REPORT OF THE ADVISORY COMMITTEE ON WAYS AND MEANS ADVANCES TO STATE GOVERNMENTS*

RESERVE BANK OF INDIA

OCTOBER 2005

* This is an edited version of the Report.

October 29, 2005.

The Governor
Reserve Bank of India
Mumbai.

Dear Sir,

Submission of the Report of the Advisory Committee on Ways and Means Advances to State Governments.

We submit herewith the Report of the Advisory Committee on Ways and Means Advances to State Governments.

We would like to place on record our deep appreciation for the outstanding professional contribution and analytical input of Shri Somnath Chatterjee, Director, Internal Debt Management Department of the Reserve Bank of India, in the preparation of the Report.

Yours faithfully,

(M. P. Bezbaruah)
Chairman

(D. K. Srivastava)
Member

(B. Mahapatra)
Member-Secretary

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REPORT OF THE ADVISORY COMMITTEE ON WAYS AND MEANS ADVANCES TO STATE GOVERNMENTS

I. Background and Issues

Institutional and Legal Arrangements

1.1. The Reserve Bank of India (RBI) has been extending Ways and Means Advances (WMA) to State Governments since 1937, under the provisions of Section 17(5) of the Reserve Bank of India Act, with the objective of covering temporary mismatches in the cash flows of their receipts and payments. According to the Act, such advances are repayable not later than three months from the date of making that advance. The maximum amount of such advance by the RBI and the interest charged thereon are, however, not specified in the RBI Act but are regulated by voluntary agreements with the State Governments. There are two types of WMA *viz.,* (i) Normal or clean advances, which were introduced in 1937; and (ii) Special or secured advances, instituted in 1953, and which are provided against the collateral of Government of India securities. State-wise limits in respect of Normal and Special WMA are fixed based on certain parameters; these limits have been revised periodically over the years. An overdraft (OD) occurs whenever these limits are exceeded. Maximum time-period (days) and/or financial limits for which State Governments can remain in OD have been specified; these limits have also been revised periodically. Payments are suspended on behalf of the State Governments in case OD limits are breached.

Periodic Revisions of the WMA/OD Scheme

1.2. The WMA Scheme has been periodically revised, beginning the early 1950s, in the light of the perceived requirements of the State Governments, keeping in view the evolving fiscal, financial and institutional developments as well as the objectives of monetary and fiscal management. Upto the late 1990s, the Normal and Special WMA limits of State Governments were fixed in terms of specified multiples of their minimum balances with the RBI. A

major change in the WMA scheme was effected in March 1999 in accordance with recommendations of the Informal Advisory Committee (Chairman: Shri B.P.R. Vithal), 1998 (henceforth, the **Vithal Committee**), in that the computation of normal WMA limits of the State Governments was explicitly linked as a multiple of their budgetary turnover (as proxied by the average level of revenue receipts *plus* capital expenditure during the previous three years). This was done because it was perceived that the erstwhile mechanism of fixing WMA limits did not capture the differing needs of the States in line with the growth in their budgetary transactions. Separate multiplying ratios were specified for Special and Non-Special Category States. Despite the resultant steep increase in normal WMA limits computed on the basis of the recommendations of the Vithal Committee, there were requests from State Governments for further enhancement of the limits. Accordingly, on the basis of the recommendations of an **Informal Group of State Finance Secretaries** (GFS) that was constituted subsequently (2001), the multiplying ratios that were applied to the base for computation of normal WMA limits were revised upwards with effect from February 2001. The last revision in the WMA Scheme was made on the basis of the recommendations of the Advisory Committee under the Chairmanship of Shri C. Ramachandran, in 2003 (henceforth, the **Ramachandran Committee**). The Ramachandran Committee changed the base for computation of normal WMA limits exclusively to the average revenue receipts of the past three years, on considerations of, *inter-alia*, transparency and simplicity, and accordingly, recommended new multiplying ratios with effect from March 2003. In accordance with the recommendations of the Ramachandran Committee, the multiplying ratios are, at present, placed at 3.19 per cent and 3.84 per cent in respect of Non-Special Category States and Special Category States, respectively. Changes in respect of the modalities of availing Special WMA and OD have also been made over the years. A summary of the historical evolution of the WMA and OD Schemes is presented in **Annex 1**. A snapshot of the evolving changes in the WMA/OD scheme is presented in **Table 1**.

1.3. The Ramachandran Committee had also recommended that the formula and the limits of WMA may be reviewed in totality after the receipt of the recommendations of the Twelfth Finance Commission (TFC).

Report of the Twelfth Finance Commission

1.4. The Report of the TFC was tabled in Parliament, on February 26, 2005. The Action Taken Report of the Government of India that was tabled simultaneously indicated that most of the recommendations of the TFC were accepted. The TFC noted the persistence of large imbalances in the finances of the State Governments and recommended a scheme of fiscal transfers that can serve the objectives of equity and efficiency within a framework of fiscal consolidation. The recommendations of the TFC, which cover the five-year period beginning 2005-06, have implications for the evolution of the finances and the liquidity position of the State Governments over the medium term. Some of the **major recommendations** of the TFC that are relevant in this context are:

(i) **Total resource transfer** from the Centre to the States (comprising shareable tax revenue and grants) has been recommended at Rs.7,55,752 crore for the period 2005-06 to 2009-10, which is nearly 74 per cent higher than that of Rs.4,34,905 crore for the period 2000-01 to 2004-05 recommended by the Eleventh Finance Commission. The increase in tax devolution and grants is around 63 per cent and 143 per cent, respectively;

(ii) Emphasis on **fiscal discipline** and **long-term fiscal sustainability** through a **fiscal restructuring plan** for the States whereby, *inter-alia*, the revenue deficit would be eliminated and the ratio of the Gross Fiscal Deficit (GFD) to GSDP would be reduced to 3 per cent by 2008-09;

(iii) In order to **incentivise fiscal discipline**, the States' eligibility to avail of **debt relief** is linked to their enactment of Fiscal Responsibility Legislation and adherence to the recommended

fiscal restructuring plan. A two-pronged approach to debt relief has been recommended by the TFC *viz*., (i) a general scheme of debt relief applicable to all States and (ii) a write-off scheme linked to fiscal performance. Loans given to States from National Small Savings Fund (NSSF) have, however, been excluded from the scope of debt relief since the Fund is maintained in the Public Account. The debt relief during the award period for all States works out to Rs.21,276 crore in interest payments and Rs.11,929 crore in repayments; and

(iv) The **States**, like the Centre, must decide their **annual borrowing programme**, within the framework of their respective fiscal responsibility legislations. Accordingly, Central loans for State Plans may be substituted by market borrowings of the States. According to the TFC, this disintermediation of the Centre in the borrowing process of the States would facilitate greater fiscal discipline on the part of the States by removing the structural obligation to borrow from the Centre and by providing increased market-orientation. If some fiscally weak States are unable to raise funds from the market, however, the Centre could borrow for the purpose of on-lending to such States, but the interest rates should remain aligned to the marginal cost of borrowing for the Centre. According to the Action Taken Report, this approach has been accepted by the Government, in principle, to be implemented in phases, in consultation with the Reserve Bank.

Recent Trends in State Government Finances

1.5. Since the submission of the Ramachandran Committee Report (2003), the State Government budgets for 2003-04, 2004-05 and 2005-06 have been presented. Some of the distinctive features of these State budgets, which could impact on their liquidity position, include:

(i) perseverance with fiscal and institutional reforms including the progressive enactment of Fiscal Responsibility Legislation (FRL).

The State budgets for 2005-06 indicate that eight more States (Assam, Chhatisgarh, Gujarat, Haryana, Himachal Pradesh, Orissa, Maharashtra and Rajasthan) have enacted FRL (*i.e.* apart from Karnataka, Kerala, Punjab, Tamil Nadu and Uttar Pradesh, which had already enacted the same). Two States (Manipur and Tripura) have presented their FRL Bills while one State (Andhra Pradesh) has promulgated an ordinance in this regard. Three more States (Madhya Pradesh, Meghalaya and Uttaranchal) have proposed FRL in their budgets for 2005-06. This should facilitate the attainment of the envisaged fiscal correction during 2005-06 as well as over the medium-term;

(ii) some moderation of fiscal imbalances over the period 2001-02 to 2004-05 (Revised Estimates). All the major deficit indicators relative to GDP recorded a decline during this period except for a temporary hike in 2003-04, which occurred mainly on account of the one-time settlement of dues of the State Electricity Boards (issuance of power bonds). The reduction in revenue deficit, in particular, was evident across most of the States. At the consolidated level, the share of the revenue deficit in the Gross Fiscal Deficit (GFD) declined sharply to 36 per cent in 2004-05 from 62 per cent in 2001-02;

(iii) a shift in the financing pattern of GFD with a sharp increase in the share of Small Savings and decline in that of loans from Centre;

(iv) sharp fiscal correction envisaged in the budget estimates for 2005-06, particularly in the revenue account, even though most State budgets have not incorporated the impact of the TFC recommendations. The envisaged fiscal correction is based upon the curtailment of non-interest revenue expenditure; and

(v) implementation of the Value Added Tax (VAT) by a number of States with effect from April 2005, with the Central Government providing for an amount of Rs.5,000 crore in its budget towards compensation for possible revenue loss incurred by the States.

Constitution of the Present Advisory Committee on WMA

1.6. In accordance with the recommendations of the Ramachandran Committee and in the context of the fiscal developments in the interregnum as well as the outlook for the liquidity position of the State Governments over the medium term, an Advisory Committee to review the WMA Scheme was constituted in April 2005. The Committee comprised Shri M. P. Bezbaruah, Banking Ombudsman, New Delhi, as Chairman, Prof. D. K. Srivastava, Director, Madras School of Economics, and member of the TFC, as Member, and Shri B. Mahapatra, Chief General Manager-in-Charge, Internal Debt Management Department (IDMD), RBI, as Member-Secretary. Shri Somnath Chatterjee, Director, IDMD, RBI was the resource person.

Terms of Reference

1.7. The terms of reference of the Committee were as follows:

(i) To review the existing WMA/Overdraft Scheme of RBI for State Governments, particularly the formula and the limits, and recommend modifications, if necessary, in the light of the recommendations of the Twelfth Finance Commission;

(ii) To examine the existing Overdraft regulations for the State Governments;

(iii) To examine the Scheme of Special WMA of the State Governments in the light of the States' request for building up investments in Central Government securities from their durable surplus for Special WMA; and

(iv) Any other issue germane to the subject.

Approach of the Committee

1.8. The Committee decided to follow, in line with past practices, a consultative approach in framing its recommendations. Accordingly, a questionnaire was issued to the 26 State Governments on various aspects of the WMA/OD Scheme. Responses were received from 24 State Governments (Goa and Jharkhand did not respond). A summary of the responses to the

questionnaire is set out in **Annex 2**. The Committee met the Finance Secretaries of various State Governments in six separate rounds. The Committee also met the Chairman of the TFC, as well as officials from the Government of India, Planning Commission, Comptroller and Auditor General of India and the Reserve Bank, and other academicians and experts. The schedule of these meetings and the list of officials and experts with whom the Committee interacted, are set out in **Annex 3 and 4**, respectively. Taking note of the various views that were expressed, the broad considerations underlying the recommendations of the Committee were to:

- adequately provide for the genuine temporary mismatches in the cash flows of the State Governments;
- ensure consistency of the WMA/OD scheme with the fiscal environment envisaged by the TFC;
- ensure consistency with the objectives of monetary management;
- closely align the interest rates charged on WMA/OD with market rates; and
- provide avenues for investment of durable cash surpluses as well as provide incentives for building up the Consolidated Sinking Fund and Guarantee Redemption Fund of the State Governments.

Structure of the Report

1.9. Against this backdrop, the remainder of the Report is organized into three chapters. The next chapter discusses the major recommendations of the TFC and their implications for the finances and liquidity management of the State Governments. Chapter III analyses the trends in the finances and liquidity position of the State Governments over the past few years, with particular reference to the period subsequent to the implementation of the recommendations of the Ramachandran Committee. An empirical exercise is also undertaken to ascertain the linkages, if any, between the liquidity mismatches of the State Governments and structural deficits in their finances as well as economic growth cycles. In the context of the terms of reference

and in the light of the empirical analysis, the last chapter sets out the Committee’s recommendations and their underlying rationale.

Table 1: 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)
Normal WMA				
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 Sates and 3.84 for special category States.
Aggregate Normal WMA Limits	Rs.2234 crore	Rs.3,941 crore	Rs.6,035 crore	Rs.7,170 crore@
i) Non-Special Category States	Rs.2032.8 crore	Rs.3,589 crore	Rs.5,385 crore	Rs.6,445 crore@
ii) Special Category States	Rs.201.2 crore	Rs.352 crore	Rs.650 crore	Rs.725 crore@
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.
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.
Rate of interest	Bank Rate	Bank Rate	Bank Rate	1 per cent below the Bank Rate.
Use of Special WMA	This is availed of after Normal WMA.	This is availed of after Normal WMA.	This is availed of after Normal WMA.	To be availed of before utilising Normal WMA limit.

Item	Just Prior to Vithal Committee (1998)	Vithal Committee (1999)	Group of Finance Secretaries (2002)	Ramachandran Committee (2003)
Overdraft Regulation Scheme				
No. of consecutive working Days a State can be under	10	10	12	14

OD (excluding holidays)				
No. of working days in a quarter a State can be in OD	-	-	–	36
No. of consecutive working days OD can be in excess of the Normal WMA limit	-	3	5	5
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.

@ Present limits of Normal WMA for all States, for non-Special Category State and for Special Category States are Rs.8,935 crore, Rs.8,010 crore and Rs.925 crore, respectively, effective April 1, 2005.

* For securities with residual maturity of more than 10 years.
** For securities with residual maturity of less than 10 years.

