Speech

STATE FINANCES AND RBI INITIATIVES*

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It is a great honour and pleasure to be with you all here, on this important occasion. Do I have a choice when the distinguished Advisory Board of Data News Features summons me? Mr. Hanumantha Rao has been collecting, collating, consolidating and marketing data on Andhra Pradesh economy for decades. He is a pioneer in recognising the importance of data dissemination and in particular data consolidation and analysis at the state level. Perhaps, this is the first compilation of its nature in our country focussing on data at State level, spanning 50 years since independence.

I believe it is customary to say a few words on an occasion like this. Since the book is yet to be released, I cannot say anything on it. Since Mr. Rao is known to most of you, I cannot add much. On the substance, I see here an array of Athirathulu, Maharathulu, Guruvulu, with Shri Vittal, Bhishmacharya of Andhra Pradesh economy at the lead, and so I will not venture into it either. I would, therefore, take this opportunity to say a few words, on the RBI's role, and initiatives in regard to state economies in general, and state finances in particular.

State Economies

We all know that in our country, states are of varying sizes and are at different levels of economic and social development. Many states are larger in terms of population than half the countries in the world. Some states have progressed very well in terms of social development, a few have also done well in rapid economic development. Thus, individually some of these states are world-class performers in some respects. Yet there is a lot more to be done in all the states of our country. To this end, there is virtual unanimity on the two most critical areas for further progress in our country, viz., social infrastructure and physical infrastructure.

In social infrastructure, we should emphasise primary education, primary health, social security and to some extent law and order. These activities are in the State's domain.

In physical infrastructure, we should emphasise water supply (both for drinking and irrigation), drainage, roads, power supply, medium and minor ports, etc. These

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have a commercial element but are proving to be serious bottlenecks for further progress. These are also mostly under the domain of states.

Today, one of the main differences of opinion on economic policy is whether we should focus more on social or on physical infrastructure. In either case, the play is essentially in the theatres of the states. The very justification for the current process of reform is lost if these areas do not get significantly more attention than they did in the past.

The tasks before states in the reform process are very very complex because we are dealing with reforms in delivery of services — quantitatively and qualitatively as also appropriate pricing or subsidies. Building a road or finalising a Power Purchase Agreement is far more complex than abolition of licensing or quantitative restrictions on imports or exports or fast-track method of investment clearance. These tasks demand more than finances, but finances are also essential.

State Finances

There is a supplement on Finances of State Governments to the RBI Bulletin of February 1998, giving a detailed account of the subject and so I will only mention a few highlights from concluding observations:

(a) The stress on the finances of the state governments became evident when their revenue account started showing deficits in the late 'eighties. The steady deterioration in the revenue account caused enlargement of states' Gross Fiscal Deficit.

(b) The curtailment in Gross Fiscal Deficit (GFD) could be achieved through deceleration in capital expenditure which would, however, have adverse implications for growth. The improvement in GFD should, therefore, be achieved through the revenue account.

(c) The last few years have witnessed a more or less stagnant tax receipts to GDP ratio and a declining non-tax receipts to GDP ratio.

(d) Most of the States' Public Sector Undertakings (PSUs), particularly State Electricity Boards and State Road Transport Corporations have been showing persistent losses, and therefore, their contribution to the State exchequer is negative.

(e) Similarly, several irrigation projects in the States reflect negative contribution due to uneconomic user charges.

(f) On the expenditure side, the rigidity in the non-plan non-developmental expenditure is a matter of concern as it adversely affects the financial health of the states. This is due to committed expenditures on interest payments and administrative expenditures on salaries and pensions. This has led to non-developmental revenue expenditure absorbing a greater proportion of revenue receipts.

(g) The problem of subsidies also needs pointed attention. Here the emphasis should be squarely on implicit subsidies, which deprive states of scarce resources.

