits. Therefore, some measures are necessary to deal with such practices. Recognising this, the Committee recommends a ceiling on overdrafts as also a restriction on the number of days in aggregate that a State can be in overdraft.

The Committee makes the following recommendations on the ***Overdraft Regulation Scheme***.

(i) No State shall be allowed to run an overdraft with the RBI for more than ***ten*** consecutive working days. In case the overdraft appears in the State's account and remains beyond ***ten*** consecutive working days, the RBI and its agencies shall stop payments on behalf of the State.

(ii) No State shall be allowed to run an overdraft with the RBI for more than ***twenty*** working days during a quarter in the financial year. In case this limit is exceeded, the RBI shall stop payments irrespective of clause (i) above. The number of working days during which the payments have been suspended shall not be taken into account in calculating the ***twenty*** working days.

For the above purpose, the financial year shall be divided into ***four*** quarters commencing on April 1, July 1, October 1 and January 1.

The overdraft shall not exceed 100 per cent of normal WMA limit. On the first occasion that this is exceeded in a financial year the RBI shall advise the State that the overdraft amount should not exceed 100 per cent of normal WMA limit on any subsequent occasion. In this case clause (i) or clause (ii) is applied which ever is relevant.

Without prejudice to clause (i) above, if during the financial year, the amount of overdraft exceeds 100 per cent of WMA limit on a second or any subsequent occasion the State shall be given only ***three*** working days notice to bring down the overdraft amount within the level of 100 per cent of normal WMA limit. If this is not adhered to payments will be stopped.

INTEREST RATE ON WMA AND SURPLUS FUNDS

WMA is a short term loan for a period of ***three*** months. States should be encouraged to liquidate this loans within a period of ***three*** months without making WMA a source of financing. The fact that some States may have become insensitive to the cost of money viz., rate of interest, so long as they are able to get over their liquidity problems, should not deter the institution of a rational regimen of interest rate as a centre piece of financial discipline. The Committee, therefore, recommends that the interest rate on WMA may be linked to the period for which it is drawn; and simultaneously States should be given some flexibility in the matter of investment of surplus funds.

IMPROVEMENT IN BANKING TRANSACTIONS

In course of the discussions it was pointed out by some Finance Secretaries that there are instances of delays in the banking system to credit the receipts of the States. The Committee, however, recognises that the delay in the banking system does not seem to have contributed to a WMA or overdraft problem. Nevertheless, there does seem to be inefficiency in the entire system of transferring funds which needs to be addressed. Therefore, the Committee recommends that the RBI may separately examine this issue in terms of technology development for improvement in banking transactions.

MARKET BORROWINGS

The Committee is of the opinion that utilisation of market borrowings as a triggering mechanism to tide over the WMA and overdraft problems may not be practicable at this stage as the borrowing programme for all States is managed together by the RBI. In the event of switching over to the auction system of borrowing, in future, the States may consider triggering the market borrowing when the WMA limit is continuously drawn and is likely to be overdrawn.

PATTERN OF RELEASE OF CENTRAL TRANSFERS AND DEVOLUTIONS

The Committee, in course of its discussion with the Finance Secretaries and Government of India officials observed that, by and large, the scheme of Central transfers and devolutions is working satisfactorily. The Committee is, however, of the opinion that in the case of special category States, where on an average the Central transfers and devolutions finance 85-90 per cent of the Budget of these States, it is for the Government of India to implement a pattern of release such that it reduces the mismatch problem of these States.

SPLIT LEVEL OF WMA

For the reasons discussed earlier, the Committee does not recommend any split level of WMA for the States.

REVISION OF MINIMUM BALANCE

Having delinked the WMA from the minimum balance and recommended linking it to the volume of transactions the Committee deliberated upon the issue of the minimum balance itself. The Committee felt that the minimum balance also should be revised and linked to the same base. This should ideally be done for both Centre and States. The minimum balance of the States has not been revised since 1976. In that year, the ratio of minimum balance to the budgetary transactions as represented by Revenue Receipts plus Capital Expenditure worked out to 0.11 percent as against 0.008 percent and non special category States and 0.010 percent for the special category States at present. Applying this same ratio 0.11 per cent to the present base the required minimum balance would work out to Rs.174 crore. The Committee recognised that it would be difficult to immediately revise minimum balances by this order of increase. The maximum ratio of present minimum balance to the budgetary transactions is 0.013 per cent for Goa (Mizoram amongst the special category states). The Committee recommends that twice this ratio i.e. 0.026 be adopted in the case of all States. On this basis, the minimum balance works out to Rs.37.97 crore for the non-special category States and Rs. 3.08 crore are for the special category States. The Committee recommends that the RBI should revise the minimum balance in consultation with the States immediately.