Chapter II

Recommendations of the Twelfth Finance Commission: Implications for State Government Finances and Liquidity Management

2.1. The TFC Report observed that the finances of State Governments had witnessed large and persistent imbalances since the early 1990s. Notwithstanding the increase in the States' own tax-GDP ratio, some of the factors underlying the persistence of fiscal deterioration included the substantial increase in the salary and pension payments, in the wake of the recommendations of the Fifth Pay Commission as also the large volume of implicit subsidies arising from inappropriate levy of user charges. In the context of State-wise fiscal performance, the TFC noted that many high and middle income States had shown deterioration, in several indicators of performance, which indicated that apart from robust resource bases, the quality of fiscal management was equally important for fiscal health.

2.2. Against this backdrop, the implications of the recommendations of the Twelfth Finance Commission (TFC) for the finances and the liquidity position of the State Governments over the medium term could be assessed mainly in terms of:

(i) Devolution of resources from the Centre to the State Governments;

(ii) Emphasis on fiscal discipline through the adherence to the recommended fiscal restructuring plan;

(iii) Modalities for debt relief; and

(iv) Substitution of Central loans for State Plans by market borrowings of the State Governments.

These issues are discussed below.

(i) Devolution of Resources from the Centre to the State Governments

2.3. The scheme of fiscal transfers recommended by the TFC has underlined the objectives of equity and efficiency within the broad framework

of fiscal consolidation. The approach to transfers comprising tax devolution and grants is guided by normative considerations including the need for equalization in respect of the provision of certain services by the State Government. Equalisation transfers neutralise deficiency in fiscal capacity but not in revenue effort. A higher amount of transfers has been considered so as to reverse the decline in the volume of transfers relative to GDP and to ensure minimum vertical transfers (between Centre and States) while correcting a larger horizontal imbalance (among States).

2.4. Total resource transfers from the Centre to the States (comprising shareable tax revenue and grants) has been placed at Rs.7,55,752 crore for the period 2005-06 to 2009-10, which is nearly 74 per cent higher than that of Rs.4,34,905 crore for the period 2000-01 to 2004-05 recommended by the Eleventh Finance Commission (EFC) (Table 2). The increase in tax devolution and grants is around 63 per cent and 143 per cent, respectively. It may be noted that the TFC recommended grants for health, education and heritage conservation as well as for the maintenance of roads and bridges, public buildings and forests, amounting to Rs.37,684 crore for the period 2005-10; such grants were not recommended by the EFC. These grants are to be provided as an additionality, over and above the normal expenditure by the States in these sectors. Conditionality governing the release of these grants has also been specified.

Table 2: Resource Transfers recommended by TFC

(Rs. Crore)

	2005-06	2006-07	2007-08	2008-09	2009-10	Total
1. Share in Central Taxes	91376	104610	120029	138027	159070	**613112**
2. Grants (a to j)	25875	29409.25	29429.25	28955.25	28971.25	**142640**
(a) Non-Plan Revenue Deficit	15092	11315	10922	9999	9528	**56856**
(b) Education	1686	1845	2018	2208	2415	**10172**
(c) Health	938	1045	1164	1296	1444	**5887**
(d) Roads & Bridges	0	3750	3750	3750	3750	**15000**
(e) Public Buildings	0	1250	1250	1250	1250	**5000**
(f) Forests	200	200	200	200	200	**1000**
(g) Heritage Conservation	0	156.25	156.25	156.25	156.25	**625**
(h) Upgradation	0	1775	1775	1775	1775	**7100**
(i) Local Bodies	5000	5000	5000	5000	5000	**25000**
(j) Calamity Relief	2959	3073	3194	3321	3453	**16000**
3. Total (1+2)	**117251**	**134019.3**	**149458.3**	**166982.3**	**188041.3**	**755752**

2.5. As indicated in the Union Budget 2005-06, the total impact of the recommendations of the TFC on the Centre for the year 2005-06, which is the first year of the award period of the TFC, would be Rs.26,000 crore. According to the Union Budget 2005-06, the increase in gross devolution and transfers (through tax sharing, grants and loans) to States in 2005-06 (BE), over the revised estimates of the previous year is around Rs.17,000 crore (Table 3). It may be observed that States' share in Central taxes in 2005-06 (BE) is higher by around Rs.3,600 crore than that recommended by the TFC during that year.

Table 3: Resource Transfers to States as set out in the Union Budget 2005-06

(Rs. Crore)

	2004-05 (RE)	2005-06 (BE)	Variation
1. Share in Central Taxes	78617	94959	16342
2. Grants	51485	77275	25790
(i) Plan Grants	37341	44005	6664
(ii) Non-Plan Grants	14144	33270	19126
3. Loans	25108	179	-24929
(i) Plan Loans	24465	151	-24314
(ii) Non-Plan Loans	643	28	-615
4. Total (1+2+3)	**155282**	**172413**	**17131**

2.6. Taking cognizance of the substantial increase in resource transfers to the States as recommended by the TFC over the five-year period beginning 2005-06 as well as the provisions made in this regard in the Union Budget for 2005-06, it is expected that the fiscal stress on the State Governments would be considerably eased over the medium term.

(ii) Fiscal Discipline and Fiscal Restructuring Plan

2.7. The TFC's emphasis on fiscal discipline is embodied in its fiscal restructuring plan. The core strategy of the recommended fiscal restructuring focuses on enhancing the trend rate of growth via an increase in the savings ratio, which, in turn, requires a large reduction in government dis-saving or the elimination of the revenue deficit. According to the fiscal restructuring plan, the revenue deficit (RD) of the States is to be eliminated by 2008-09 from its level of 2.0 per cent of GDP in 2004-05. The Gross Fiscal Deficit (GFD)-GDP ratio is also to be brought down to 3 per cent in 2008-09 from 4.5 per cent in 2004-05. The restructuring plan envisages an average annual correction of 0.4 percentage point in the RD-GDP ratio and 0.3 percentage point in the GFD-GDP ratio. The envisaged restructuring would be largely contingent upon an improvement in tax revenues. The prescribed correction in revenue expenditure of States would be from 13.6 per cent to 13.2 per cent of GDP, while capital expenditure as ratio to GDP would increase from 2.6 per cent to 3.1 per cent. The ratio of interest payments to revenue receipts should decline by 2009-10 to 15 per cent. According to the restructuring plan, each State should enact Fiscal Responsibility Legislation (FRL) providing for the elimination of the revenue deficit by 2008-09 and the reduction of the fiscal deficit to 3 per cent of GSDP. The fiscal restructuring is expected to be brought about by, *inter-alia*, taxation reforms, appropriate levy of user charges, proper allocation of expenditure, rationalisation of subsidies, public sector restructuring and institutional frameworks including ceilings on debt and deficits and mechanisms for their monitoring through State-level FRL.

(iii) Modalities for Debt Relief

2.8. Another critical element of the TFC Report is the mechanism for availing debt relief by the State Governments. A two-pronged approach to debt relief has been adopted by the TFC *viz*., (i) a general scheme of debt relief applicable to all States and (ii) a write-off scheme linked to fiscal performance with a view to providing an incentive for achievement of revenue balance by 2008-09. **Loans given to States from NSSF have been excluded from the scope of debt relief since the Fund is maintained in the Public Account.** Under the general scheme of debt relief, all Central loans to the States contracted till March 31, 2004 and outstanding on March 31, 2005 (amounting to Rs.1,28,795 crore) are to be consolidated and the interest rate thereon fixed at 7.5 per cent along with a uniform tenor of 20 years. This will be subject to the State enacting Fiscal Responsibility Legislation, with the benefit accruing prospectively. The debt relief during the award period for all States works out to Rs.21,276 crore in interest payments and Rs.11,929 crore in repayments. Under the debt write-off scheme, repayments due from 2005-06 to 2009-10 on Central loans contracted upto March 31, 2004 and recommended to be consolidated and rescheduled as above, will be eligible for write-off subject to the quantum of write-off of repayment being linked to the absolute amount by which the revenue deficit is reduced in each successive year during the award period and fiscal deficit of the State being contained at the level of 2004-05. The enactment of Fiscal Responsibility Legislation would be a necessary pre-condition for availing the debt relief under this scheme also with the benefit accruing prospectively.

2.9. Many of the States have, however, expressed that the exclusion of NSSF (high-cost) loans from the ambit of debt relief would limit the positive impact of the recommended debt relief package and, thus, interest payments would continue to remain a stress factor on their financial and liquidity positions. Addressing this issue is beyond the mandate of the Committee. At this juncture, the Committee perceives that the gains from the recommended

debt relief package, if availed, would certainly not be inconsequential to the finances and hence to the liquidity management of the State Governments.

2.10. Thus, quite apart from the large volume of devolution, the fiscal restructuring plan and the incentivised debt relief package as recommended by the TFC, as explained above, is likely to spur the enactment of FRL at the State level, which would further ease the strain on their finances and liquidity position.

(iv) Substitution of Central Loans for State Plans by Market Loans

2.11. According to the TFC, it would be appropriate for States to take advantage of the market rates and avoid the spread charged by the Centre. Accordingly, the TFC recommended that the Central Government should not act as an intermediary for future lending and allow the States to approach the market directly. If some fiscally weak States are unable to raise funds from the market, the Centre could borrow for the purpose of on-lending to such States, but the interest rates should remain aligned to the marginal cost of borrowing for the Centre.

2.12. According to the Action Taken Report, this approach has been accepted by the Government in principle, to be implemented in phases, in consultation with the Reserve Bank. The Union Budget for 2005-06 has, in accordance with the TFC recommendation not provided for Central loans for State Plans and has instead indicated that the States (and Union Territories with Legislature) would have to raise loans amounting to Rs.29,003 crore directly from the market for financing their Annual Plans for 2005-06.

2.13. There has been a general apprehension that the replacement of an ‘orderly’ flow of resources (Plan loans from the Centre) by market borrowings could lead to liquidity mismatches purely on account of the time elapsed between the need for funds and the actual mobilisation of requisite market

loans by a State Government. Moreover, in the context of the under-subscription to the market loans of some of the State Governments in the recent past, it has been perceived that such States could find it difficult to mobilise the required resources on their own accord, which may aggravate cash flow/liquidity management problem. The initial experience during 2005-06 so far has, however, been to the contrary. As many as 13 States opted for the auction route for raising resources under the market borrowing programme as compared with only three States in the previous year. The total amount raised through auctions in the 2005-06 (upto end-September 2005) is Rs.3,780 crore as compared with Rs.885 crore in the (full) previous year. Comfortable liquidity position coupled with more salubrious market perception regarding the prospective financial health of these State Governments – induced in some cases by the enactment of Fiscal Responsibility Legislation – seemed to have contributed to the success of the auctions with lower spread (over the corresponding GOI securities) vis-à-vis the tap issues. Notwithstanding these initial successes, the Committee recognizes that States would need some more time to adjust to the new borrowing regime envisaged by the TFC. In this context, it is also pertinent to mention that a Technical Group has been constituted by the Government of India under the Chairmanship of Deputy Governor of the Reserve Bank, to examine the modalities for operationalisation of this recommendation of the TFC, with effect from 2006-07. This Group is expected to submit its Report by end-October 2005, which would, *inter-alia,* help to obtain a more comprehensive picture of the issues involved. At this juncture, the Committee perceives that in accordance with the recommendation of the TFC, the Government of India would on-lend to the States, wherever necessary, which would help to ease liquidity pressures. Over the medium-term, with the progressive reform in State Government finances following the enactment of FRL and with higher devolution of resources recommended by TFC, such cash flow problems should be largely obviated.

2.14. In sum, therefore, the Committee perceives that the recommendations of the TFC would have an increasingly positive impact on the finances and liquidity position of the State Governments over the medium term. At the same time, the Committee feels that necessary modifications to the existing arrangements with respect to WMA/OD may need to be such that these facilitate adjustment to the recommended changes in the framework for borrowing of the State Governments over the next year or so.

Chapter III

Finances and Liquidity Position of State Governments: An Empirical Analysis

3.1. This Chapter reviews the finances and liquidity position of the State Governments in recent years. An empirical analysis is also undertaken to ascertain linkages between structural imbalances and liquidity mismatches, in order to assess the likely trend in the latter over the medium term. The adequacy of existing Normal WMA limits and the need for further enhancements of these limits, is then evaluated. Finally, the issue of durable surplus of State Governments is discussed.

A. Fiscal Situation of the State Governments

3.2. In contrast to the rapid deterioration in the finances of the State Governments during the 1990s, some improvement has been evident in recent years. All the major deficit indicators relative to GDP have recorded a decline in the past four years except for a temporary hike in 2003-04, which occurred mainly on account of the one-time settlement of dues of the State Electricity Boards **(Table 4 and Chart)**. The share of the revenue deficit in the Gross Fiscal Deficit (GFD) declined sharply to 36 per cent in 2004-05 (Revised Estimates) from 62 per cent in 2001-02 **(Table 5).** The reduction in revenue deficit as also the ratio of revenue deficit to GFD has been evident across most of the States **(Annex Table 1)**. The general reduction in fiscal imbalances have reflected the on-going fiscal and institutional reforms at the State Government level, supported by initiatives by the Central Government and the Reserve Bank of India[1].

TABLE 4: MAJOR DEFICIT INDICATORS OF STATE GOVERNMENTS

[1] Please refer to the "Study on State Budgets 2004-05", published by the Reserve Bank, for a detailed analysis of State Government finances. The Reserve Bank's Annual Report 2004-05 contains a preliminary analysis of the State budgets for 2005-06.

