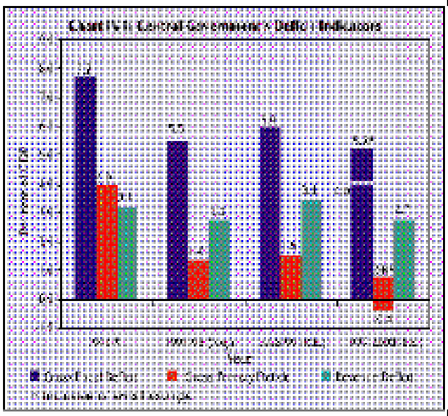
Government Finances

4.1 During 1998-99, there was a marked increase in the major deficit indicators in the area of fiscal management. In respect of the Central Government finances, gross fiscal deficit as well as revenue deficit moved up both in absolute amount and in relation to GDP. The year was also characterised by an increase in market borrowings. Given the already high government internal debt, the burden of debt servicing would increase, placing pressure on the Government's current accounts. The pay revisions of the government employees added additional strain on fiscal management. With the revenue falling short of budgeted target, the difficult fiscal position of both the Central and State Governments had spilled over to the arena of public debt management. The Reserve Bank as a debt manager had to face the challenges by devising appropriate strategies and optimising the objectives that modulate the pursuit of coordinated fiscal and monetary policy.

CENTRAL GOVERNMENT FINANCES: 1998-99[1]

4.2 During 1998-99, the fiscal position of the Government came under severe strain. The deceleration in tax collection observed in 1997-98 continued during 1998-99. Furthermore, there were expenditure over-runs. As a result, the major deficit indicators in relation to nominal GDP exceeded the respective actuals since 1994-95 with the exception of monetised deficit in regard to 1995-96 and 1997-98 (Chart IV.1, Appendix Table IV.1). The overall resource gap, as measured by the gross fiscal deficit (GFD), was placed higher at Rs.1,03,737 crore in the revised estimates for 1998-99 as against Rs.91,025 crore as per budget estimates and Rs.88,937 crore in 1997-98. As a proportion to GDP, GFD amounted to 5.9 per cent as against the budgeted estimate of 5.1 per cent and an actual of 5.7 per cent in1997-98. The sharp rise in revenue deficit, at Rs.60,474 crore (3.4 per cent of GDP) in 1998-99 was higher by Rs.12,406 crore over the level budgeted. The primary balance showed a deficit of Rs.26,489 crore, much higher than the deficit of Rs.16,025 crore in the budget.

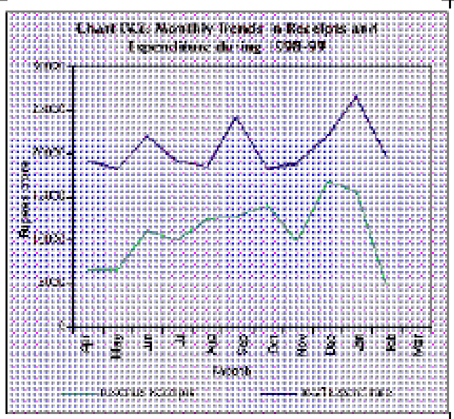
1. Unless otherwise stated, all data are taken from budget documents. The ratios given are in relation to GDP at current market price with revised base (1993-94) unless otherwise stated.



4.3 The slowdown in industrial growth in 1998-99 exerted pressure on revenue growth. Gross tax collection of the Central Government fell by 0.4 percentage point of GDP from the budget estimates, led by a 0.2 percentage point fall in the Union excise duty collection, which was adversely affected by the deceleration in industrial output, and a decline in customs revenue by 0.3 percentage point, due to deceleration in imports. Total expenditure of the Central Government expanded by 0.9 percentage point of GDP over the budget estimates, with revenue expenditure increasing by 0.6 percentage point of GDP and capital expenditure by the balance 0.3 percentage point. The cyclically-induced budgetary gap, attributable to revenue shortfall and the increase in expenditure, particularly in capital account, however, provided some stimulus to aggregate demand and investment in the absence of pick up in domestic private investment and exports.

4.4 The liquidity management by the Government during the year reflected a close co-ordination between fiscal and monetary policies. Accordingly, the Reserve Bank gave initial support to Government borrowing programme together with an active use of open market operations (OMO) as part of the strategy to pursue a reasonable interest rate policy. The Reserve Bank's initial support to Government borrowing programme including private placement in 1998-99 was higher at Rs.38,205 crore than Rs.13,028 crore in 1997-98, but by the year-end Reserve Bank's incremental investment in dated securities declined to Rs.10,235 crore (at face value) due to open market sale of dated securities.

4.5 The Centre's finances remained under pressure throughout 1998-99 as reflected by the gap between monthly receipts and expenditures (Chart IV.2). This had necessitated the Centre resorting to Ways and Means Advances (WMA) on a continuous basis for the major part of the year (April 1, 1998 to August 14, 1998 and from October 3, 1998 to December 22, 1998). During the year, the Central Government took recourse to overdraft on 11 occasions up to the maximum of five consecutive working days. For the fiscal year 1998-99, the agreed limit of WMA for the first half (April-September 1998) was fixed at Rs.11,000 crore and for the second half (October-March 1999) at Rs.7,000 crore. During the first quarter, the average utilisation of WMA stood at Rs.7,411 crore which declined progressively to Rs.2,134 crore in the second quarter and Rs.1,772 crore in the third quarter. While during the last quarter, the average utilisation of WMA was placed at Rs.2,203 crore, the year closed with an outstanding WMA of Rs.3,042 crore as against Rs.2,000 crore at the end of 1997-98 (Table 4.1).



4.6 Revenue receipts in the revised estimates at Rs.1,57,665 crore were lower by 2.7 per cent than the budget estimates, on account of shortfall in tax collections, especially customs and Central excise. While customs revenue shrank by Rs.5,500 crore against the level anticipated in the budget due to a sharp deceleration in imports, Union excise duty, net of States' share, under the impact of industrial deceleration posted a shortfall of Rs.2,247 crore from the budget estimates. The shortfall in tax receipts was only partly offset by the rise in non-tax revenues (Rs.2,991 crore) over the budget estimates.