Given the above picture of finances of states, we should assess the massive effort needed to improve social infrastructure and strengthen physical infrastructure to the levels desired. The limits to dependence on financial transfers from the Centre are recognised and there is a feeling in some states that access to external assistance or capital markets is an easy way out to finance Government and its enterprises. I would submit that it is not an easy way out but desirable option to be exercised with a combination of skill and caution. We, in fact, addressed these and other issues in a meeting with Finance Secretaries early this month and I will elaborate on this after presenting a brief account of role of Reserve Bank of India in regard to states.

Role of the RBI

The Reserve Bank of India's major concerns are price stability and ensuring adequate credit to productive needs of a growing economy. Price stability provides a national economic environment conducive to growth with justice — to all States.

Credit flows to agriculture and infrastructure are emphasised and enabled but actual absorption in a particular state would depend on the infrastructure as well as other enabling environment. As a responsible central bank, the RBI can persuade but cannot force credit flows to states which are yet to provide productive as well as congenial credit culture. So, the RBI and the states do work together on this through institutional mechanisms such as SLBCs (State Level Bankers Committees). I must admit that Andhra Pradesh has the tradition of being one among the best in ensuring cordial and effective co-ordination between banks and Government.

The RBI also performs the functions of a Manager of Public Debt. While in the past, it was possible to pre-empt financial resources of banks, in a liberalised environment, the RBI would soon find it difficult to ensure success of debt issues of states whose finances are perceived to be not well-managed. We are already alerting the states on this issue.

The RBI also functions as a banker to states. It is our duty to perform services efficiently. For example, we have launched Electronic Fund Transfer of salaries of State Government Employees in Andhra Pradesh, thanks to the progressive initiatives taken by the Chief Minister. We are taking initiatives to render advice to states on matters such as cash management. That leads me to the initiatives taken recently.

Recent Initiatives

The RBI had two rounds of discussions with State Finance Secretaries, based on a number of technical papers prepared by both the RBI and State Governments. As a result of the latest round, a consensus was reached on many issues. These do reflect initiatives already taken and flag areas of mutual concern. Let me share with you some of the major issues addressed.

Cash Management and Ways and Means Advances

First, the states recognised the importance of cash management as a medium-term objective, but noted that there is limited scope for cash management on the expenditure side. However, each state would make a standard analysis for monthly requirements so that even at the margin, the scope for its management would improve. In the light of such an exercise, it would be possible for each state government to work out the seasonality in the expenditure and their borrowing requirements could, if possible, be appropriately adjusted. This information would be used by the Reserve Bank as an input in deciding the timings of floating tranches of the borrowing programme for the state governments in conjunction with other factors, such as, conditions of liquidity in the market, interest rate determination and synchronisation with Central Government borrowings, etc.

On Ways and Means Advances (WMA), the Reserve Bank agreed to consider changes such as dual limits and advance warning system. The Finance Secretaries wanted the Reserve Bank to continue to manage the investment of their surpluses, but change the mechanism in such a way that they get a return close to what they pay for their drawals from the RBI, say, under WMA. The Reserve Bank has agreed to continue to invest the surpluses of the State Governments, introduce 28-Day Treasury Bills as an additional instrument and to review the present system to enable the state governments to obtain a better return than now on investment of their surpluses.

Public Debt

Second, while some states favoured the establishment of a formal ceiling on public debt by law, others felt that the more important requirement is greater transparency in the matter of public debt and awareness of its implications. Further, the states unanimously felt that the focus should also be on revenue deficit. It was decided that state governments should be encouraged by the RBI to consider both greater transparency and a legal ceiling on public debt.

The Reserve Bank was requested to actively pursue with the Government of India the consensus of the State Finance Secretaries for permitting freedom in the range of 5 to 35 per cent to access the market outside the consolidated tranches of borrowing.

While there was a general agreement that a Consolidated Sinking Fund (CSF) is a good idea, many felt that it would not be desirable to consider this at a stage when revenue deficits persist and when scope for return on investments made in CSF is not very clear. Some state governments, however, requested the Reserve Bank to detail the modalities of such a CSF for immediate consideration.