(As per cent of GDP)

	1990-95 (AVG.)	1995-00 (AVG.)	2000-01	2001-02	2002-03	2003-04	2000-04 (AVG.)	2004-05 (RE)	2005-06 (BE)
GFD	2.8	3.5	4.3	4.2	4.1	4.4	4.2	3.8	3.1
RD	0.7	1.7	2.6	2.6	2.2	2.2	2.4	1.4	0.7
PD	1.6	1.4	1.8	1.5	1.0	1.5	1.5	1.1	0.4

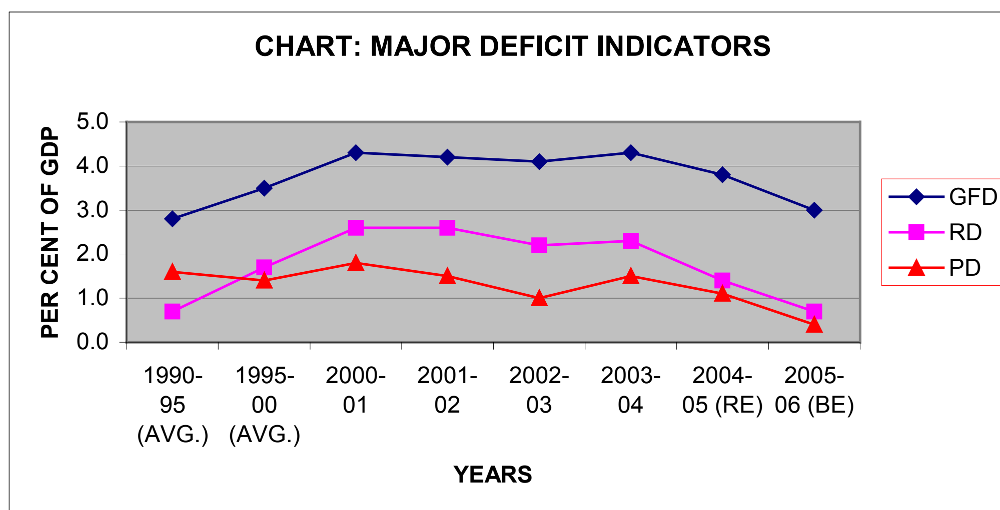

Table 5: Decomposition of Gross Fiscal Deficit

(per cent)

	1990-95 (Avg.)	1995-00 (Avg.)	2000-01	2001-02	2002-03	2003-04	2004-05 RE	2005-06 BE
(1+2+3)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1. Revenue Deficit	24.7	44.7	59.8	61.7	54.0	50.4	36.2	22.9
2. Capital Outlay	55.3	43.2	34.8	33.6	35.8	42.0	54.9	69.7
3. Net Lending	20.0	12.1	5.4	4.7	10.2	7.6	8.9	7.4

3.3. A major shift in the financing pattern of GFD is also evident with the share of Small Savings (NSSF) increasing sharply to nearly 68 per cent in 2004-05 from 37 per cent in 2001-02 **(Table 6)**. The share of net market borrowings increased sharply during 2002-03 to 2004-05 reflecting additional allocations under the Debt Swap Scheme (DSS). With large pre-payments of Central loans on account of the DSS, net loans from the Centre were negative during 2002-03 to 2004-05.

Table 6: Financing of Gross Fiscal Deficit

(per cent)

	1990-95 (Avg.)	1995-00 (Avg.)	2000-01	2001-02	2002-03	2003-04	2004-05 RE	2005-06 BE
(1+2+3+4+5)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1. Loans against Securities Issued to NSSF	-	5.8	36.4	37.1	51.2	54.6	67.6	52.9
2. Market Borrowings	16.0	16.1	13.8	14	27.9	38.6	27.3	15.3
3. State Provident Fund	14.3	13.4	14.6	10.6	7.0	5.7	7.9	7.3
4. Central Loans	49.0	40.6	9.4	11.4	-0.9	-26.7	-18.7	13.9
5. Others *	20.7	24.0	25.8	26.9	14.8	27.8	15.9	10.6

* Includes negotiated loans from banks and financial institutions, compensation and other bonds, etc.

3.4. Notwithstanding the reduction in deficit indicators, certain structural weaknesses in the finances of the State Governments have persisted. These are manifested in, *inter-alia*, low and stagnant own non-tax revenues and high share of the non-developmental component (including interest payments, administrative services and pensions) of revenue expenditure (44 per cent). Moreover, the ratio of interest payments to revenue receipts has been placed at around 23 per cent in recent years which is higher than the norm of 18 per cent recommended by the Eleventh Finance Commission (EFC) from the viewpoint of debt sustainability over the medium term. These structural factors have tended to impinge upon the pace of improvement in liquidity management by the State Governments.

3.5. The State Government budgets for 2005-06 have envisaged a sharp reduction in fiscal imbalances, primarily through the containment of non-interest revenue expenditure. It may be noted that most of the State budgets for 2005-06 have not incorporated the impact of the TFC recommendations. This is evident from the fact that even though the Centre would not provide loans for State Plans in 2005-06, net loans from the Centre as per the State budgets is placed at around Rs.14,000 crore, accounting for about 13 per cent

of GFD. If the TFC recommendations, as reflected in the Union Budget 2005-06, were to be incorporated, the State budgets would show a further improvement in the financial position, through higher flows of tax devolution and grants. Moreover, as per the Union Budget 2005-06, higher flows to the States under NSSF would more than compensate for the elimination of Central loans for State Plans, resulting in an over-funding of the GFD and the building up of cash surpluses.

3.6. Thirteen States have already enacted FRL and six more are in the various stages of finalizing the same. This should facilitate the attainment of the envisaged fiscal correction during 2005-06 as well as over the medium-term. On the whole, therefore, the pressure on the finances of the State Governments is expected to ease significantly over the medium-term.

B. Liquidity Management of the State Governments

3.7. There has been a distinct improvement in liquidity management of the State Governments in recent years, as evident from the key trends highlighted below.

Normal WMA

- Across most States, there was a decline in average utilization of Normal WMA in the recent period, particularly during 2004-05.
- Normal WMA utilization had, in general, declined relative to its limits, across States. In respect of Non-Special Category States, the average ratio of Normal WMA utilization to its limits had declined from 58.1 per cent in 2001-02 to 18.8 per cent in 2004-05, whereas for Special Category States, the ratio had declined from 46.5 per cent to 17.5 per cent, respectively, over this period;
- 12 States utilized only upto 10 per cent of their normal WMA limit in 2004-05 as against five States in 2001-02
- In 2004-05, only one State utilized more than 70 per cent of its Normal WMA limit as against 11 States in 2001-02.

- Only 6 States availed of WMA for more than 200 days in a year in 2004-05 as against 18 in 2001-02 **(Table 7).**

Table 7: Number of Days In Normal WMA - Frequency Distribution Of States

Number of days	2001-02	2002-03	2003-04	2004-05
Non-Special Category States				
0-99	3	5	5	10
100-199	0	1	3	2
200 and above	14	11	9	5
Special Category States				
0-99	3	3	5	4
100-199	2	1	1	4
200 and above	4	5	3	1

Special WMA

- Average utilization across most Non-Special Category States increased sharply in 2003-04 following the implementation of the Ramachandran Committee recommendation that Special WMA should be availed before Normal WMA. Special WMA utilization declined in 2004-05 in the case of most States.

Overdraft (OD)

- There has been a decline in the average amount of OD in the case of most States since 2001-02.
- During 2004-05, 11 Non-Special Category States did not resort to OD as compared with 3 in 2001-02. Only one Special Category States did not resort to OD during 2001-02 to 2004-05 **(Annex Table 2).**
- Only 5 States remained in OD for more than 100 days in 2004-05 as compared with 13 in 2001-02. No State was in OD for more than 200 days in 2004-05 as against 6 in 2001-02.
- The number of occasions of OD declined substantially in 2004-05 in respect of all States except for one State.
- Only a handful of States continued to have OD problems, even though their severity had declined over the years.

__Overall Liquidity Mismatches__

- Annual average **overall liquidity mismatches** (as measured by the utilization of **Normal WMA, Special WMA and Overdrafts**) **(NSO)** had also declined across States. On an average, NSO declined from the Rs.283 crore in 2001-02 to Rs.151 crore in 2004-05 in respect of Non-Special Category States, and from Rs.94 crore to Rs.45 crore, respectively, over this period in the case of Special Category States. It is also pertinent to note that in the case of Non-Special Category States, NSO relative to the Normal WMA limit was, *on an average*, consistently placed below 100 per cent and declined from 93 per cent in 2001-02 to 31 per cent in 2004-05. In the case of Special Category States, this ratio was, on an average, placed above 100 per cent during 2001-02 and 2002-03, but declined thereafter to 43 per cent in 2004-05.
- The trend component of NSO (as measured by a three quarter moving average) has shown a general downward movement in the case of all but two States, indicating thereby that WMA requirements are being progressively governed by seasonal factors (rather than structural imbalances) that reflect the periodicity of mismatch.
- The outstanding amount of NSO as at end of the fiscal year, which essentially reflects the roll over of liquidity mismatches and their concomitant addition to fiscal deficit, has also shown a decline across the States. In fact, 10 States had outstanding NSO as at end-March 2005 as compared with 16 States as at end-March 2002.

__Investment in Treasury Bills__

- There has been a steady increase in average investment in 14-day Intermediate Treasury Bills since 2001-02 and a very sharp rise during 2004-05 and 2005-06 (till August 2005). The increase in investment during 2005-06 is on account of growth in NSSF flows, release of enhanced grants on the basis of TFC recommendations and increased

buoyancy in Central tax collections resulting in larger devolution to the States.

C. Structural Imbalances and Liquidity Mismatches

3.8. The Committee took note of the **synchronous improvement** in the finances and liquidity position of the State Governments in recent years. In this connection, an **econometric (panel regression) exercise** was undertaken in order to confirm the linkages between structural imbalances and liquidity mismatches which could, in turn, have a bearing on the evolution of liquidity mismatches over the medium term. Separate regressions were run for Non-Special Category and Special Category States over the period 2000-01 to 2004-05 (The detailed results are shown in **Annex 5**). The results showed that, (i) liquidity mismatches are likely to widen in tandem with the proportion of borrowings (GFD) that is required to be spent on revenue expenditure (a large part of which is committed in nature in the form of interest payments, wages and pensions, and which is independent of the level of borrowings in that year); and (ii) a downswing in the economic growth cycle is likely to adversely impact upon the buoyancy and regularity of revenue receipts, which, in turn, could induce liquidity pressures. Expectedly, the severity of the impact of such possible cyclical downturns would be better withstood in an environment of enhanced fiscal discipline. Thus, it should be expected that with the States enacting FRL and adhering to the TFC's fiscal restructuring plan of eliminating the revenue deficit over the medium term, the size of liquidity mismatches, and consequently, the need to avail of WMA, is likely to decline over the medium term. In such a scenario, temporary liquidity mismatches would reflect genuine seasonal factors with a few occasional disturbances.

D. Adequacy of Existing Normal WMA Limits

3.9. Notwithstanding the general reduction in structural and liquidity imbalances in the recent period, many of the States have argued for

enhanced Normal WMA limits on the grounds of an increased volume of budgetary transactions. In this connection, the Committee observed that since the introduction of formula-based limits in March 1999, the Normal WMA limits have been revised upwards *every year* since 2001-02, in consonance with the growth in the specified base. The compound average growth rate (CAGR) of the aggregate Normal WMA limits for all the 26 State Governments over the five-year period 1999-2000 to 2004-05 worked out to 15.6 per cent which was **higher** than the CAGR of their revenue expenditure (10.6 per cent) and total expenditure (i.e. revenue expenditure plus capital expenditure) (11.4 per cent) (**Table 8**). The Committee also noted that the budget estimates for 2005-06 envisage a growth of around 6 per cent in revenue expenditure and 5.5 per cent in aggregate disbursements, whereas Normal WMA limits have been increased by nearly 10 per cent.

Table 8: Annual Growth Rates of Expenditure and Normal WMA Limits of State Governments

(per cent)

		2001-02	2002-03	2003-04	2004-05	CAGR (1999/00-2004/05)	2005-06
1	**Revenue Receipts**	6.4	9.9	13.2	21.6@	**13.2**	11.7*
2	**Revenue Expenditure**	7.7	6.8	13.1	13.1 @	**10.6**	6.1 *
3	**Capital Expenditure+**	3.0	11.8	61.5	12.8 @	**16.3**	2.5*
4	**Total expenditure (2+3)**	7.2	7.4	18.9	13.1@	**11.4**	5.5*
5	**NWMA Limits #**	34.1 $	14.2	18.8	13.5	**15.6**	9.8

+ Excluding repayments @ Revised Estimates * Budget Estimates $ Increase over 1999-00

The base to compute Normal WMA was revenue receipts plus capital expenditure (including repayments) during 1999-2000 to 2002-03 and was revenue receipts from 2003-04 to 2005-06.

3.10. The Committee also noted that the increases in Normal WMA limits recommended by the Vithal and Ramachandran Committees were expected to help the States to tide over their liquidity management problems over a **transitory period**. For example, the Vithal Committee (1998) justified the minimum increase of 40 per cent in the normal WMA limits of Non-Special Category States on the grounds of "*problems of adjustment in the short-run*", and provided for a minimum increase of 50 per cent in the case of Special Category States *"as a transitional provision….taking into account the peculiar problems."* Similarly, the Ramachandran Committee, "*for purposes of computing the WMA limits, started with a premise of protecting the existing levels to which States have become accustomed***.**" The higher WMA limits recommended by the Ramachandran Committee (2003) were justified as follows, "*…….in the predicament in which many States are placed, the Committee feels obliged to continue the already prevalent liberal dispensation for some more time, pending the necessary fiscal correction. The Committee believes that this would not delay the corrective initiatives which are urgently required. It also hopes that the States will recognize that the WMA presently available is only a limit and not an entitlement.*"

3.11. In the opinion of the Committee, with fiscal correction well underway at the State level, as evident from the reduction in fiscal imbalances, it can now be reasonably expected that the 'transitory period' specified by the Vithal and Ramachandran Committees, is nearly past. In this context, it is also pertinent to recall that the Vithal Committee had indicated that, "***….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 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.*** " Similarly, the Ramachandran Committee had underscored that, ***"….the roadmap for the future must not be the perpetuation or enlargement of the already adequate space provided in the liberal limits of WMA but to retract from the present trend of using it as a budgetary resource.***"

3.12. In the light of the reduction in overall liquidity mismatches in recent years, as discussed above, the Committee perceives that the existing **Normal WMA limits are more than adequate**. The Committee expects that in the future, possibly higher liquidity mismatches induced by increases in aggregate disbursements would need to be addressed by mobilizing higher revenues as well as better cash management by the States. Some States have highlighted the adverse impact of the large ensuing bullet repayments of market borrowings under the Debt Swap Scheme, on their liquidity position. In this connection, the Committee feels that this, in fact, strengthens the need for setting up Consolidated Sinking Funds (CSF) and urges those States, which are yet to set up the CSF, to initiate appropriate action in this regard, in their own interests.