Table 4.1 : Loans and Advances and Net RBI Credit to the Centre @

(Rupees crore)

Fiscal Year	Average Loans and Advances			Net RBI Credit to Centre		
	1999-2000	1998-99	1997-98	1999-2000	1998-99	1997-98
1	2	3	4	5	6	7
First Quarter (April-June)	4,276	7,411	785	8,349	6,121	5,165
Second Quarter (July-September)	2,110*	2,134	-	10,171*	11,543	- 3,088
Third Quarter (October-December)		1,772	-		14,471	- 826
Fourth Quarter (January-March)		2,203	1,022		17,985	7,495
End-March (outstanding)		3,042	2,000		11,800	12,914
Fiscal Year Average $		3,204	514		12,668	2,585

@ As per RBI records. * Up to July 30, 1999.

$ Average of all fortnightly reporting Friday figures of loans and advances and the end-March figures, after the closure of Government accounts.

4.7 The large shortfall in tax collections during 1998-99 needs to be viewed against a decline of over 1 percentage point in the ratio of Centre's gross tax revenue to GDP between 1991-92 and 1997-98 (from 10.0 per cent to 8.9 per cent). Excluding trade taxes, revenue from domestic taxes as a percentage of GDP fell by 0.4 percentage point during this period. This trend has been reinforced in 1998-99, with the overall tax-GDP ratio declining further to 8.5 per cent and domestic tax-GDP ratio to 6.0 per cent. This decline is attributable to several factors, including the unfinished nature of the indirect tax reform, particularly that relating to Value Added Tax (VAT); the recent slowdown in the industrial growth; and the changing structure of the economy tilting more towards the services sector, which is not taxed to its full potential. During the recent years, the share of services sector to GDP has seen a steady increase from 45.4 per cent in 1991-92 to 51.2 per cent in 1997-98, with corresponding decline in the shares of agriculture (including allied activities) and industry from 30.0 per cent and 24.7 per cent, respectively, in 1991-92 to 26.4 per cent and 22.3 per cent in 1997-98. Given low levels of taxation on agriculture, any slowdown in industrial output has significant adverse impact on overall revenue position of the Government. Furthermore, as services sector is yet to be fully integrated into the taxation net through a full-fledged VAT system, the changing composition of real economy is also contributing to the recent reduction in the tax-GDP ratio. This is a structural factor in fiscal management requiring the application of an appropriate medium-term strategy.

4.8 The aggregate expenditure in the revised estimates grew by Rs.13,985 crore (5.2 per cent) over that proposed in the budget estimates. Expenditure over-run was particularly significant under the heads, subsidies (Rs.2,658 crore), interest payments (Rs.2,248 crore) and pensions (Rs.2,712 crore). In addition, buoyancy in small savings collections increased the loan outgo to States and Union Territories (UTs), to the extent of Rs.9,588 crore over those in the budget estimates. Reflecting these outcomes, while revenue expenditure was higher by 3.8 per cent over the budget estimates, capital expenditure exceeded the budgeted target by 10.2 per cent. The higher growth in capital expenditure was, however, masked by substantial growth in loans to States on account of small savings collections which financed State governments' expenditure during the year. The pattern of expenditure allocation in the revised estimates was reflected in the reduction of 15.9 per cent in the Central Plan outlay from the approved level of Rs.1,05,187 crore which was shared between the budget support and the internal and extra-budgetary resources of public enterprises. While the budget support to the Central Plan fell short by Rs.4,201 crore (9.9 per cent) against the target of Rs.42,464 crore, the contribution of internal and extra-budgetary resources of public enterprises showed a sharp decline of Rs.12,504 crore over Rs.62,723 crore proposed in the budget estimates. The Plan cut was severe in the energy sector (Rs.6,103 crore) followed by industry and minerals (Rs.3,596 crore), transport (Rs.1,789 crore) and social services (Rs.1,770 crore). The pattern of expenditure in the budget tilted more towards non-Plan expenditure, which provided some offset to the general slowdown in the growth of aggregate demand in the rest of the economy. The net market borrowings of the Central Government amounted to Rs.64,911 crore in the revised estimates, exceeding the budget estimates of Rs.48,326 crore by Rs.16,585 crore (34.3 per cent). Consequently, the share of net market borrowing in the total capital receipts increased to 52.2 per cent, financing 62.6 per cent of fiscal deficit in 1998-99 as against 36.5 per cent in 1997-98. Resource mobilisation through disinvestment was higher at Rs.9,000 crore than the provision of Rs.5,000 crore made in the budget estimates.

Central Government Budget: 1999-2000

4.9 Against the backdrop of the fiscal slippage in 1998-99, the budget for 1999-2000 has set the tone for fiscal correction as a part of the medium-term strategy to reduce the fiscal deficit to below 2 per cent of GDP and to eliminate revenue deficit by 2003-2004. The budget has adopted a six-fold strategy encompassing (i) a medium-term plan of revenue augmentation, (ii) reforms in indirect taxes to promote productivity and employment, (iii) deepening and widening of economic reforms in all sectors, (iv) safeguarding the economy from external shocks, (v) strengthening the knowledge-based industries, and (vi) revitalising and redirecting public programmes for human development. For the year 1999-2000, the budget has proposed a fiscal deficit target of 4 per cent of GDP (excluding loans against small savings to States) as against 5.9 per cent (including loans against small savings to States) in 1998-99. The revenue deficit budgeted at Rs.54,147 crore is expected to go down to 2.7 per cent of GDP from 3.4 per cent in 1998-99. The corrections proposed both on the revenue and expenditure sides would see the primary account turning to a surplus of Rs.8,045 crore from a deficit of Rs.26,489 crore in 1998-99 (Appendix Table IV.1).

4.10 The fiscal consolidation process is sought to be achieved through specific policy initiatives in the areas of expenditure management, tax reforms and restructuring of the public sector. Expenditure management consists of promoting transparency, downsizing the Government and curbing the growth of contingent liabilities. Recognising that high growth in non-developmental expenditure has been the major constraint in ensuring efficient expenditure management, the Government has proposed to constitute an Expenditure Reforms Commission which would look into the areas for curtailing expenditure. Towards promoting transparency and curbing the growth of Government contingent liabilities, a *Guarantee Redemption Fund* has been proposed with an initial corpus of Rs.50 crore. The strategy towards public sector reforms continues to be a judicious mix of strengthening strategic units and privatising non-strategic ones through disinvestment or strategic sales and rehabilitation of weak units. In particular, the measures include encouraging marginally profit-making enterprises to reduce manpower. Public sector enterprises (PSEs) would also be encouraged to issue bonds to workers opting for Voluntary Retirement Scheme (VRS). The budget has proposed to enhance proceeds from disinvestment to meet the requirements of social and infrastructure sectors. The budget has introduced a new accounting system for the treatment of collections under small savings and loans given to the States/ Union Territories (Box IV.1).