ASSOCIATED MONETARY IMPACT

The recommended revision of normal WMA limits increases the potential liquidity that can be tapped by States for financing their liquidity mismatches. However, the overall liquidity impact of the measures recommended by the Committee has to factor in the new regime of overdraft regulation. The new regulations on overdrafts, together with the new and higher normal WMA limits, may be expected to diminish the severity as well as the frequency with which some States have resorted to overdrafts in the past.

For measuring the monetary impact of the revisions, the potential full use of the existing

WMA limits with that of the suggested ones can be compared. This yields an estimated increase in high powered money to the extent of Rs.1,423 crore or 0.59 per cent. The actual use of WMA in the future and the intra year variations in the WMA that the States will draw is difficult to predict. However, it is clear that with the increased financial stress on State Governments, it is quite likely that there will be an increase in recourse to WMA by the States in the future. If the monetary impact is estimated based on the difference between the full use of WMA limits in the future and the actual utilisation in the past, the estimated increase in high powered money is Rs.3,274 crore or 1.36 per cent. These orders of increase in high powered money will have to be kept in view in considering the revision of the WMA limits.

FUTURE REVISION

The major thrust of the Committee was to rationalise the present system of WMA and overdraft to States. The exercise has been done on the basis that a logical and appropriate base for a revision of WMA is revenue receipts plus capital expenditure. However, it is not the intention of the Committee that the WMA should be automatically linked to this base and indexed accordingly. Upto certain limits the mismatches between receipts and expenditures should be managed within the existing WMA limits even when the volume of transactions goes up. The increase in volume does not automatically lead to an increase in mismatch. A review of WMA limits should be a periodic exercise and not an automatic one linked to any base.

Given the fact that Finance Commission recommendations affect the fundamentals of State finances and these recommendations have a normal validity of five years, there is a merit in synchronising WMA revisions with Finance Commission recommendations. In view of this, the Committee recommends that the revised limits should apply for the period covered by the recommendations of Eleventh Finance Commission.

REVISED SCHEME OF WAYS AND MEANS ADVANCES TO STATE GOVERNMENTS WITH EFFECT FROM MARCH 1, 1999

On the basis of the above recommendations of the Vithal Committee, the present scheme of WMA to State Governments was revised and the scheme was made effective from March 1, 1999.

The features of the revised scheme are :

(i) The base for the revised WMA limits will be three year average of revenue receipts plus capital expenditure. Accordingly, the normal WMA limits have been increased by 65 per cent to Rs.3,685 crore (from Rs.2,234.40 crore).

(ii) The limits for Special WMA will be liberalised. Accordingly, under the revised scheme, there will be no upper limit on special WMA as a multiple of minimum balance. The States will be provided special WMA against their actual holdings of dated Government of India securities.

(iii) No State shall be allowed run an overdraft with RBI for more than ten consecutive working days. If overdraft remains beyond ten consecutive working days, RBI will stop payment on behalf of the State. The overdraft shall not exceed 100 per cent of normal WMA limits. If overdraft exceeds 100 per cent of WMA limit in a financial year, on the first occasion RBI will advise the State Governments; on a second or any subsequent occasion, the State shall be given only three working days' notice to bring down the overdraft within the 100 per cent limit. If this is not adhered to, payments will be stopped.

(iv) The revised scheme of WMA has been implemented with effect from March 1, 1999.

(v) The minimum balance will be revised upward linking it to the same base as for WMA from the same date the RBI will receive the concurrence from the State Governments.

(vi) The recommendation that no State shall be allowed to run an overdraft for more than twenty working days during a quarter in the financial year will be implemented after two years.

(vii) The review for future revision will be made by the Reserve Bank of India after three years and the same criteria as now, will be used with latest three years actuals.