3.13. The other arguments put forward by the State Governments for enhanced WMA limits in the future related to (i) persistently high wage bills

(apart from pensions and interest payments) which had their roots in the recommendations of the Fifth Pay Commission; (ii) abrupt shortfalls in devolution of resources from the Centre; and (iii) implementation of VAT. The Committee feels that these are undoubtedly significant issues in State Government finances, but should not materially impact upon the already adequate dispensation under the WMA Scheme, as briefly discussed below.

3.14. High levels of committed expenditure in terms of wages, pensions and interest payments are essentially structural (rather than temporary) and predictable aspects of State Government budgets, for which any prescribed increase in WMA limits, however large, would clearly be insufficient over a period of time, in the absence of fiscal reforms. It needs to be recognized that such structural problems are outside the realm of liquidity facility from a central bank and should rather be dealt with by fiscal reforms.

3.15. On the issue of abrupt shortfalls in Central transfers, the Committee reaffirms the following views of the Ramachandran Committee, "*The ratio of 3.19 per cent and 3.84 per cent of the average revenue receipts effectively work out to 38.28 per cent and 46.08 per cent of their average monthly receipts for the Non-Special Category and the Special Category States, respectively. A limit of this order should provide more than sufficient cushion to cover the monthly liquidity problems that could arise even from any unexpected shortfall in devolution and transfer which, many States argued, were the main cause of their fiscal difficulties.*" The States have also admitted that shortfalls and/or delays usually occur in respect of transfers other than those from the Ministry of Finance and that such delays are partly caused by the non-submission of utilization certificates. The Committee suggests that such weaknesses in institutional arrangements should be speedily redressed by the concerned entities. The Committee would also like to add that the estimation of Central transfers by the State Governments may need to take increased cognizance of the past trends in Central finances as also the

evolving macroeconomic environment, so as to minimize the adverse liquidity impact of shortfalls, if any.

3.16. On the revenue impact of VAT, complete information is not available at this stage. The Central Government has, however, announced that it would compensate the States (in a phased manner over three years) for their revenue losses on account of the implementation of VAT. Accordingly, the Central Government budget for 2005-06 has made provision of Rs.5,000 crore towards this objective, which should help to alleviate liquidity pressures that may arise in this regard. In the medium to long-term, VAT is expected to be revenue augmenting.

E. Durable Surplus of State Governments

3.17. The States have been requesting RBI to invest their cash surpluses in dated GOI securities with a view to availing Special WMA at a concessional rate of interest and earn a higher return on their investment. However, as many States continue to record fiscal and revenue deficits, the RBI has not been encouraging the States to make such investments, unless they have 'durable surplus.' There is, however, no clarity or unanimity on the definition of 'durable surplus', as evident from the discussions in the biannual Conferences of State Finance Secretaries organized by the RBI as also from the interaction of the States with the Committee. In the past, when the fiscal and liquidity positions of the State Governments were under stress, the duration of cash surpluses tended to be limited as the States invariably remained in WMA/OD for prolonged periods. Permitting the States to invest such temporary cash surpluses in dated Government securities and thereby avail of Special WMA was, therefore, not in accordance with sound financial principles.

3.18. The trends in interest rates over the past five years indicate a differential in the movements of the cost and return on funds of the State

Governments. The Bank Rate - the rate to which the interest rates on WMA/OD are linked - has declined by one percentage point over the period 2000-01 to 2005-06 (as on end-September 2005) **(Table 9 and Annex Table 3)**. The interest rates on various Government of India (GOI) debt instruments (Treasury Bills and dated securities) are, at present, also lower than their respective levels at the beginning of the decade, even though some firming up has been evident since

Table 9: Trends in Interest Rates in Recent Years

(per cent)

	INTEREST RATE	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06
1	Repo Rate	9.00	8.00	7.00	6.00	6.00	6.00
2	Bank Rate	7.00	6.50	6.25	6.00	6.00	6.00
3	GOI Treasury Bills						
(i)	14-Day Intermediate	4.00	5.50	5.25	5.00	5.00	5.00
(ii)	91- Day	8.96	7.25	5.89	4.37	5.32	5.20
(iii)	182- Day	8.92	-	-	-	-	5.40
(iv)	364- Day	9.93	8.96	5.89	4.44	5.61	5.61
4	Weighted Avg. Rate On GOI Dated Securities	10.94	7.74	6.45	5.31	6.86	7.36
5	Weighted Avg. Rate On State Govt. Securities	10.99	9.20	7.49	6.13	6.45	7.62
6	Loans From Centre To States	12.50	12.00	11.5	10.5	9.5	-

Note: The interest rates are those prevailing at the end of the last quarter of the year.
The interest rates for 2005-06 are as on end-September 2005. The Repo Rate was raised to 6.25 per cent with effect from October 26, 2005.

2004-05. Over this period, the extent of decline in the interest rates on GOI debt instruments (by 3 to 4 percentage points) has, however, been higher than that in respect of Bank Rate (by one percentage point). At present, the Bank Rate is higher than the interest rates of GOI Treasury Bills. The interest rate on 14-day Intermediate Treasury Bills - the instrument in which the cash surpluses of the State Governments are automatically invested - has been fixed at 1 percentage point below the Bank Rate with effect from 2001-02 (as against 3 percentage points earlier). Many States have pointed out that their cash surpluses, in the form of 14-day Intermediate Treasury Bills, have been built up in the recent period essentially through buoyant receipts from NSSF, the interest cost of which is 9.5 per cent. The interest rate on 14-day

Intermediate Treasury Bills is, however, only 5 per cent, which is also lower than other forms of borrowings (such as market loans and loans from Centre). The discount rate on GOI 91-day Treasury Bills is around 5.2 per cent, at present. The revenue loss to the States is thus clearly evident. The States have argued that in case they are allowed to invest their cash surplus in dated GOI securities, the weighted average interest rate in respect of which is 7.3 per cent at present, this revenue loss could be reduced. Moreover, the holdings of GOI securities would enable them to avail of Special WMA at a concessional interest rate and thereby the need to access Normal WMA would decline. A counterview is that States could utilize their surplus cash balance to pre-pay past high cost debt including those in respect of Small Savings.

3.19. With the improvement in the finances and liquidity position of the State Governments in the recent period and given the extant differentials between the cost of funds and returns on investment of cash surpluses, it is perceived that some liberalisation of the existing modalities for investment of their cash surpluses may be warranted but with some safeguards to ensure that the cash surpluses are truly durable.

IV. Concluding Observations and Recommendations

4.1. It is evident from the foregoing discussion that the **backdrop** as well as the **evolving scenario** in the context of which this Committee is required to frame its recommendations is quite different from those of the previous (Vithal and Ramachandran) Committees on WMA to State Governments. The reduction in fiscal imbalances as well as the significant improvement in liquidity management in the case of most of the State Governments during the preceding four-year period has provided a unique (if not unprecedented) setting to this Committee vis-à-vis the previous two Committees. Furthermore, with higher devolution of Central resources (as recommended by the TFC) and the progressive enactment of Fiscal Responsibility Legislation – induced in some measure by the TFC recommendations - the prospects for further improvement in the State finances and liquidity management over the medium term, appear to be much better at this juncture than the outlook of the previous two Committees. It is in this context that the Committee has framed its recommendations, in accordance with its terms of reference.

A. Normal WMA Limits

Present Status

4.2. At present, Normal WMA limits of the States are formula-based and are fixed *every year* as a specified ratio of their respective average revenue receipts (with lottery receipts taken on a *net* basis) during the last three years (Revised Estimates of the previous year and actuals of the two prior years). The multiplying ratios are, at present, 3.19 per cent in the case of Non-Special Category States and 3.84 per cent in the case of Special Category States.

Views of the States

4.3. Many of the States have expressed satisfaction with the existing formula for computing Normal WMA limits. The States felt that Normal WMA limits should be increased on an annual basis in line with the growth of their

budgetary transactions. Some of the States have suggested for a change in the base to total expenditure (instead of revenue receipts) as also increase in the multiplying ratios. Views of the States were divided with regard to the impact of TFC recommendations on the requirement of WMA over the medium term: some States indicated no impact, some expressed that reliance on WMA would decline in view of higher devolution of resources, while many indicated the emergence of liquidity pressures on account of the recommended shift to market borrowings in lieu of Central Plan loans.

Views of the Committee

4.4. Taking note of the views of the States, the Committee perceives that the formulation of WMA limits by the RBI over the medium term needs to take into consideration the following:

(i) the **adequacy of existing WMA limits** to cover temporary mismatches in the cash flows of the State Governments, based on the recent experience;

(ii) the size of expected temporary cash flow mismatches over the **medium term** particularly in the context of the **recommendations of the TFC;** and

(iii) consistency with the objectives of **monetary management**.

Issues (i) and (ii) are discussed below, while issue (iii) is elucidated in para 4.21.

(i) Adequacy of Existing Normal WMA Limits

4.5. The Committee feels that the computed **Normal WMA limits** over the past four years have been **more than adequate** to address the liquidity mismatches of the State Governments. As discussed in the previous chapter, this is evident from various indicators, which reflect the improvement in liquidity position across most States, such as the reduction in Normal WMA utilization relative to its limits; reduction in the amount and frequency of resort to overdrafts; reduction in overall liquidity mismatches [as given by the sum of

Normal WMA, Special WMA and Overdrafts (NSO)], in nominal terms as well as in terms of ratio to Normal WMA limits; downward movement in the trend component of NSO; and an increase in investment in 14-day Intermediate Treasury Bills.

4.6. The Committee notes that since March 1999, Normal WMA limits have been increased every year (except in 2000-01) and the annual average increase in Normal WMA limits since then has exceeded the average annual rate of growth of expenditure of the State Governments. In the opinion of the Committee, with fiscal correction well underway at the State level as evident from the reduction in fiscal imbalances in the recent period, and with the prospective improvement in the financial position of the States as envisaged by the TFC, **the need to further increase the Normal WMA limits, year after year, in line with the growth of average revenue receipts (in accordance with the existing methodology) may not be as compelling over the ensuing medium term, as it was during the late 1990s and the early part of the present decade when State finances were under greater stress.** It also needs to be noted in this context that the Centre's WMA limits have so far remained unchanged since 2000-01.

(ii) Implications of TFC and Medium Term Outlook

4.7. Taking cognizance of the substantial increase in resource transfers to the States as recommended by the TFC over the five-year period beginning 2005-06, as elucidated earlier, it is expected that the fiscal stress on the State Governments would be considerably eased over the medium term. Secondly, the fiscal restructuring plan and the incentivised debt relief package as recommended by the TFC, is likely to spur the enactment of FRL at the State level, which would instill greater fiscal discipline and further ease the strain on their finances and liquidity position.

4.8. The above perceptions were confirmed by an **econometric (panel regression) exercise, discussed in the previous Chapter,** which showed

that, (i) liquidity mismatches are likely to widen in tandem with the proportion of borrowings (GFD) that is required to be spent on revenue expenditure (a large part of which is committed in nature in the form of interest payments, wages and pensions, and which is independent of the level of borrowings in that year); and (ii) a downswing in the economic growth cycle is likely to adversely impact upon the buoyancy and regularity of revenue receipts, which, in turn, could induce liquidity pressures. Expectedly, the severity of the impact of such possible cyclical downturns would be better withstood in an environment of enhanced fiscal discipline. Thus, it should be expected that with the States enacting FRL and adhering to the TFC's fiscal restructuring plan of eliminating the revenue deficit over the medium term, the size of liquidity mismatches, and consequently, the need to avail of WMA, is likely to decline over the medium term. In such a scenario, temporary liquidity mismatches would reflect genuine seasonal factors with a few occasional disturbances.

4.9. Notwithstanding the prospective improvement in the fiscal environment over the medium term, the Committee recognises that 2006-07 would continue to be a period of transition for the State Governments mainly in the context of the shift from Central Plan loans (which are relatively 'orderly' flows to the States) to market borrowings, as recommended by the TFC. Although information regarding the actual impact of the TFC recommendations on State Government finances is not fully available at this stage, most of the States have expressed that the transition to market borrowings in *lieu* of Central loans is likely to be associated with uncertainties relating to the financing of their Plan expenditures which could, in turn, manifest in liquidity mismatches during the year, even though overall devolution and transfers from the Centre would be higher. The Committee perceives that State Governments would, accordingly, require some more time to adjust to the fiscal *milieu* envisaged by the TFC. By such time, the steadfast commitment to fiscal correction and consolidation as embodied in the FRLs, being enacted by an increasing

number of State Governments, would also get firmly entrenched, which would enable them to assimilate easily other changes in the policy environment.

4.10. In view of the above, the Committee feels it would be appropriate to ensure that there is no reduction in the Normal WMA limits for 2006-07 vis-à-vis those fixed for 2005-06. This would be necessary, notwithstanding the observed adequacy of existing limits in the past few years as well as the expected improvement in ensuing fiscal/liquidity conditions, so that the States are provided sufficient headroom to address possible liquidity mismatches while they adjust their extant financial and institutional arrangements to the new environment.

4.11. The considerations underlying the formulation of WMA limits **with effect from the following year i.e. 2007-08** (by when the States would have adjusted to the new arrangements) should, however, take cognizance of the evolving environment of enhanced fiscal discipline and enduring improvement in the fiscal situation, as envisaged by the TFC.

Recommendation of the Committee

4.12. The Committee noted the evolving changes in the base and formula for computing Normal WMA limits. As indicated earlier, in accordance with the recommendations of the **Vithal Committee (1998), the base was total expenditure (which is the logical surrogate for cash flows)** ***less*** **revenue deficit, (in order to remove the incentive to increase imprudent expenditure).** The base, thus, worked out to revenue receipts (net of lottery expenditure) *plus* capital expenditure (including repayments of internal debt and loans to Centre). The Vithal Committee observed that "….*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 multiplying ratios to be applied to the base were 2.25 per cent in the case of Non Special

Category States and 2.75 per cent in the case of Special Category States. **The GFS (2001) did not change the base** but increased the multiplying ratios to 2.40 per cent and 2.90 per cent, respectively. **The Ramachandran Committee (2003) changed the base to revenue receipts on the grounds of, *inter-alia*, transparency, simplicity and inter-State differences in the computation of capital expenditure.** The exclusion of capital expenditure from the base was compensated by adopting higher multiplying ratios. The multiplying ratios were accordingly increased to 3.19 per cent and 3.84 per cent, for Non-Special Category and Special Category States, respectively.