4.11 The thrust of the fiscal correction is placed on containing the overall expenditure growth to 10.0 per cent during 1999-2000. Accordingly, total expenditure is budgeted at Rs.2,83,882 crore in 1999-2000 as compared with Rs.2,58,125 crore (excluding loans against small savings to States) in 1998-99.

4.12 The growth in revenue expenditure has been proposed to be contained at 8.6 per cent as compared with 21.0 per cent in 1998-99, with two major components of revenue expenditure *viz.,* interest payments and defence budgeted to decelerate and subsidies estimated to decline. Total interest payments projected at Rs.88,000 crore, would show an increase of 13.9 per cent in 1999-2000, much lower than 17.7 per cent in 1998-99, reflecting partly the downward movement of interest rates in government securities market. The growth in revenue component of defence expenditure and major subsidies is expected to decline to 7.9 per cent and 6.5 per cent, respectively, from 18.5 per cent and 15.5 per cent, respectively in 1998-99. The capital outlay budgeted for 1999-2000 at Rs.24,400 crore would be higher by Rs.4,881 crore (25.0 per cent) than that of Rs.19,519 crore (11.4 per cent) in the revised estimates for 1998-99. The Central

Plan outlay for 1999-2000 has been enhanced by Rs.15,039 crore (17.0 per cent) to Rs.1,03,521 crore with the energy sector receiving a step up of 26.4 per cent in its outlay followed by social sector (16.8 per cent), transport (16.3 per cent), and communications (16.2 per cent). The measures to enhance public investment, especially infrastructure, are expected to provide stimulus to overall domestic investment, given the complementarity of public and private investments.

Box IV.1
Accounting Framework for Small Savings in the Budget

As per the existing scheme, seventy-five per cent of small savings collections are passed on to the States/ UTs in the form of non-Plan loans and forms a part of the expenditure for reckoning the fiscal deficit of the Central Government. The Union Budget for 1999-2000 has proposed to change this accounting system so that small savings collections would be credited to “National Small Savings Fund” (NSSF) in the Public Account. All withdrawals of small savings by the depositors would be made out of the accumulation to the Fund. The balance in the Fund will be invested in Central and State Government securities. The income of the Fund will consist of the interest earned from the government securities while the servicing cost and the cost of management of small savings will be the expenditure of the Fund. All investments in Central Government securities out of the Fund would form a part of the Central Government's internal debt. Due to this change in the accounting system, non-Plan expenditure of the Centre is budgeted to be lower by Rs.25,000 crore in 1999-2000 which is reflected on the fiscal deficit. In the absence of the new accounting framework for small savings, the Centre's fiscal deficit would rise to 5.2 per cent of GDP in 1999-2000 from 4.0 per cent proposed in the budget.

4.13 While the expenditure policies as laid down in the budget would act as a stimulant to economic growth, the fiscal consolidation process largely focuses on enlarging revenue mobilisation from taxes and non-debt capital receipts. On the taxation front, the budget has introduced measures of rationalisation and reforms of indirect taxes, keeping in view the medium-term strategy of moving towards a single rate and a full-fledged Value Added Tax (VAT) system and phasing down custom duty rates to Asian levels in 5 years. As multiple rates of indirect taxes are generally a major source of misclassification, tax evasion and avoidance and cumbersome litigation, the budget proposes a comprehensive restructuring of both excise and custom duties. Accordingly, the existing 11 major *ad valorem* rates of excise duty are reduced to 3 rates. In the case of custom duties, the existing 7 major *ad valorem* rates have been reduced to 5 basic rates. In the sphere of direct taxes, however, the rate structure has been kept unaltered and the budget has, in fact, proposed an across-the-board surcharge of 10 per cent on corporate and all other categories of assessees. The budget has also attempted to use the instrument of taxation to promote investment in the three major areas of housing, capital market, and infrastructure. The housing sector has been given a major tax incentive by way of exemption of interest on loan for self-occupied property up to Rs.75,000 as against Rs.30,000 earlier. This measure is expected to encourage investment in owner-occupied property and provide boost to construction activities. A package of tax incentives announced for the capital market highlights the feel-good aspects of the budget proposals in 1999-2000, and the importance of the dividend and capital gains tax structure for promoting equity investment in the economy. While all incomes from UTI and other mutual funds received in the hands of investors have been exempted from income tax, exemption from dividend tax allowed for US-64 scheme as also for all open-ended equity-oriented schemes of UTI and mutual funds with more than 50 per cent investment in equity is extended for another three years. The long-term capital gains tax for resident Indians on transfer of shares and securities has also been reduced from 20 per cent to 10 per cent. In the infrastructure sector, the tax incentives available for infrastructure activities have been extended to State Electricity Boards (SEBs) in order to facilitate restructuring and rehabilitation. The budget proposals are expected to mobilise a net revenue of Rs.9,334 crore during 1999-2000, with a major portion of the revenue coming from Union excise duties (Rs.4,765 crore), followed by income tax (Rs.2,000 crore), customs duties (Rs.1,469 crore) and corporation tax (Rs.1,100 crore).