Guarantees

Third, recognising the importance of guarantees and their implications on the finances, it was decided to include the following in terms of a Working Group on State Guarantees:

(a) Hidden liabilities, including especially the letters of comfort, which have the consequence of a guarantee.

(b) The level of guarantee fee.

(c) The implications of linkage with the value of any foreign currency, where it exists in regard to such a contingent obligation, especially in the guarantees offered in the power sector.

(d) The possibility of prescribing a legal ceiling on all guarantees and criteria for fixing a ceiling.

(e) The importance of attaching weights to risks and arriving at risk weighted guarantee limits.

(f) Discouraging the public sector entities from insisting on guarantees; and

(g) Prohibition on seeking or giving of guarantees for working capital needs of enterprises.

A concern was expressed about the guarantees at the state level for various projects from international investors in foreign currencies. While, at present, the magnitude of such exposures to foreign currency obligations may not be large, its assessment and some mechanism to gauge effects of such dollarisation would be necessary to mount hedging mechanisms. It was agreed that a study on this subject should be encouraged by the RBI, particularly, in the context of power sector, where the power tariff may be linked partly to the domestic value of the foreign currency.

Study of Public Accounts

Fourth, a suggestion was made that the complexities of pension, provident fund and small saving liabilities are such that they are required to be analysed by the Reserve Bank. More important, there was a unanimous suggestion that transactions in public accounts which are in the nature of banking transactions by the state governments require to be closely scrutinised by the Reserve Bank due to its responsibilities as lender of the last resort and due to the systemic implications. It was also indicated that a study on public account transactions by the Reserve Bank should ideally cover both the Centre and states. The Reserve Bank agreed to take up such a study in regard to the states, initially, as a part of its Development Research Group Studies by utilising the services of both in-house expertise and outside talent.

Inter-generational Equity

Fifth, considering the prospects of the burden on the future generation on account of the rising public debt, contingent and other liabilities, and with a view to increasing the awareness of this issue, it was decided that, accounting mechanisms should be adopted to depict inter-generational equity considerations in managing public finance. The Reserve Bank agreed to the request that it should develop a model of accounting practice for this purpose by obtaining necessary information on the best practices in the world.

Fiscal Stabilisation and Restructuring Fund

Sixth, while some progress has been made in regard to fiscal reform at the state level with the assistance of the World Bank and the Asian Development Bank, many states felt that a fund to be administered by the Reserve Bank should be considered. Such a fund can provide additional resources on the basis of progress in the reform and thus encourage the state governments to undertake reforms. The package so designed should be realistic and made suitable to the individual states. It was agreed that the Reserve Bank would consider such a fund initially at the senior level internally and later in consultation with the Government of India.

Health Card

Seventh, there was a consensus on the usefulness of assessment of the financial health of each state as an important means to encourage fiscal responsibility. It was suggested that the responsibility of assessing the financial health should be undertaken by the Reserve Bank. The Reserve Bank agreed that they would consider the relevant data, the periodicity and the parameters for working out such a health card. Prima facie on the basis of the information in the RBI's study on Finances of State Governments some financial indicators can be evolved and these can be released along with the annual volume on the finances of State Governments, as in the case of the financial ratios for individual banks published in the Report on Trend and

Progress of Banking in India. Some more work is needed to arrive at the most appropriate ratios for such a health card. The RBI would, no doubt, seek advice from select Finance Secretaries or other experts on the relevant data, periodicity, detail, etc., before launching such an exercise.

Conclusion

In conclusion, let me reiterate the importance of states in furthering reform. Indeed, positive elements of redefining the relationship between the state and the market have to occur in India at the state level even more than at the Central level and that is no easy task. Such a reform has to be based on reliable data and sound analysis. The present volume on Andhra Pradesh with contributions from the best and the brightest on the subject in the state is a good model. Other states could emulate. I commend this book to all researchers, policy makers and senior students.

I have great pleasure in releasing the Volume.