4.13 Notwithstanding the advantages of using revenue receipts exclusively as the base for computing Normal WMA limits, as highlighted by the Ramachandran Committee, **this Committee feels that there is merit in formulating a base that would more truly reflect the total volume of budgetary transactions. The Committee recognizes that there could be inter-State differences in the computation of capital expenditure (as highlighted by the Ramachandran Committee) but perceives that such problems would tend to impact on the classification of revenue and capital expenditures rather than on the level of total expenditure.** The Committee also noted that some of the State Governments had suggested that the base may be changed to total expenditure. **Accordingly, the Committee recommends that the base may be defined as total (revenue *plus* capital) expenditure excluding repayments and adjusted for one-time ad hoc expenditures.** Lottery expenditures should also be excluded from the base since these are quite large in respect of some of the States and thus tend to inflate the base even if these are nearly equal to lottery receipts. In the case of a State Government which has a revenue surplus, the base may be defined as above, while in the case of a State having a revenue deficit, the base should exclude the revenue deficit.

4.14 The justification for excluding the revenue deficit from the base has already been explained by the Vithal Committee, as indicated above. **The**

exclusion of the revenue deficit from the base would also mean that with the progressive reduction in the revenue deficit over the medium term, as envisaged by the TFC, the base and concomitantly, the Normal WMA limits would be more closely related to the total expenditures or the scale of budgetary operations of the State Governments. At the same time, higher capital investment by the States would be reflected in the base used for calculating the Normal WMA limits. On the other hand, the rationale for excluding repayments from the base is that these are expended out of gross borrowings and hence, the volume of repayments, by itself, should not strain the general liquidity position of the State Governments. Moreover, the setting up of Consolidated Sinking Funds by the State Governments should facilitate orderly repayments of their market borrowings. One-time expenditures (such as the settlement of dues of the State Electricity Boards through the issue of power bonds in 2003-04 and 2004-05) also need to be excluded from the base not only as a matter of principle, given their intrinsically sporadic nature, but also because their expansionary impact on the WMA limits would tend to persist over subsequent periods, under the present system of averaging of the base for the latest three years.

4.15. The Committee also noted that the Ramachandran Committee had recommended that the base (revenue receipts) should be obtained as the average of the latest three years (two years' actuals and one year's pre-actuals as approved by the CAG). Normal WMA limits for the next fiscal year (beginning April) are fixed by the RBI usually in the month of February/March. At the time of fixing the limits, the latest data that are usually available, however, relate to the budget estimates of the current year, the revised estimates of the previous year and the actuals of the year before. This is because not all the State Government budgets are presented at the usual time of fixing the Normal WMA limits. Pre-actuals data are also not provided by all the State Governments on a timely basis. As a consequence, the base for fixing the WMA limits of the ensuing fiscal year has been incorporating the lagged revised estimates and the actuals of the two years immediately prior to

the revised estimates. In view of the deviations of the revised estimates from the actuals data, **the Committee recommends that the base needs to incorporate only actuals data,** even if these are dated by one more year than the revised estimates.

4.16. The modification in the definition of base as recommended in para 4.13 would necessitate **changes in the multiplying ratios with a view to maintaining equivalence with existing Normal WMA limits.** Towards this objective, the sums of the State-wise averages of the Normal WMA limits for the years 2003-04, 2004-05 and 2005-06, were obtained, separately for Non-Special Category and Special Category States. Next, the sums of the State-wise averages of the recommended base for the years 1999-2000, 2000-01 and 2001-02 (all acutals data as reported in the budget documents) were worked out. The *three*-year lag between the centre year (2004-05) of the Normal WMA limits and the latest actuals (2001-02) incorporated in the base may be noted. The multiplying ratios, obtained by dividing the sum of the limits by the sum of the new base, worked out to 3.07 per cent in the case of Non-Special Category States and 4.06 per cent in the case of Special Category States **(Annex Table 4)**. **The Committee recommends that, after approximation, the multiplying ratios may be taken as 3.1 per cent for Non-Special Category States and 4.1 per cent for Special Category States, and applied to their respective base. The base should be taken as the average of the latest three years for which actual data are available.**

4.17. The Committee thus recommends the computation of Normal WMA limits for the period **2006-07 to 2009-10** (i.e. coterminous with the remaining period of award of the TFC) on the following lines:

(i) The Normal WMA limits for 2006-07 (beginning April 2006) may be computed by taking the average of the base as defined in para 4.13 for the years 2001-02, 2002-03 and 2003-04 (all actuals data as presented to

the State Legislatures). As part of one-time expenditures, actual amounts mobilized via power bonds during 2003-04 may be excluded from the base. Multiplying ratios of 3.1 per cent and 4.1 per cent may be applied to the average of the base for the three years in respect of Non-Special Category States and Special Category States, respectively. The limits may be rounded off to the nearest multiple of Rs.5 crore. It also should be ensured that there is no reduction in the Normal WMA limits for any State Government from the existing (2005-06) levels.

(ii) The Normal WMA limits may be reviewed every year. The Committee expects that with the reduction in the revenue deficit over time, the limits as computed for 2006-07 may prove to be quite adequate, in which case annual revision of the limits may not be necessary.

4.18. The proposed Normal WMA limits for State Governments for 2006-07 are set out in **Table 10.** These limits are tentative and are based on data compiled from the budget documents of the State Governments, and are adjusted for the *full* amount of power bonds issued in the year 2003-04, as per RBI records. The aggregate amount of power bonds issued in 2003-04 was Rs.27,345 crore in respect of 24 State Governments (i.e. except Goa and Jharkhand) which have WMA facility from the RBI. In 2004-05, power bonds amounting to Rs.899 crore were issued in respect of Jharkhand. The tenure of these bonds commenced from October1, 2001 and the States were required to pay accumulated coupon from the date of issue *i.e.* October 1, 2001. It is understood that the settlement of the dues of the SEBs via the issue of power bonds in 2003-04 (and 2004-05) had a revenue and/or capital expenditure component, the details of which are not clearly available in the budget documents of all the State Governments. Since the revenue deficit is excluded from the recommended base, the adjustment of the revenue expenditure component of the settlement of SEB dues through power bonds could result in an over-correction of the base. **Accordingly, the Committee suggests that the data, as presented to the State Legislatures, that are**

relevant for the computation of the recommended base may be confirmed by all the State Governments at the earliest (and latest by mid-February 2006) to enable the RBI to fix the Normal WMA limits for 2006-07.

Table 10: Proposed Normal WMA Limits for 2006-07

(Rs. Crore)

		EXISTING LIMITS	**BASE**	**RECOMMENDED LIMITS**
	STATES	**2005-06**	**(AVG. of 2001-02 to 2003-04)**	**2006-07**
1	**2**	**3**	**4**	**5**
I	**Non-Special Category States (RATIO: 3.1 per cent)**			
1	Andhra Pradesh	770	28282	880
2	Bihar	380	12508	425
3	Chhattisgarh	175	6082	190
4	Goa	65	1704	65
5	Gujarat	575	20263	630
6	Haryana	225	9387	295
7	Jharkhand	280	8708	280
8	Karnataka	570	20117	625
9	Kerala	345	11202	350
10	Madhya Pradesh	420	14701	460
11	Maharashtra	1050	37353	1160
12	Orissa	270	9644	300
13	Punjab	360	9639	360
14	Rajasthan	440	16241	505
15	Tamil Nadu	670	23470	730
16	Uttar Pradesh	920	32810	1020
17	West Bengal	495	17563	545
	Sub-Total	**8010**		**8820**
II	**Special Category States (RATIO: 4.1 per cent)**			
1	Arunachal Pradesh	50	1488	65
2	Assam	295	7216	300
3	Himachal Pradesh	145	4553	190
4	Manipur	55	1450	60
5	Meghalaya	55	1465	60
6	Mizoram	50	1313	55
7	Nagaland	65	1913	80
8	Tripura	80	2399	100
9	Uttaranchal	130	3470	145
	Sub-Total	**925**		**1055**
	TOTAL (ALL STATES)	**8935**		**9875**

It may be observed that the recommended limits for 2006-07 are, in the aggregate, higher by over 10 per cent than the existing limits for 2005-06.

B. Special WMA Limits

4.19. Since March 1999, Special WMA limits of the State Governments are linked exclusively to their holdings of GOI securities, adjusted for margin. These securities are revalued every quarter by CAS, Nagpur and the holdings of such securities by State Governments can fluctuate on a daily basis (reflecting addition to holdings and redemption or sale of securities held). The Ramachandran Committee had observed that this Scheme was working well and had further liberalised the Scheme (with some safeguards) in order to encourage the State Governments to build up reserves of GOI securities which could be leveraged to raise collateralized funds from the RBI.

4.20. The Committee recognizes the need for encouraging the State Governments to build up reserves of GOI securities as well as the implications of the transition from Central loans to market borrowings for financing the State Plans, over the short to the medium terms. Accordingly, the Committee does not suggest any change in the Special WMA Scheme. In line with extant Scheme, State Governments would be required to avail Special WMA before Normal WMA.

4.21 However, keeping in view the evolving fiscal scenario, the Committee would, nevertheless, like to flag the issue of Special WMA limits from the point of view of monetary management, for re-consideration at an appropriate juncture, particularly after the States have adjusted to the changes in the policy environment as envisaged by the TFC and by their own FRLs. The Committee recognizes that persistent increases in WMA limits have potentially adverse implications for monetary stability even though net RBI credit to State Governments has *so far* usually constituted a small component

of reserve money. This is because linking Special WMA limits exclusively to the holdings of GOI securities, adjusted for margin, render these limits to be **potentially unbounded**. Apart from being potentially unrestrained, these limits **bear little relation to the size of budgetary transactions** and, are therefore, **inequitably distributed across the States**. It may also be recalled that since 2003, Special WMA are required to be availed before Normal WMA. With the improvement in the liquidity position of the State Governments over the medium term, their cash surpluses are likely to increase which would enable them to invest in eligible GOI securities, and thereby permit them to avail commensurately larger and an unpredictable amount of Special WMA. Early traces of such a trend are already evident from the rapid increase in the aggregate Special WMA entitlements of the State Governments from Rs.2,862 crore as at end-March 2005 to Rs.5,207 crore as at end-June 2005 and further to Rs.7,630 crore as at September 19, 2005 i.e. an increase of over 166 per cent within a span of less than six months, with most of the increase concentrated only in respect of three States. At the same time, under the present Overdraft Regulation Scheme, States can resort to an unlimited amount of OD for a period of five days, on the first such occasion. Thus, over the medium term, the total (Normal plus Special) WMA limit and Overdraft of State Governments, under the existing modalities, could potentially be disproportionately large, if not unlimited. **Keeping this in view, the Committee suggests that issue of rationalizing the limits for Special and Normal WMA within a single integrated limit may be examined at an appropriate time, from the standpoint of monetary stability.**

C. Interest Rate on WMA

4.22. At present, the interest rate on WMA upto 90 days is the Bank Rate, while WMA beyond 90 days is charged at 1 per cent above the Bank Rate. The interest rate on Special WMA is, at present, one per cent below the Bank Rate.

4.23. With the current Bank Rate at 6 per cent, most of the State Governments have favoured a reduction in the interest rate on WMA. There is

also a general view that the interest rate on WMA should be linked to a more market-related rate rather than the Bank Rate. Some of the States have also indicated that their recourse to WMA would hardly be affected by the interest rate thereon since the facility is used under financial compulsions.

4.24. The Committee noted that the interest rate on WMA has been less than those in respect of other sources of borrowing (although of different maturities) as for instance, market loans, loans from the Centre and securities issued to the NSSF. The Committee feels that the principle regarding the interest rate structure in respect of WMA should continue to be such that it discourages availment of the facility for prolonged periods. The Committee also perceives that there is merit in linking the interest rate on WMA to one that is more reflective of short-term market conditions since the Bank Rate is a signal for medium-term monetary policy stance. Two rates that may be considered relevant in this context are the **Repo Rate** and the **91-day Treasury Bill rate**. The repo is an instrument for liquidity injection to meet day-to-day mismatches in the cash flows of commercial banks and, in this context, the Repo Rate signals the short-term policy rate. On the other hand, the 91-day Treasury Bill rate is a market-determined one and the maturity period of the instrument is similar to that of WMA. From the viewpoint of **operational convenience**, however, it would be simpler to link the WMA rate to the Repo Rate, rather than the 91-day Treasury Bill rate. It may be noted that the Repo Rate which has been equal to the Bank Rate (6 per cent) since the last quarter of 2003-04, was raised to 6.25 per cent with effect from October 26, 2005, keeping in view the current macroeconomic and overall monetary conditions.

4.25. **Accordingly, the Committee recommends that the interest rate on WMA upto 90 days should be should be the Repo Rate, while WMA beyond 90 days should be charged one percentage point above the Repo Rate. The Committee also recommends that Special WMA may be charged one per cent below the Repo Rate, as an incentive to build up**

reserves of such securities, subject to other relevant considerations by the RBI such as availability of such securities with it.

D. Overdraft Regulation Scheme

4.26. The existing stipulations regarding overdrafts are based on the recommendations of the Ramachandran Committee. The Ramachandran Committee had recommended an increase in the total number of consecutive working days that a State can remain in OD from 12 to 14. The two additional days were recommended as many State Governments had requested more time to arrange funds to clear the OD without disrupting their essential operations. It was also in accordance with the recommendations of the Sarkaria Commission (1988). Furthermore, if a State's OD exceeds 100 per cent of WMA limit continuously for 5 days for the second occasion, then payments are stopped. Payments are also stopped if a State remains in OD for more than 36 days in a quarter (The Vithal and Ramachandran Committees had recommended 20 days and 30 days, respectively, in this regard).