4.14 Total revenue receipts during 1999-2000 inclusive of additional resource mobilisation are estimated at Rs.1,82,840 crore showing a growth of Rs.25,175 crore (16.0 per cent). Owing to the change in the accounting system for small savings collections, capital receipts at Rs.1,01,042 crore show a decline of Rs.23,205 crore (18.7 per cent) over the revised estimates of 1998-99 (Appendix Table IV.2). Tax receipts (net to Centre) estimated at Rs.1,32,365 crore would show a rise of Rs.22,828 crore (20.8 per cent), while non-tax receipts are budgeted to show a modest increase of Rs.2,347 crore (4.9 per cent). The net profits transferred to the Centre by the Reserve Bank are estimated at Rs.5,700 crore as compared to Rs.4,150 crore in 1998-99. The receipts from disinvestment are estimated higher at Rs.10,000 crore as against Rs.9,000 crore in the revised estimates for 1998-99. The non-debt capital receipts (disinvestment and recovery of loans) together are estimated to contribute about 21.0 per cent of the capital receipts while debt components would constitute 79.0 per cent. The additional resource mobilisation measures and the expected buoyancy in tax revenue along with larger mobilisation of non-debt capital receipts would reduce the reliance on market borrowings for financing the fiscal deficit during 1999-2000. The net market borrowings (comprising short-term, medium and long-term borrowings) are thus budgeted lower at Rs.57,461 crore than Rs.64,911 crore in 1998-99. At the level proposed in 1999-2000, net market borrowings would finance 71.9 per cent of the GFD in 1999-2000 as compared with 62.6 per cent in 1998-99 and 36.5 per cent in 1997-98.

4.15 Notwithstanding the proposed lower levels of market borrowings in 1999-2000, the overall magnitude of draft of resources by the Government from the market remains high in relation to the growth in absorptive capacity. In the absence of well-developed securities market, the success of Government borrowing programme depends on the response of the captive investors such as commercial banks. The commercial banks were holding excess government securities to the extent of Rs.56,000 crore, in March 1999 which was 33 per cent of their net demand and time liabilities as against the statutory requirement of 25 per cent. Therefore, further subscription to government paper by these investors would be largely guided by their portfolio choice based on the attractiveness of these investments. During 1998-99, despite large increase in Central Government's market borrowing, the weighted average interest rate on government securities declined to 11.86 per cent from 12.01 per cent in 1997-98, partly reflecting the Reserve Bank's strategy to privately place a significant part of these borrowings with itself, followed by open market operations. While this strategy helped to minimise the adverse effects of Government's borrowing programme on the interest rates in 1998-99, the pressure on interest rates may, however, become unavoidable unless the size of the market borrowing programme is contained. The Reserve Bank's support to Government borrowing programme can not be unlimited as it has wider implications for the primary liquidity in the system and the inflationary potential for the economy.

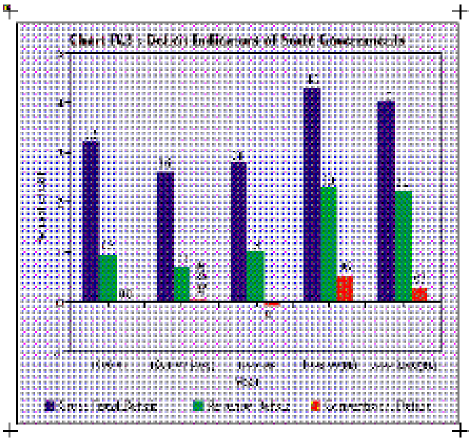
4.16 During 1999-2000, the limit for WMA to the Centre has been kept unchanged at the previous year's level at Rs.11,000 crore for the first half (April-September 1999) and Rs.7,000 crore for the second half (October-March 2000). With effect from April 1, 1999, the interest rate on WMA has been revised to the Bank Rate and on overdrafts beyond the WMA has been revised to the Bank Rate *plus* two percentage points. The transitory period of two years provided for the implementation of overdraft regulation has come to an end on March 31, 1999. As per the provisions of the Agreement dated March 26, 1997 between the Central Government and the Reserve Bank, overdrafts beyond ten consecutive working days will not be allowed from April 1, 1999. The minimum balance required to be maintained by the Central Government with the Reserve Bank has also been revised from not less than Rs.50 crore to Rs.100 crore on Fridays and from not less than Rs.4 crore to Rs.10 crore on other days.

STATE GOVERNMENT FINANCES[2]

Budgetary Operations of State Governments: 1999-2000

4.17 An analysis of consolidated budgetary data of twenty-six State governments indicates severe fiscal stress as evidenced by the deterioration of major deficit indicators (Chart IV.3). The finances of State governments have been affected by further pressures on the revenue account, with the growth in expenditure outpacing that of revenue receipts. The revenue deficit of States for 1998-99 more than doubled to Rs.40,539 crore from Rs.16,372 crore in 1997-98 registering an increase of 147.6 per cent. The revenue deficit for 1999-2000 is estimated to increase to Rs.43,236 crore even after taking into account Additional Resource Mobilisation (ARM) of Rs.2,946 crore by eleven States. In addition, it reflected the adverse effect that the deceleration in growth of revenue from Central taxes had on the devolution of resources from the Centre to the States. On the expenditure side, the additional expenditure on pay revision of State government employees and interest payments contributed in a major way to the worsening of the revenue account and to the rise in the overall borrowing requirements. As a result, the combined gross fiscal deficit (GFD) of the States is budgeted at Rs.80,223 crore (a steep 4.0 per cent of GDP) for 1999-2000, with the revenue deficit contributing to 53.9 per cent of GFD. The pre-emption of borrowed funds on current expenditures has in the process caused a sharp decline in States' capital outlay; the proportion of GFD being utilised on capital outlay has come down significantly to 34.5 per cent in 1998-99 from 51.5 per cent in 1997-98. For 1999-2000 it is estimated at 35.7 per cent.

2. Based on provisional data relating to the budgets of 26 State governments including the National Capital Territory of Delhi, of which, five are Vote-on-Account.



4.18 The persistent deterioration in the revenue account of State governments has been a matter of serious concern and many State governments have taken initiatives to raise tax and non-tax resources. Nonetheless, while the revenue receipts of State governments are budgeted to rise higher by 15.0 per cent in 1999-2000 than 11.0 per cent in 1998-99, the revenue expenditure of States is budgeted to rise by 13.5 per cent on top of a steep rise of 23.0 per cent in 1998-99. As a result, the revenue deficit would widen to Rs.43,236 crore (2.2 per cent of GDP) in 1999-2000 as compared with Rs. 40,539 crore (2.3 per cent of GDP) in the previous year (Appendix Table IV.5 and Chart IV.3). Consequent upon States' efforts towards ARM, the States' own tax receipts are budgeted to show a rise of 18.8 per cent as compared with the rise of 15.2 per cent in 1998-99. However, the non-tax receipts indicate a slight deceleration with interest receipts for 1999-2000 being estimated lower than those in 1998-99.

