

Chapter 4

Recommendations of the Committee

4.1 The recommendations of the Committee, formulated in view of the discussions in the earlier chapter, are contained in the present chapter. They 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

4.2 Although for the reasons discussed in the earlier chapter, 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.

4.3 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.

4.4 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.

4.5 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.

4.6 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

4.7 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.

4.8 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

4.9 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

4.10 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

4.11 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) 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, is given in *Table 4.1*.
- d) 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.
- e) 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	<i>Existing Normal WMA</i>	<i>Revised Normal WMA</i>
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.	Maharashtra	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

4.12 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. The revised limits thus calculated, are set out in **Table 4.2**. As may be seen from the **Table 4.2** 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.

REVISED WMA (Special Category States)

		(Rs. Crore)	
Sl. No.	State	<i>Existing Normal WMA</i>	<i>Revised Normal WMA</i>
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

Special WMA

4.13 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.

4.14 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.

Aggregate WMA

4.15 Taking in to account the normal WMA recommended at para 4.11 (for non-special category States) and at para 4.12 (for special category States) and the present prescribed limit for special WMA, the aggregate WMA limit is set out in Table 4.3.

OVERDRAFT REGULATION SCHEME – REVISION OF

4.16 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.

4.17 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.
- iii) For the above purpose, the financial year shall be divided into *four* quarters commencing on April 1, July 1, October 1 and January 1.
- iv) 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.

- v) 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

4.18 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

4.19 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

4.20 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

4.21 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

4.22 For the reasons discussed in Para 4.7 and 4.8, the Committee does not recommend any split level of WMA for the States.

REVISION OF MINIMUM BALANCE

4.23 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 (*Table 4.4*) and Rs. 3.08 crore are for the special category States (*Table 4.5*). The Committee recommends that the RBI should revise the minimum balance as set out in *Table 4.4* and *4.5* in consultation with the States immediately.

ASSOCIATED MONETARY IMPACT

4.24 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.

4.25 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

4.26 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.

4.27 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.