4.27. A few State Governments have not suggested any change in the time limit on OD. Most of the others have sought liberalisation of the various time limits in respect of OD, generally citing financial compulsions.

4.28. The role of OD is to meet temporary spikes in liquidity mismatch, which arise due to a sudden need for expenditures such as natural calamities, without a corresponding increase in revenues. In this context, the Committee noted with concern the fairly frequent resort to OD by some of the State Governments in the past notwithstanding the steady enhancement of WMA limits over the years. As aptly observed by the Vithal Committee, *"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. The Committee is in concurrence with this view and **feels that recurrent ODs are a manifestation of structural imbalances and/or unsatisfactory cash management.** The Committee, however, notes the improvement in liquidity management across most States in the recent period as reflected by (i) the reduction in the trend component of NSO; (ii) the decline in outstanding amount of NSO as at the end of the fiscal year (which implies some restraint on the tendency to roll over of temporary liquidity mismatches and their concomitant conversion into the fiscal deficit); (iii) substantial reduction in the number of States with OD beyond 100 days in a year; and (iv) reduction in the number of occasions of OD during a year. The Committee is of the opinion that with the further enhancement of WMA limits with effect from 2006-07, and consistent with the *milieu* of fiscal discipline embodied in the FRLs, there is little justification to liberalise the existing time limits on OD. **Nevertheless, given the onset of a changed fiscal regime as envisaged by the TFC, the Committee decided not to modify the existing time limits for OD at this stage.**

4.29. The Committee also recommends that State Governments need to be cautioned to take remedial measures to avoid emergence of overdraft, whenever they avail of WMA in excess of 75 per cent of their Normal WMA limit. The Committee noted that the Reserve Bank has a standing arrangement in this regard. **The Committee recommends that all the State Governments should also put in place a monitoring mechanism for their availment of WMA.** It is expected that with an effective ‘early warning’ system, the States would be have sufficient time to undertake suitable corrective measures to prevent the occurrence of ODs.

4.30. Presently, OD upto 100 per cent of the Normal WMA limit is charged at 3 per cent above the Bank Rate, while OD beyond this level is charged 6 per cent higher than the Bank Rate. Most of the State Governments have generally favoured a more liberal interest rate structure on OD in view of the fact that these are resorted only under financial duress and a high interest rate thereon only serves to exacerbate the problem by increasing the revenue deficit. In consonance with the changes recommended in the interest rate structure in respect of WMA, and taking cognizance of the views of the States, the Committee recommends some liberalistion of the interest rate structure on OD. **Accordingly, interest rate on OD upto 100 per cent of the Normal WMA limit should be charged 2 percentage points higher than the Repo Rate, while OD in excess of 100 per cent of the Normal WMA limit should be charged 5 percentage points above the Repo Rate.**

E. Investment of Durable Cash Surplus

4.31. The Committee noted the present interest rate differential between the cost of funds and rates of return on alternative avenues for investment of cash surpluses of the State Governments. It also noted that in the past, when many States were frequently availing of WMA and resorting to ODs, there was a justifiable apprehension about the durability of their cash surpluses (The discussion in para 3.17 on the issues relating to the definition of a durable surplus may be recalled in this context). The Committee feels that some liberalization may now be warranted in the light of the realized and prospective improvement in the financial and cash position of the State Governments. The Committee also acknowledged the continued need to ensure that cash surpluses that could be permitted for 'longer-term' investment should reflect enduring improvement in the liquidity position of States. On balance of considerations, the Committee recommends that **States may be permitted to invest their cash surplus in dated GOI securities, provided that they have not availed WMA in the immediately preceding period of 90 consecutive days, and subject to other relevant considerations by the RBI such as availability of such securities with it.**

The minimum specified period of 90 days would be consistent with the tenure of WMA, and should help to obviate any possible incentive to utilise short-term accommodation from RBI for purposes of longer-term investment. The Committee also suggests that States may take a view on the alternative benefits of investing their cash surplus in dated GOI securities or using it to pre-pay some of their existing high-cost debt.

F. WMA and Balances in CSF/GRF

4.32. The Committee also examined the issue of permitting the investments in the Consolidated Sinking Fund (CSF) and Guarantee Redemption Fund (GRF) as eligible collateral to avail WMA. The Ramachandran Committee had prohibited this stating that, "*Special WMA should continue as an exclusive scheme based on investments in Central Government securities which are* ***unencumbered****…*" The TFC has also observed that balances under CSF should be used exclusively for redemption of borrowings. Some of the States, on the other hand, have suggested that such investments should, as a matter of incentive, be made eligible for availing Special WMA.

4.33. The Committee recognized the need for building up CSF/GRF balances. In particular, under the TFC recommendations, the States would be required to access the markets directly for their borrowing requirements. It will be prudent for the States to build up necessary capacity through the mechanism of the CSF, for meeting possibly lumpy repayments of these borrowings, and also the market borrowings during 2002-03 to 2004-05 to repay high-cost debt to the Central Government under the Debt Swap Scheme and power bonds issued during 2003-04 and 2004-05, so that such spikes in disbursements do not unduly affect their finances. Similarly, as part of the fiscal discipline envisaged by the TFC, States are being encouraged to minimize the provision of guarantees on loans taken by their PSUs and departmental enterprises. If guarantees are given, then a guarantee fee should be levied, the proceeds of which should be put in a GRF and not used

as normal budgetary resource. The balance in the GRF could then be used in the event of default by the primary borrowers.

4.34. The Committee perceives that the concerns that have been expressed regarding 'double mortgage' of CSF/GRF balances continue to remain paramount. At the same time, the Committee feels that in the context of the expected improvement in the fiscal environment over the medium term, such concerns could be addressed by putting in place some safeguards. **The Committee, accordingly, recommends that *net incremental (i.e. new investment less redemption/liquidation)* annual investment of States in CSF/GRF may be made eligible for availing Special WMA.** It may be noted that this incentive would *not* be applicable to the *outstanding* balances under CSF/GRF. Rather, States would need to continually add to their CSF/GRF balances in order to avail of this incentive. The States would not be permitted to avail Special WMA in case there is a decline in the outstanding balances of CSF/GRF. The Committee has been given to understand that the States have set up CSF/GRF Schemes under notifications issued by them. Unless the CSF/GRF Schemes so provide, it may not be possible to utilize the GOI securities invested under these Schemes, for investment in Special WMA. **The Committee, therefore, recommends that, in case the CSF/GRF Schemes of the State Governments incorporate the above provision, then the Special WMA against the net incremental annual investment in CSF/GRF, may be provided but upto a ceiling equivalent to their Normal WMA limit.**

F. Next Review of the WMA/OD Scheme

4.35. The Committee recommends that the next review of the WMA/OD scheme may be undertaken after the receipt of the recommendations of the **Thirteenth Finance Commission.**

ANNEX 1

Ways and Means Advances, Overdrafts and Minimum Balances: A Historical Overview

The banking operations and the management of the public debt of a State Government are handled by the Reserve Bank on the basis of a voluntary agreement, under the provisions of Section 21A of the Reserve Bank of India Act, 1934. The RBI does not receive any fee from the State Government for the conduct of ordinary banking business and also does not pay any interest on the cash balance of the State Government. So far, twenty six State Governments have entered into such voluntary agreements with the RBI. These apart, the State Governments of Jammu and Kashmir and Sikkim have agreements with RBI only for the purposes of managing their public debt.

The RBI provides Ways and Means Advances (WMA) to State Governments under the provisions of Section 17(5) of the Reserve Bank of India Act, with the objective of covering temporary mismatches in the cash flows of their receipts and payments. **According to the Act, such advances are repayable not later than three months from the date of making that advance.** The maximum amount of such advance by the RBI and the interest charged thereon are, however, not specified in the RBI Act but are regulated by the voluntary agreements with the State Governments.

There are two types of WMA *viz.,* (i) Normal or clean advances, which were initiated in 1937; and (ii) Special or secured advances which were instituted in 1953, were provided against the collateral of Government of India dated securities. The limits of these advances were fixed on the basis of select parameters; the set of parameters and/or the limits of WMA were revised periodically. An overdraft (OD) occurred whenever these limits were exceeded.

Prior to tracing the historical evolution of Normal WMA limits, it is apposite to review the fixation of minimum balances since the former were obtained as a multiple of the latter till February 1999.

I. Minimum Balances

In terms of the voluntary agreements between the State Governments and the RBI, the latter is required to transact the general banking business of the States. In this connection, State Governments have to keep a specified minimum balance with RBI. Under the agreements, the States were required to meet any temporary deficits in their minimum balances either by using their own Treasury Bills or by obtaining WMA from the RBI. The minimum balances were fixed for the first time in April 1937 but became effective from April 1, 1938. The minimum balances were fixed in 1937 on the **basis of the ratio of the total revenue and expenditure of the concerned provincial Government to the total revenue and expenditure of the pre-provincial autonomy Central Government.** The Finance and Revenue Accounts of the three years 1931-32 to 1933-34 were considered for this purpose. The minimum balances thus aggregated Rs.1.95 crore. The minimum balances were periodically reviewed and revised upwards if found to be inadequate, as reflected in 'excessive' availment of WMA. Such upward revisions in minimum balances have occurred five times – (i) April 1953 (aggregating Rs.4.00 crore): The minimum balances were increased by the ratio of the **increase** in total of average **revenue and expenditure charged to revenue** during 1948-49 to 1950-51 over 1931-32 to 1933-34; (ii) March 1967 (Rs.6.25 crore): The minimum balances were increased in the ratio in which **notional pre-decentralisation minimum balance of the Government of India** increased during the period 1937 to 1967. The inter-se allocation of minimum balances was determined by the share of revenue and expenditure charged to revenue of each State in the consolidated position of all States as per the actuals of 1964-65; (iii) May 1972 (Rs.6.5 crore): This was due to the fixation of minimum balances in respect of four new States *viz.,* Himachal Pradesh,

Manipur, Meghalaya and Tripura; (iv) May 1976 (Rs.13.00 crore) and (v) April 1999 (Rs.41.04 crore). No changes have been effected in the minimum balances since then.

Normal WMA

Normal WMA limits were, from the time of initiation of the WMA Scheme in 1937 till February 1999, obtained as a multiple of the minimum balances of State Governments. Subsequently (*i.e.* with effect from March 1999), these limits were linked to a surrogate for cash flows. The limits for normal WMA were equivalent to the minimum balances at the initiation of the Scheme in 1937. The minimum balances and normal WMA limits were periodically reviewed and progressively increased over the years, in the light of evolving circumstances; ten such revisions were made in Normal WMA limits till August 1996. In 1953, the minimum balances were increased and the WMA limits were fixed at twice the minimum balance. The Normal WMA limits were increased to 12 times of the minimum balances in 1967 and further to 168 times the minimum balances in 1996. During the period October 1986 to March 1988, two intra-year Normal WMA limits were specified: 52 times the minimum balance during the first half of the year and 48 times the minimum balance in the second half.

The Vithal Committee recommended the delinking of the size of the Normal WMA limit with the minimum balance held by the States on the grounds that "*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*." The Vithal Committee instead proposed linking the normal WMA limit to the cash flows of the State. In this context, it proposed total (i.e. revenue *plus* capital) expenditure *less* revenue deficit, as the surrogate for cash flows. It was perceived that this base, which worked out

to revenue receipts *plus* capital expenditure, obviated the incentive for increasing imprudent expenditure as a means to obtain a higher WMA limit.

The actual normal WMA limits for non-Special Category States and Special Category States were obtained by applying a ratio of 2.25 per cent and 2.75 per cent, respectively, to the **base** which was the **average of revenue receipts (including lottery receipts on a *net* basis) and capital expenditure** of the States during the previous three years (1994-95 to 1996-97).

The revised WMA limits of **Non-Special Category States** were obtained as follows. For each State, the ratio of its *existing* WMA limit to its base was obtained. The maximum ratio (2.25 per cent) was obtained in the case of Goa. This ratio (**2.25 per cent**) was then applied to the base of each of the States to obtain the revised WMA limits. The aggregate of the revised WMA limits thus obtained was around 62 per cent higher than the sum of the existing limits. It was also found that the increase in the WMA limits was less than 40 per cent in the case of four States *viz.,* Goa, Orissa, Punjab and West Bengal. Given the problems of adjustment in the short run, it was considered desirable that the increase in normal WMA limit should be at least 40 per cent over the existing limits for any State Government. The revised WMA limits of these four States were accordingly obtained as 40 per cent higher than their respective existing WMA limits. The aggregate of the final revised limits of the Non-Special Category States thus worked out to around 65 per cent higher than the sum of their existing limits.

The revised WMA limits of **Special Category States** were obtained as follows. The aggregate of the *existing* WMA limits of these States were increased by 62 per cent (*i.e.* the same order of the initial increase in the case of the Non-Special Category States). The resultant amount was expressed as a percentage of the sum of the bases of all the Special Category States. This multiplying ratio, which worked out to **2.75 per cent**, was then applied to the

base of each of the Special Category States, to obtain the revised WMA limits. It was found that the order of increase over the existing WMA limit was less than 50 per cent in the case of two States *viz.,* Meghalaya and Mizoram. Taking into account the peculiar problems of Special Category States, it was recommended that, as a transitional provision, the revised WMA limit for each of these States should be at least 50 per cent higher than their respective existing limits. Accordingly, the revised WMA limits of these two States were obtained as 50 per cent higher than their respective existing WMA limits. The aggregate of the final revised WMA limits of all Special Category States thus worked out to around 65 per cent of their existing limits. Thus, the aggregate normal WMA limit for all the (23) States was increased by 65 per cent to Rs.3,685 crore with effect from March 1, 1999.

Following the formation of the new States, revised limits were fixed in November 2000 for the six reorganised States *viz.,* Bihar, Jharkhand, Madhya Pradesh, Chhatisgarh, Uttar Pradesh and Uttaranchal. The aggregate revised WMA limits of all 26 States thus worked out to Rs.3,941 crore, which was 76.4 per cent higher than the limits prevailing immediately prior to the Vithal Committee.