4.19 Developmental expenditure of States in 1999-2000 under revenue account is budgeted to rise by 7.1 per cent as against that of 22.3 per cent in 1998-99. The growth in social services is budgeted much lower at 8.2 per cent than 26.8 per cent in 1998-99. Again, the growth in expenditure on economic services would come down to 5.1 per cent from 15.5 per cent in 1998-99. Non-developmental revenue expenditure is budgeted to rise by 24.1 per cent over and above the rise of 23.9 per cent in 1998-99. Interest payments, administrative services and pensions would account for 85.2 per cent of total non-developmental revenue expenditure. As a result of sharp rise in non-developmental expenditure, its share in total revenue expenditure would go up to 42.0 per cent in 1999-2000 from that of 38.4 per cent in 1998-99. It is important to note that the share of non-developmental expenditure in total disbursements has been going up persistently in the last few years. The share of non-developmental expenditure in aggregate disbursement for 1999-2000 would be much higher at 35.8 per cent compared with 32.3 per cent in 1998-99. The capital outlay budgeted for 1999-2000 at Rs.28,640 crore shows a lower rise of 10.1 per cent over 1998-99 than the rise of 14.0 per cent in 1998-99.

4.20 The increasing burden of interest payments has become a matter of serious concern as it casts a heavy burden on state finances. State governments can no longer rely on SLR obligations to satisfy their market borrowing programme at concessional rates and have, in fact, to borrow at market related interest rates. Presently States have an option to access market borrowings outside the tranche of all States, to the extent of 5 to 35 per cent of their annual borrowing programme. The response to direct borrowings would, however, depend on the financial health of States and they would therefore be required to take corrective steps for improving the general macro-economic conditions at their level, including the fiscal position.

4.21 The question of reform of state finances has gained in significance with the fiscal deficit of State governments reaching an unsustainable level of 4.3 per cent of GDP in 1998-99. In this context, the State governments have taken policy initiatives aimed at reforms and attracting private investment towards infrastructure sectors. States have aimed at reforms in power sector through constitution of State Regulatory Commissions for fixing power tariffs, corporatisation and restructuring of the electricity boards, as also separating transmission and distribution activities to other agencies. Some States have also set up new corporations for raising finances towards road development. Importance has been accorded to information technology and software with the creation of info-tech parks and electronic towns/ zones in some of the States. These initiatives, although commendable, may be inadequate to meet the stupendous tasks before them.

Ways and Means Advances and Overdrafts of States

4.22 The Ways and Means Advances (WMA) and overdraft facilities are extended by the Reserve Bank to meet temporary mismatches between receipts and payments of States. The limits on the normal and special WMA for States were last increased in August 1996. The use of WMA facility and emergence of overdrafts by States have become more frequent in recent years, reflecting stress as much on liquidity management as on the underlying structural imbalances in State finances. Realising the difficulties faced by State governments, and following the recommendations of the *Informal Advisory Committee on Ways and Means Advances to State Governments*, constituted by the Reserve Bank (Chairman: Shri B.P.R. Vithal), the Bank has revised the amount of WMA with effect from March 1, 1999 (Box IV.2).

Box IV.2
Revision of Ways and Means Advances to State Governments

Under Section 17(5) of the Reserve Bank of India Act, 1934, the Reserve Bank has been providing WMA to States which bank with it against the balances maintained with the Reserve Bank to help them tide over temporary mismatches in the cash flow of their receipts and payments. There are two types of WMA -normal and special. The normal WMA are clean or unsecured advances while special WMA are given against the pledge of the Central Government securities held by State governments. As per the scheme in existence before March 1, 1999, both normal and special WMA were linked with the cash balances of States maintained with the Reserve Bank and the limits for normal and special WMA were revised from time to time depending on the evolving liquidity situation faced by State governments, 10 revisions were effected to the limits of WMA available to States, between April 1937 and end-February 1999.

The Reserve Bank constituted an Informal Advisory Committee on Ways and Means Advances (WMA) to State governments under the Chairmanship of Shri B.P.R. Vithal to consider rationalisation of the then existing scheme of WMA to State governments including revision of limits, keeping in view the needs of the State governments, as also issues relating to fiscal and monetary management. The Report was submitted in November 1998. The major recommendations of the Committee are:

- Delinking of WMA limits from the minimum cash balance and switching over to a formula-based approach (three year average of the total revenue receipts and capital expenditures) in the case of normal WMA. The rationale of the formula is that it would closely approximate the States' cash flows, while excluding the impact of the revenue deficit.

- Adoption of a liberalised approach to special WMA, under which States will be allowed to draw special liquidity accommodation from the Reserve Bank against their holdings of Government securities.

- There should be no relaxation in the disciplinary mechanism underlying the current Overdraft Regulation Scheme but additional criteria over the present limit of 10 consecutive working days were suggested by way of a ceiling on overdrafts (100 per cent of normal WMA limits) and a restriction on the number of days (20 working days during a quarter in the financial year).

- The minimum balances were to be revised and linked to the same base as taken for the revision of normal WMA.

Based on the recommendations of the Committee, and after consultation with State governments, the scheme of WMA to State governments has been revised and made effective from March 1, 1999. Its features are as follows:

(a) The revised WMA limits are based on the three-year average of revenue receipts *plus* capital expenditure. Accordingly, the normal WMA limits have been increased by 65 per cent to Rs.3,685 crore over the earlier limit of Rs.2,234.40 crore.

(b) The limits for Special WMA have been liberalised. Accordingly, under the revised scheme, there is no upper limit on special WMA. States will be provided special WMA against their actual holdings of Central Government securities.

(c) No State shall be allowed to run an overdraft with Reserve Bank for more than ten consecutive working days. If overdrafts remain beyond ten consecutive working days, the Reserve Bank will stop payment on behalf of the State in question. The overdraft shall not exceed 100 per cent of normal WMA limit in a financial year. In case the limit is exceeded, Reserve Bank will on the first occasion advise the State government. On the second or any subsequent occasion, the State shall be given only three working days' notice to bring down the overdraft within the 100 per cent limit. If this is not adhered to, payments will be stopped.

(d) The minimum balances have been revised upwards linking them to the volume of budgetary transactions as in the case of normal WMA.

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

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

4.23 An analysis of the levels of normal WMA, special WMA and Overdrafts availed by State governments during 1998-99 indicates that the total monthly average peak level amounted to Rs.2,147 crore with the peak average level for months varying between Rs.536 crore in May 1998 and Rs.4,818 crore in March 1999. During 1998-99, 17 States resorted to overdraft; of them 11 States (5 special category and 6 non-special category States) took frequent recourse to overdrafts. Five States could not clear their overdrafts with the Reserve Bank within the stipulated time limit and consequently the Reserve Bank had to stop payments on their behalf.

COMBINED BUDGETARY POSITION OF THE CENTRE AND STATES

4.24 According to the budget estimates for 1999-2000, the combined gross fiscal deficit of Centre and States is estimated at Rs.1,52,799 crore or 7.6 per cent of GDP, lower than 8.5 per cent of GDP (Rs.1,49,592 crore) in 1998-99[3] . The improvement in the overall gap in the combined budgetary operations primarily reflects moderation in Centre's GFD (4.0 per cent of GDP in 1999-2000 against 5.9 per cent in 1998-99). The other major deficit indicators *viz*., the combined revenue deficit and the net primary deficit are slated to decline to 4.9 per cent and 2.4 per cent of GDP, respectively, in 1999-2000 from 5.7 per cent and 3.5 per cent of GDP in 1998-99 (Table 4.2).

3. The combined fiscal deficit of the Government sector would be neutral to the change in the accounting system of loans against small savings to States, which is in the nature of an intergovernmental transaction and has to be netted out from the compilation.

4.25 The improvement in the combined deficit indicators is expected to be realised through larger resource mobilisation, especially on the revenue front, and better expenditure management. The combined receipts are budgeted to grow at a lower rate of 10.3 per cent (19.1 per cent in the previous year). While the combined revenue receipts are budgeted to increase by 14.5 per cent, capital receipts are estimated to grow significantly lower by 2.3 per cent (growth of 30.2 per cent in the previous year). The improvement in revenue receipts would be solely contributed by tax revenue, estimated to grow at 18.6 per cent. Non-tax revenue, on the other hand, is estimated to decline marginally by 0.8 per cent. Better expenditure management is reflected in significantly lower combined aggregate disbursements, which are estimated to grow by 9.5 per cent compared with that of 21.8 per cent in the previous year (Appendix Table IV.6). The combined expenditure-GDP ratio would thus decline to 26.2 per cent in 1999-2000 from 27.2 per cent in the previous year. The combined tax-GDP ratio, on the other hand, is likely to improve to 14.5 per cent in 1999-2000 from 13.9 per cent in 1998-99.

4.26 The pattern of expenditure indicates the continuing trend of decline in expenditure under developmental heads. Developmental expenditure is budgeted to rise by 5.8 per cent as compared with a growth of 22.0 per cent in 1998-99. Consequently, the share of developmental expenditure in total expenditure would come down to 51.2 per cent from 53.0 per cent in 1998-

99 (Chart IV.4). The persistent increase in non-developmental expenditures, especially interest payments, continues to steadily pre-empt the resources at both the levels of the Government for undertaking developmental activities. At the budgeted level of Rs.1,07,830 crore, combined interest payments would increase by 16.2 per cent, accounting for 30.5 per cent of combined revenue receipts and 20.8 per cent of the aggregate receipts. Within the developmental expenditure, allocations for the social sector would decelerate to 7.3 per cent in 1999-2000 from 27.2 per cent in 1998-99. As a result, the expenditure on social sector as a ratio of GDP would come down to 7.4 per cent in 1999-2000 from 7.8 per cent in 1998-99 (Appendix Table IV.6).

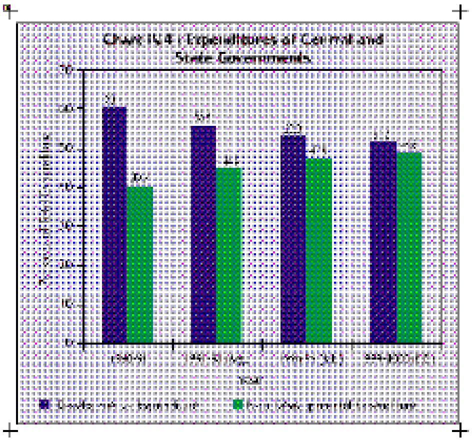


Table 4.2 : Measures of Deficit of the Central and State Governments as proportion to GDP* @

(Per cent)

Year	Gross Fiscal Deficit	Conven-tional Deficit	Revenue Deficit	Net Primary Deficit
1	2	3	4	5
1990-91	9.2	1.9	4.1	4.5
1991-92	6.8	1.0	3.3	2.8
1992-93	6.8	1.4	3.1	2.4
1993-94	8.1	1.3	4.2	3.4
1994-95	6.9	-0.3	3.6	2.1
1995-96	6.4	0.6	3.1	1.8
1996-97	6.2	1.4	3.5	1.8
1997-98 #	7.1	-0.1	4.0	2.5
1991-98 (Average)	6.9	0.8	3.5	2.4
1998-99 (RE) #	8.5	0.5	5.7	3.5
1999-2000 (BE)# $	7.6	0.3	4.9	2.4

RE Revised Estimates. BE Budget Estimates.
(-) Indicates Surplus.
@ The GDP figures have been revised as per new series with 1993-94 as base year. The

figures, therefore, will not match with those published earlier.

* The combined deficit indicators have been worked out after netting out the inter-governmental transactions between the Centre and States. As such, these figures will not be equal to the total deficits as worked out separately for the Centre and for the States. Details of the adjustments in respect of each deficit indicator are given in the note below.

Data in respect of State governments are provisional and relate to the budgets of 26 States including the National Capital Territory of Delhi.

$ Worked out on the basis of the implicit nominal GDP underlying the Union budget estimates of GFD/GDP ratio of 4.0 per cent of 1999-2000.

Note : 1. Combined GFD is the GFD of the Central Government *plus* GFD of the State governments *minus* net lending from the Central Government to State governments.
2. Conventional deficit is the difference between aggregate receipts and aggregate expenditures of the Central and State governments net of inter-governmental transactions in the revenue and capital account.
3. Revenue deficit is the difference between revenue receipts and revenue expenditures of the Central and State governments net of inter-governmental transactions in there venue account.
4. Net primary deficit is defined as combined GFD *minus* net lending and net interest payments.