Despite the steep increase in limits as allocated by the Vithal Committee, there were requests from several State Governments for further liberalization of these limits. The issue was discussed in the meeting of the State Finance Secretaries held on November 3-4, 2000 and an Informal Group of State Finance Secretaries (GFS) was constituted which submitted its Report to RBI in January 2001. On the basis of the recommendations of the GFS, the ratio was revised to **2.40 per cent** for the Non-Special Category States and **2.90 per cent** for the Special Category States, i.e., a uniform increase of 0.15 per cent for both the categories of States. For the reorganized States, interim limits were fixed on their bifurcation in November 2000. Accordingly, the total revised normal WMA limits worked out to Rs.5,283 crore (based on revenue receipts and capital expenditure of 1997-98 to 1999-2000) as against the then

existing limits of Rs.3,941 crore, an increase of 34 per cent with effect from February 1, 2001. As recommended by GFS, the limits were revised again in April 2002 to Rs.6,035 crore based on the average of revenue receipts and capital expenditure during the latest three years (1998-99 to 2000-01).

The Ramachandran Committee on WMA (2003) modified the formula for computing WMA limits by linking it exclusively to revenue receipts. The choice of revenue receipts was based on the following factors: *"(a) it determines the repaying capacity of the States, (b) it is relatively transparent, (c) it is simpler to calculate, and (d) inclusion of capital expenditure tends to cause distortions because: (i) there are inter-State differences in computing capital expenditure; (ii) not all capital expenditure that is incurred by the States need be from the Consolidated Fund of the State; (iii) deficit on the capital account is camouflaged by carrying forward the unpaid bills on an incremental basis annually; and (iv) there is likely to be far less mismatch between receipts and expenditure on capital account than in the case of revenue account.*" The exclusion of capital expenditure from the base was compensated by applying a higher multiplicative factor (ratio) in order to obtain the normal WMA limits. Thus, ratios for Non-Special and Special Category States were fixed at **3.19 per cent** and **3.84 per cent**, respectively, as compared with the earlier ratios of 2.40 per cent and 2.90 per cent, respectively. Applying these ratios to the average revenue receipts for the period 1994-95 to 1996-97, the aggregate normal WMA limit worked out to Rs.7,170 crore, an increase of 18.8 per cent. The Committee observed, "*A limit of this order should provide more than abundant cushion to cover the monthly liquidity problems that could arise even from any unexpected shortfall in devolution and transfer which, many States argued, were the main cause of their fiscal difficulties.*" The Committee also recommended that henceforth the ratios were to be applied to the average of the latest three years revenue receipts (two year's actuals and one year's pre-actuals as approved by the CAG), to revise the limits annually with effect from April 1 every year. Based on the recommendations of the

Ramachandran Committee, the present aggregate normal WMA limits effective April 1, 2005 are placed at Rs.8,935 crore.

Special WMA

At time of the initiation of the scheme of Special WMA, on April 1, 1953, a uniform limit of Rupees two crore was allocated to each State. The sanctioned limits of Special WMA were linked to (six times) the minimum balance in 1967 and were periodically revised upwards to 64 times the minimum balance in 1996.

The Vithal Committee observed that the scheme had not been effectively used by the State Governments since its inception as the operative limits were lower than their sanctioned limits in the absence of sufficient collaterals held by the States. The Vithal Committee was, however, of the view that a scheme, which encouraged the States to build up reserves in the form of Central Government securities, should not be discontinued. The Vithal Committee, therefore, recommended that Special WMA should also be delinked from minimum balances and that States be allowed to draw Special WMA freely against their holdings of Government of India securities. Since 1999, the limits were made directly proportional to the State Governments' holdings of Government of India dated securities and Treasury Bills without any ceiling. Accordingly, the State Governments were allowed Special WMA to the extent of around 85 to 90 per cent of the market value of their holdings of such securities after providing for margins against price risk, with a higher margin for securities of residual maturity in excess of 10 years.

The Ramachandran Committee (2003) observed that the Special WMA Scheme was working well and with a view to encouraging the States to build up reserves of Government of India securities which could be leveraged to raise collaterised funds from the RBI, recommended further liberalisation of the scheme with some safeguards. Accordingly, a uniform margin of 5 per cent (as compared with 10-15 per cent earlier) was applied on the market

price of the securities. Secondly, it was recommended that States could utilise normal WMA only after fully availing Special WMA. The Committee also recommended that, "*Special WMA should continue as an exclusive scheme based on investments in Central Government securities which are unencumbered and should not include those securities which are covered under the Consolidated Sinking Fund, the Guarantee Redemption Fund or any other such special schemes*."

Overdraft Regulation

Large overdrafts (OD) of the States became a persistent feature since the mid-1960s. The Central Government periodically bailed out the States to help them clear their OD. Under the OD Regulation Scheme of 1985, all ODs of the State Governments were cleared on October 1, 1985; 90 per cent of the OD were cleared through medium-term loans from the Centre. It was also stipulated that payments would be stopped by the RBI in case OD remained beyond seven continuous working days. Subsequently, based on the representations from certain State Governments, RBI introduced some flexibility in the above scheme by enhancing the period for which a State Government could run on OD from seven working days to 10 consecutive working days with effect from November 1, 1993.

The Vithal Committee observed that notwithstanding the relaxation in the WMA/OD Scheme, while some States had remained in OD persistently, in the case of some others, the size of OD was several times the WMA limits, which defeated the very purpose of regulation. Recognising this, in addition to the existing limit of 10 consecutive working days that a State could be in OD, the Vithal Committee recommended a ceiling on the amount of OD, i.e., up to 100 per cent of Normal WMA limit and also a restriction on the number of days that a State could be in OD, i.e., 20 working days during any quarter in the financial year. In response to requests from the States, RBI deferred the implementation of the recommendation restricting the OD to 20 working days but accepted the imposition of a ceiling on the OD amount at 100 per cent of

the normal WMA limit with the provision that any OD over 100 per cent of the Normal WMA limit had to be cleared within three working days.

Subsequently in 2001, based on the recommendations of the GFS, the limit of 10 consecutive working days was extended to 12 consecutive working days and the restriction for bringing down the OD level within the level of 100 per cent of the Normal WMA limit was relaxed to five consecutive working days. Implementation of the norm to restrict the duration of the OD to 20 working days in a quarter continued to be deferred.

The Ramachandran Committee (2003) observed that, "*As the WMA limits stand enhanced, occasions for resort to OD should become rarer and also the need for OD beyond 100 per cent of the WMA limit should be practically non-existent. If such resort to OD nonetheless occurs in case of any State, then it should be seen as an indication of a deep rooted fiscal and structural problem that demands urgent correction…….One of the salutary recommendations of the IAC that would have arrested to some extent the utilization of this facility as a financial resource, outside the purview of Article 293(3) of the Constitution, was that of restricting the prevalence of OD within any quarter to not more than 20 working days. The Committee fails to understand why States cannot adhere to this principle, but for the fact that the OD has already become a resource rather than a facility to meet temporary and extra-ordinary liquidity problems.*" The Committee recommended, *inter-alia*, (i) A State Government could be in OD for a period of 14 consecutive working days as compared with 12 earlier; (ii) A State should not be in OD in any one quarter for more than 30 working days, otherwise payments would be stopped. This stipulation was relaxed to 36 working days in a quarter.

II. Interest Rates on WMA and OD

Prior to May 1976, the interest rate on WMA did not exceed the Bank Rate. Thereafter the rate of interest on these advances was revised. From May

1976 to August 1996 a graduated scale of charges based on the duration of the advance was introduced to discourage the States from using the facility as a normal budgetary resource. Since then a single rate of interest is being applied on WMA. The interest rates on WMA and OD witnessed periodic revisions. In general, while WMA were charged not above the Bank Rate, the interest rate on OD usually exceeded the Bank Rate.

The Vithal Comittee observed that, "*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.*" The rate of interest charged on normal and special WMA was Bank Rate, while OD were charged 2 per cent above the Bank Rate.

The Ramachandran Committee (2003) recommended differential and more stringent interest rate structure. The interest rate on WMA upto 90 days was the Bank Rate, while WMA beyond 90 days were charged at 1 per cent above the Bank Rate. OD upto 100 per cent of WMA limit were charged at 3 per cent above the Bank Rate, while OD beyond this level were charged 6 per cent higher than the Bank Rate. The Committee was of the view that such interest rates were still lower than the then prevailing interest rates.

ANNEX 2

Summary of Responses to the Questionnaire*

III. A. General

1. In your view how should temporary mismatches between receipts and payments be defined?

Many of the State Governments have generally defined temporary mismatch as an unanticipated shortfall in receipts and/or rise in expenditures. On the receipts side, shortfalls in Central transfers as well as in own tax collections have been cited as the main causative factors, while on the expenditure side, bulk outgo under committed heads such as interest payments, repayments, salaries and pensions, have been highlighted.

2. Do you see any specific patters of cash crunch during any particular period of a month / year considering the pattern of receipts and expenditure?

No specific pattern of cash crunch emerged from the responses across States. As far as Special Category States are concerned, while some experience cash crunch in the first half of the year, particularly the initial months, there are other States that experience liquidity crunch towards the end of the year. Also for some States, the intra month cash crunch is in the beginning of the month while for some States, it is towards the end of the month. As regards non-special category States, lumpiness in repayment of debt, rush of expenditure to exhaust budget payments (March), spilling over of payment of bills (April), unevenness of tax revenue receipts, delayed receipts of commercial taxes, etc., are some of the factors. As regards intra-month liquidity crunch, some States have indicated that payment of salaries (beginning of month) and repayment of loans to Centre (mid-month) are responsible.

3. In your view what are the factors contributing to mismatches in the State Government's receipt and expenditure ?
Can you indicate the approximate weightage to each of the following factors (in percentage terms):

a. Seasonal factors (receipts being fairly regular whereas payments were bunched at specific times).
b. Capital transactions like large and lumpy repayments with limited control over the timing of capital receipts, such as, borrowings.

c. Timing of transfers from Government of India.
d. Leads and lags in realisation of revenue receipts, particularly, tax receipts.

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* Responses were not received from Goa and Jharkhand.

e. Any other factors (eg. State specific reasons; like major festivals) (please specify).

The views of the State Governments varied widely, even though certain areas of congruence could be distilled. A number of State Governments attributed seasonal factors to be the primary cause of temporary mismatches. In the context of seasonal factors, a number of Special Category States indicated that while (committed) expenditure flows were fairly regular, receipts were irregular. On the other hand, some of the Non-Special Category States indicated that while receipts were regular, expenditures followed a cyclical pattern. Lumpiness in capital transactions and timing of transfers from the Government of India (GOI) were generally considered to be the second most important factors causing temporary mismatches. In the context of GOI transfers, the State Governments indicated that while transfers from the Ministry of Finance were regular, those from the other Ministries were not, in some of the cases. Irregularity and/or shortfall in GOI transfers were partly attributed to the delays in submission of utilization certificates by the States themselves. Higher expenditures on account of State-specific factors such as major festivals were also considered to be important in determining temporary mismatches. In the case of the north eastern States, all of which are Special Category States, apart from weaknesses in the revenue base emanating from geographical factors, problems in the present system of reimbursement of military expenditure connected with insurgency were reckoned to be specific factors causing temporary mismatches.

4. Do you think that the system of WMA and overdraft is currently serving other purposes rather than merely meeting the temporary mismatches?

Most of the States responded that the WMA/OD system was being used only for addressing liquidity mismatches.

4(a) What are the measure that you have undertaken to improve Cash Management System in your State? Do you see any reduction in the reliance on WMA/OD/Special WMA from RBI in the light of the State (a) in the immediate future (b) in the medium term.

Close monitoring and streamlining of treasury receipts and payments, computerisation of treasuries, improved tax administration, improved forecasting of cash flows, FRL, timely submission of reimbursement claims and utilisation certificates of Central Assistance, putting in place a monthly ceiling on drawal of fund against each major head of account, are some of the measures that the States have put in place to improve the cash management system in their States. About half of the States expected that their reliance on WMA/OD etc. would decline over the medium term, if not in the immediate future.

4(b) What are the specific factors that have contributed in the improvement of WMA / OD position of your State?

Increase in tax revenue, reforms-led reduction in the growth of revenue expenditure, higher proceeds of NSSF, reduction in Non-Plan gap due to enhanced allocation by the TFC, debt swap scheme, proper estimation of receipts and expenditures, enhanced operative limits of WMA, closure of Treasury Public Accounts maintained by Local Self Government Institutions, and staggering of expenditure, are some of the factors that have contributed in the improvement in WMA/OD position.

4(c) Are you contemplating Fiscal Responsibility Legislation (if not done so far)?

Most of the States indicated that they have either enacted FRL or were contemplating its formulation/enactment.

4(d) If yes, what are main features? Does it contain any provision relating to availment of WMA / Special WMA / OD from the Reserve Bank?

A few States that had enacted FRL indicated that it included a provision relating to WMA/OD.

5. Do you think over the years WMA / OD has started to finance the budget deficit? If so, what other mechanism / instrument can be considered to address the issue of temporary mismatches exclusively?

Only a few States indicated that WMA /OD have started to finance the budget deficit. One State suggested that apart from WMA/OD, there should also be a system of providing contingency accommodation of mismatches from RBI at least twice a year.

6. How frequently should WMA / OD limits be revised? Should it be based on a formula?

Most States indicated that WMA/OD should be revised every year and should be formula-based. The formula may be reviewed every three to five years.

7. Do you think issuance of short-term Treasury Bills could be one such instrument to finance temporary cash requirements ?

Most of the Special Category States seemed to favour the issue of short-term Treasury Bills while views were divided in respect of Non-Special Category States.

8. Do you think that the minimum balance required to be maintained by the State Governments at CAS, Nagpur should be increased? If so, why?

Very few States indicated that the minimum balances could be increased, but this was conditional on the increase in the WMA limits.

9. Does your State periodically resort to seeking of temporary accommodation directly or indirectly through State level PSUs/Co-operative bodies? If so, give details.

None of the Special Category States and only three of the Non-Special Category States indicated that they resorted to seeking temporary accommodation from State level PSUs.