Market Borrowings

4.27 The Reserve Bank has taken a number of initiatives in the recent period to meet the liquidity requirement and facilitate market borrowings of Central and State governments :

(i) With the revision effected in March 1999, as explained earlier, the normal WMA extended to States by the Reserve Bank has been enhanced by 65 per cent from Rs.2,234 crore in 1996 to Rs.3,685 crore in 1999. The limit on special WMA has been removed.

(ii) Since 1990-91, the borrowing programme handled by the Reserve Bank has increased nearly ten-fold, from Rs.11,000 crore to about Rupees one lakh crore for both Centre and States, while the SLR prescription has gone down from 38.5 per cent to 25 per cent over the same period.

(iii) The bulk of market borrowing programmehas to be undertaken during the first six months, when there would be less pressure on the banks to lend to the commercial sector. Almost about 90 per cent of borrowing programme would need to be completed in the first half of the year. Magnitudinally, this implies that the Reserve Bank has to manage total Government borrowings amounting every month to roughly 1 per cent of GDP during the first half of the year.

(iv) Currently, as on July 16, 1999, banks are holding SLR securities to the tune of Rs.2,60,194 crore, and excess holding of securities amounting to over Rs.60,000 crore. Assuming that the deposit growth in the banking system is about 15-20 per cent during 1999-2000, which translates to an increase of about Rs.1,30,000 crore, SLR required to be maintained would be around Rs.32,500 crore, which is less than the level of excess SLR holding by banks. This would mean that the SLR prescriptions do not in reality under current circumstances obligate banks to buy fresh government paper. Further, as a result of rising level of borrowing, the ratio of interest payment to revenue receipts is rising. Therefore, there is a case for keeping the rising level of public debt (including other liabilities) under control by placing a statutory ceiling on public debt (Reserve Bank of India, 1997)[4] .

Central Government

4.28 During the year 1998-99, market borrowings of the Central Government increased by 57.5 per cent over the previous year. As per Reserve Bank records, the gross market borrowings of the Central Government aggregated Rs.93,953 crore (exceeding the budget estimates by 18.4 per cent) and net Rs.62,903 crore (exceeding the budget estimates by 30.2 per cent) (Appendix Table IV.9). The amount mobilised through dated securities aggregated Rs.83,753 crore and that through 364-day Treasury Bills to Rs.10,200 crore. The Reserve Bank's subscription to primary issues of Central Government securities amounted to Rs.38,205 crore during 1998-99 which accounted for 45.6 per cent of the gross amount mobilised through dated securities. Of this, private placement was to the extent of Rs.30,000 crore and the devolvement in the auctions amounted to Rs.8,205 crore. However, on account of significantly active open market operations, the effect of Reserve Bank's initial subscription on the monetised deficit was contained. At the end of the financial year, Reserve Bank's holding of government dated securities increased by Rs.10,235 crore (at face value) resulting in a lower level of net Reserve Bank credit to Centre at Rs.11,800 crore as against Rs.12,914 crore in 1997-98.

4. For reference to a discussion paper on this subject, see "Placing a Statutory Limit on Public Debt", *Reserve Bank of India* Bulletin, December 1997.

4.29 Notwithstanding large-scale borrowing programme of the Government, the interest rates remained fairly stable during the course of the year. With a view to moderating the adverse impact of the large borrowing programme, the Reserve Bank accepted private placements of government stocks and released them to market when interest rate expectations became favourable. The weighted average yield rate on dated securities declined from 12.01 per cent in 1997-98 to 11.86 per cent during 1998-99, which was very close to the level that was observed in 1991-92 (Table 4.3). The yield rates during the year were 11.40 per cent for a 2-year stock and 12.60 per cent for a 20-year stock. Although the yield rates remained stable for most part of the fiscal year 1998-99, a rising trend was evident since the second quarter with the yield rate on a 10-year stock strengthening from 12.00 per cent in June to 12.22 per cent in July, 12.25 per cent in September 1998 and remaining stable thereafter. The yield rate on a 5-year stock rose from 11.10 per cent in April 1998 to 11.75 per cent in July, to 11.78 per cent in August and thereafter remained at that level. On the whole, the real interest rate on market loans declined by 215 basis points to 5.0 per cent in 1998-99, the lowest since 1995-96. A low and stable real yield rate regime in government securities market has assumed critical importance in the context of the prevailing investment environment as it provides the benchmark for pricing of other debt instruments. During 1998-99, the yield rate in government securities market was considerably influenced by the degree of effectiveness in co-ordination between debt management policy and monetary policy, with the former focussing on the timing of loan for deriving maximum benefit of liquidity conditions and the changing maturity mix of borrowings. Apart from these factors, the background for high absorption of government stocks was provided by the slack in demand for bank credit and the generally surplus liquidity condition with the banking system. However, in the medium-term, for effective debt management, there is need for significant reduction in government borrowing requirement from the market and for fiscal policy to dampen inflation expectations.

Table 4.3 : Weighted Average Coupon Rates on Government of India Dated Securities

(Per cent per annum)

Fiscal Year	Weighted Average Rates	Range
1	2	3
1980-81	7.03	5.98-7.50
1985-86	11.08	9.00-11.50
1989-90	11.49	10.50-11.50
1990-91	11.41	10.50-11.50
1991-92	11.78	10.50-12.50
1992-93	12.46	12.00-12.75
1993-94	12.63	12.00-13.40
1994-95	11.90	11.00-12.71
1995-96	13.75	13.25-14.00
1996-97	13.69	13.40-13.85
1997-98	12.01	10.85-13.05
1998-99	11.86	11.10-12.60

Source : Reserve Bank Records.

4.30 Recognising the roll-over problems arising from the bunching of redemption in the medium-term, the maturity structure was lengthened with the introduction of long-term securities of 11, 12, 15 and 20-year maturity during 1998-99. In order to ensure that the long-term rates remain within a reasonable band, the long maturity stocks were initially privately placed with the Reserve Bank and then offloaded on to the market through the sale window of the Reserve Bank. As a result of these measures, the weighted average maturity of dated securities rose to 7.7 years in 1998-99 from 6.6 years in 1997-98 and 5.5 years in 1996-97.