IV. B. Normal WMA

10. Do you think there is need for revision in the present scheme for grant of WMA by RBI to State Governments? If yes, why?

11. Do you think that the current methodology of arriving at WMA limits, i.e, certain percentage (i.e. 3.19% for Non-Special Category States and 3.84% for Special Category States) of the average of the last three years' revenue receipts needs to be changed ? If yes, what alternate methodology would you suggest ?

12. If you think there should be a revision, should it be by way of increase in the limit on advances? If so, by how much and what is the basis for suggesting the order of an increase?

Many of the States have expressed satisfaction with the existing formula for computing Normal WMA limits. The States felt that Normal WMA limits should be increased on an annual basis in line with the growth of their budgetary transactions. Some of the States suggested for a change in the base to total expenditure (instead of revenue receipts) as also increase in the multiplying ratios. One State suggested that 50% of the monthly revenue receipts could be used as a benchmark to calculate Normal WMA limits.

13. How do you monitor the availment under the WMA ? What steps do you take when it exceeds the limits ? Is your State in a position to clear WMA within a period of three months as stipulated ?

States generally indicated that they monitor their daily balance position and expenditure is regulated and/or releases are pursued from GOI when WMA limit is exceeded. Most States indicated that they were in a position to clear WMA within the stipulated period of three months.

14. Do you have any views on the interest charged on WMA in relation to its rate, impact on you budget, etc ?

There is a general view that the interest rate on WMA should be reduced and linked to a more market-related rate (such as the Repo Rate) rather than the Bank Rate. Some of the States also indicated during the course of discussions that their recourse to WMA would hardly be affected by the interest rate thereon since the facility is used under financial compulsions.

V. C. Overdraft Regulation Scheme

15. Is the present overdraft (OD) Scheme working satisfactorily ? Do you have any suggestion to improve the scheme ? Please also give your specific views / suggestions on :-

(a) (i) Whether you consider the five day limit is having a salutary effect?

(ii) With the improvement in payment system do you think there can be reduction in number of days from the limits of five days.

(b) Whether the 14 day limit on OD is appropriate ?

(c) Under the present scheme no State Government is allowed to avail OD for more than 36 working days in a quarter. Do you think that this should be modified. If so, what are your views ?

Many States indicated that the OD scheme was in general satisfactory and most States indicated that the five-day limit should not be reduced. A number of States indicated that the 14-day limit should be increased to 20 working days and the 36-day limit should be increased to 45 working days. Some States indicated that there should be only limit of 14-18 days.

16. How frequently your State gets into Overdrafts and the reasons therefor?

States generally indicated the improvement in their liquidity management. Some attributed unsustainable debt servicing liability, large opening deficits, and other structural factors. Some indicated their inability to provide precise explanations.

17. Do you think there should be a ceiling on the amount of OD? If so, how should it be computed?

Most States were not in favour of a ceiling on OD. A few States indicated that the ceiling on OD may be equal to Normal WMA.

18. What are your views on interest being charged on OD ? Should the interest rate of OD be related to the level of drawings and/ or the period of OD?

Most States generally favoured a reduction in the interest rate. Various alternative rates suggested included (a) 1 per cent below Bank Rate; (b) Should not be related to the level or period of OD; (c) Equal to rate on WMA; (d) 1 per cent more than WMA; (e) should be related to the level of OD; (f) current rate of SLR market borrowing, irrespective of period of OD; (g) Bank Rate irrespective of amount and period of OD; (h) Abolition of differential interest rate on OD.

19. How does your State monitor the OD position? How do you normally clear the OD ?

States generally indicated that they monitor daily cash position and clear overdrafts with the release of Central dues and States' resources or by regulating expenditure.

D. Special WMA

20. Are you satisfied with the existing system of investment of your Government's surpluses - both temporary (i.e. in Intermediate Treasury Bills) and more enduring (i.e., in auction Treasury Bills and Government of India dated securities) ?

Most of the States expressed their satisfaction with the existing arrangements. Some States indicated that modalities for immediate automatic reinvestment of maturity proceeds and interest accruals should be worked out. Some States indicated that other investment avenues for surplus funds need to be identified which could provide higher returns.

21. Do you think that the scheme of Special WMA link to the holdings in auction Treasury Bills and Government of India dated securities is working satisfactorily ? If not, specify the difficulties and give suggestions for addressing them.

Most of the States expressed their satisfaction with the existing arrangements. Some States indicated that GRF/CSF should be taken into account for sanction of Special WMA.

22. Do you have any suggestion to improve the existing Special WMA scheme in terms of:-

a. *Margin*
b. *Pricing*

c. *Instruments*
d. *Coverage*
e. *Place of holding of securities.*

Any other relevant aspect

Most States did not specific suggestions but some States indicated that there should be no margin, others indicated that margin should be raised, while some others indicated that margin should not exceed 5 per cent of the value of GOI securities.

23. Do you have any other suggestions / comments on the existing systems and procedures relating to WMA / OD scheme and investment of your surpluses ?

Most States did not have any additional specific suggestions.

24. Do you think that, implementation of the recommendations of the Twelfth Finance Commission will impact on the liquidity management by the State Governments. If so, please give details of the likely impact as perceived by you.

While some of the Special Category States indicated that liquidity would improve considerably on account of revenue deficit grants and fiscal discipline, others indicated that there would be no impact on liquidity since these relate to structural (and not cyclical) aspects. Yet another State has indicated that substitution of market loans for Central loans would adversely affect liquidity. Among the Non-Special Category States, most indicated that substitution of market loans for Central loans would adversely affect liquidity. Some States indicated no impact/ improvement of liquidity levels on account of higher volume of transfers, debt relief and FRL. One State has indicated that liquidity would be conditional upon tax policy and collection efficiency of Central Government. Many States also indicated during the course of discussions that the debt relief package recommended by TFC does not cover (high-cost) Small Savings loans, which form a predominant share of their outstanding liabilities. Consequently, the positive impact of the recommended debt relief package would be limited and interest payments would continue to remain a stress factor on the finances and liquidity position of State Governments.

25. Do you think that normal WMA should be done away with and there should be only special WMA (along with OD) ?

Only one State indicated that there should be only Special WMA (alongwith OD), if the Special WMA limit was equivalent to the present Special WMA plus Normal WMA limit.

26. Should Special WMA be delinked from the concept of 'durable surplus' and only linked to actual investment ?

Less than half the number of States indicated that Special WMA may be de-linked from the concept of 'durable surplus'.

ANNEX 3

Schedule of the Meetings of the Advisory Committee with Officials/Experts

Sr. No.	Date	Place	Officials/Experts
1	May 5, 2005	New Delhi	Committee Meeting
2	May 10, 2005	Nagpur	Officials of the Central Accounts Section, RBI
3	May 11, 2005	Mumbai	Top Management of RBI; Officials of the Department of Government and Bank Accounts (DGBA) of the RBI
4	May 24-26, 2005	New Delhi	Dr. C. Rangarajan, Chairman, Economic Advisory Council to the Prime Minister and Chairman, Twelfth Finance Commission; Shri V.N. Kaul, Comptroller and Auditor General of India; Officials from the Government of India and Planning Commission.
5	June 13-14, 2005	New Delhi	Officials of the State Governments of Uttar Pradesh, Rajasthan, Punjab and Uttaranchal.
6	July 4-5, 2005	Kolkata	The Committee called on Shri A. Dasgupta, the Hon'ble Finance Minister of West Bengal. The Committee also met officials of the State Governments of Madhya Pradesh, Mizoram, Orissa, Tripura and West Bengal; as also the following experts *viz.,* Dr. Mihir Rakshit, Director, Monetary Research Project, ICRA, and Prof. H. Bhattacharya, IIM, Kolkata.
7	July 15-16, 2005	Guwahati	Officials of the State Governments of Arunachal Pradesh, Assam, Manipur, Meghalaya and Nagaland; as also the following experts *viz.,* Dr. Jayant Madhab, Financial Adviser to the Chief Minister, Assam; Dr. Atul Sarma, Vice Chancellor, Arunachal Pradesh University; Shri H.N. Das, former Chief Secretary, Assam and former Banking Ombudsman; Shri P. K. Datta, Banking Ombudsman, Guwahati; Dr. S. Borbora of the Indian Institute of Technology, Guwahati.
8	July 22, 2005	Bangalore	Officials of the State Governments of Andhra Pradesh, Karnataka, Kerala and Tamil Nadu.
9	August 18-19, 2005	Mumbai	Officials of the State Government of Maharashtra; as also Shri C. Ramachandran, Chairman of the former Advisory Committee on WMA to State Governments. This was followed by a Committee Meeting.
10	September 1-2, 2005	Chennai	Committee Meeting
11	October 10, 2005	New Delhi	Committee Meeting
12	October 29, 2005	New Delhi	Committee Meeting

ANNEX 4

List of Officials/Experts met by the Committee

A. Government of India, Ministry of Finance
Dr. Adarsh Kishore
Shri S.C. Garg
Shri B.S. Bhullar

B. Comptroller and Auditor General of India
Shri V.N. Kaul

C. Planning Commission
Dr. Renuka Visvanathan

D. Experts
Dr. C. Rangarajan
Dr. A. Dasgupta
Dr. Mihir Rakshit
Shri C. Ramachandran
Prof. Hrishikesh Bhattacharya
Dr. Jayanta Madhab
Shri H.N. Das
Dr. Atul Sarma
Shri P.K. Datta
Dr. S. Borbora

E. Reserve Bank of India
Top Management of the RBI
Shri Jasbir Singh
Shri P. Aravind
Shri A.Narayana Rao
Shri B.N. Ananthaswamy
Shri S. Ramaswamy
Smt. Madhumita Sarkar-Deb
Shri Subhash Chander

F. State Governments

Andhra Pradesh
Shri A. Giridhar

Arunachal Pradesh
Shri C.S. Jeinow
Shri J. Sinha

Assam
Shri H.S. Das

Karnataka
Shri S. Subramanya
Shri Ritvik Pandey

Kerala
Shri K.Jose Cyriac

Madhya Pradesh
Shri Sumit Bose

Maharashtra
Shri V. Kanade

Manipur
Shri H. Deelep Singh

Meghalaya
Shri P.K. Srivastava

Mizoram
Shri Lalthansanga

Nagaland
Shri H.K.Khulu
Shri R.C.Acharjee

Orissa
Shri H.P. Panigrahi

Punjab
Shri K.R. Lakhanpal

Rajasthan
Shri S.C.Dinkar

Tamil Nadu
Shri K. Gnanadesikan
Shri Brajendra Navnit

Tripura
Shri D.K.Tyagi

Uttaranchal
Shri Indu Kumar Pande

Uttar Pradesh
Shri SekharAgarwal
Shri B.M. Joshi

West Bengal
Shri Samar Ghosh

Note: Representatives from the Governments of Bihar, Chattisgarh, Goa, Gujarat, Haryana, Himachal Pradesh, and Jharkhand were unable to attend the meetings with the Advisory Committee.

ANNEX 5

PANEL REGRESSION RESULTS

A panel regression exercise was conducted in order to ascertain the linkages between structural/fiscal imbalances and economic growth on the one hand and liquidity imbalances of the State Governments, on the other, over the period 2000-01 to 2004-05. The dependent variable was overall liquidity mismatch, as given by the sum of the annual averages Normal WMA, Special WMA and Overdrafts, which was normalized by the aggregate (revenue plus capital) expenditure (NSO/EXPD). The independent variables were revenue deficit as a ratio to GSDP (RD/GSDP), revenue deficit as a ratio of Gross Fiscal Deficit (RD/GFD) and the rate of growth of GSDP (ROGGSDP). Separate regressions were run for Non-Special Category States and Special Category States. Hausman Test indicated the superiority of the Fixed Effects model for Non-Special Category States and that of the Random Effects model for the Special Category States. In each case, the variable RD/GSDP was found to be statistically insignificant among alternative combinations of independent variables, and hence was excluded from the final regression results reported below.

A. Non-Special Category States

DEP. VAR	R^2	F	IND. VARs	COEFF	T-STAT	SIGNIFICANCE
NSO/EXPD	0.61	8.29	RD/GFD	0.0087	2.76	0.0075
			ROGGSDP	-0.0240	-1.90	0.0615

The overall fit of the above equation is fairly good. The coefficient of RD/GFD is positive and statistically significant at 1 per cent level. The positive sign indicates that overall liquidity mismatches, as a ratio to aggregate expenditure (NSO/EXPD), would increase with an increase in the preemption of

borrowings by revenue expenditure (RD/GFD). Alternatively, with a reduction in RD/GFD, reflecting an improvement in the quality of fiscal adjustment, overall liquidity mismatches would decline. This seems likely since a large part of revenue expenditure is committed in nature (in terms of interest payments, wages and salaries, pensions, etc) and directed towards non-developmental purposes. If increases in revenue expenditure are more than covered by an enhancement of revenue receipts, then the revenue deficit would be reduced over a period of time, and would, thus, pre-empt a lower proportion of overall borrowings. This, in turn, is likely to reduce the day-to-day mismatches in the cash flows of receipts and expenditures.

The coefficient of the other independent variable, the rate of growth of GSDP (ROGGSDP) is negative and statistically significant at the 10 per cent level. This indicates that an increase in the rate of growth of GSDP is associated with a reduction in overall liquidity mismatches. This is again on expected lines, since the size and regularity of cash inflows are likely to enhance during a phase of buoyant economic growth.

B. Special Category States

DEP. VAR	R^2	IND. VARs	COEFF	T-STAT	SIGNIFICANCE
NSO/EXPD	0.75	RD/GFD	0.1751	2.11	0.034
		ROGGSDP	0.0325	0.95	0.344

The overall fit of the above equation is quite good. The coefficient of RD/GFD is positive and statistically significant at the 5 per cent level, underscoring the significance of the quality of fiscal adjustment for liquidity management by these States. The coefficient of the rate of growth of GSDP is, however, not found to be statistically significant possibly because of the weak linkages between Government revenue flows and economic growth in the region.

Click here to view **ANNEX TABLES 1- 4**