State Governments

4.31 According to the Reserve Bank records, gross market borrowing programme of 25 State governments aggregated Rs.12,114 crore as against Rs.7,749 crore in 1997-98. The net market borrowings amounted to Rs.10,700 crore which was higher by 48.8 per cent than Rs.7,193 crore in 1997-98. In the first tranche of 10-year State Development Loans on April 20, 1998, 24 State governments (excluding Bihar) raised an amount aggregating Rs.5,130 crore as against the notified amount of Rs.2,780 crore, facilitated by easy liquidity conditions in the market. In the second tranche of 10-year market loans on October 12, 1998, 25 State governments mobilised Rs.4,462 crore as against the notified amount of Rs.3,100 crore. In the third tranche, for a similar maturity loan on December 28, 1998, 15 State governments raised Rs.1,612 crore. Thus, the aggregate amount mobilised by State governments through pre-announced issues stood at Rs.11,204 crore; Punjab borrowed Rs.60 crore through auction. In addition, on February 10, 1999, Andhra Pradesh, Goa and Uttar Pradesh mobilised Rs.850 crore through tap issues of 12.50 per cent 10-year maturity loans.

4.32 The State governments have so far been raising their market borrowings through conventional floatations with pre-announced coupon rates. As an integral part of the policy to move towards a system of auctioning of State loans, the State governments have been given flexibility to raise to the extent of 5 to 35 per cent of the allocated borrowings through auction with the flexibility to decide the timing, maturity and interest rates on the issues. It is significant to note that the Government of Punjab, which borrowed Rs.60 crore through an auction held on January 13, 1999, exercised this option, at an interest rate slightly below the rate on the conventionally floated loans by other States for similar maturity.

4.33 In line with the softening of yield rates on the Central Government securities, the coupon rate on State loans of 10-year maturity declined to 12.15 per cent in April 1998 from 13.05 per cent in April 1997. However, the yield rates strengthened by 35 basis points to 12.50 per cent in October 1998 *pari passu* with the rising trend in the yield rates on Central Government securities. Reflecting the benefit of tapping the market at competitive rates, the weighted average yield on the auction of Punjab Government loans issued in January 1999 emerged 12.39 per cent, which was 11 basis points lower than the coupon rate offered on conventional floatation of similar maturity with the pre-announced rates of 12.50 per cent.

4.34 The gross market borrowing of the Central Government for the fiscal 1999-2000 is placed at Rs.84,014 crore (net Rs.57,461 crore) consistent with the fiscal deficit target of Rs.79,955 crore (4.0 per cent of GDP). This represents an increase of 40.9 per cent over the gross borrowing of Rs.59,637 crore in 1997-98. The alloted net borrowings of State governments for the fiscal year 1999-2000 are placed at Rs.10,966 crore (gross Rs.12,267 crore). The success of borrowing programme of the Government during 1999-2000 would depend on the evolving market condition, particularly the pick up in industrial activity, the recovery of capital market and demand for credit from the banking system, and situation in respect of gross domestic savings. Presently, banks are holding government securities much in excess of the SLR stipulations. Therefore, their future subscription to government paper would be largely guided by market considerations and their lending behaviour in the credit market in the event of revival of industrial activity. While some improvement in the financial saving is expected in 1998-99, its strengthening in 1999-2000 would depend on the rate of growth of GDP. A higher growth rate in 1999-2000 would help arrest the slowdown in bank deposit growth seen in 1998-99, augment investible resources with the banks, and create conditions for absorption of Government borrowing requirement by the market without any deleterious effect on interest rates.

DOMESTIC PUBLIC DEBT

4.35 The accumulation of public debt (including all internal and external liabilities) and the rising servicing burden have become an issue in the sustainability of the fiscal position. This is reflected in combined domestic liabilities of the Government sector rising from 53.8 per cent of

GDP to 54.9 per cent of GDP between end-March 1992 and end-March 1999. Had the debt servicing burden been contained, there could have been larger amount of resources spared for sectors such as health, education, social welfare and other productive sectors of the economy. This is especially so since a major portion of the rising proportion of borrowed funds is used for financing current consumption. Moreover, a disproportionate burden of debt is shifted on to the future generations by excessive growth in public debt and rising debt-servicing burden. Besides, net borrowing would progressively decline, if the present trends continue. For instance, the ratio between gross and net borrowing which was 1: 0.84 in 1991-92 has come down to 1: 0.67 in 1998-99.

4.36 The fiscal consolidation efforts have brought about a marginal decline in the ratio of internal debt of Centre (including all domestic liabilities) to GDP from 47.4 per cent to 46.6 per cent between 1991-92 and 1998-99. However, the stock of internal debt in nominal terms has been growing at an annual growth rate of 14.2 per cent during the same period. Such sustained growth in the stock of internal debt is the cumulative result of fiscal deficits over years. The gross fiscal deficit of the Centre as ratio of GDP has remained at about 5.5 per cent, on an average, during the period of fiscal reforms (*i.e*., 1991-92 to 1998-99). The high overhang of internal debt has adverse macro-economic implications which could pose problems for progress of financial sector reforms and the further opening up of the economy. The existing stock of internal debt and debt servicing tend to push up the magnitude of market borrowings in excess of the absorptive capacity of the market and have two-fold implications on the stability of the financial sector. First, it puts pressure on the interest rates in the government securities market, which leads to hardening of interest rates in other market segments. A continuous pressure on interest rates has adverse implications for the banking sector's investment portfolio and its profitability, apart from acting as a constraint on the progress towards the mark to market system. It also creates uncertainty regarding the future interest rates, giving rise to adverse inflation expectations. Secondly, high levels of domestic debt and interest rates pose challenges in the area of management of capital flows in the context of the liberalisation in capital account. While it provides incentive for inflow of short-term capital into the economy, the need to maintain these flows and carry out sterilisation operations in the money market may require raising the interest rates to unsustainable levels. This could act as a deterrent in progress towards further liberalisation of external sector and achieving higher integration between the domestic and international financial markets.

4.37 The high overhang of debt has resulted in bulging repayment obligations. The repayment liability of the interest bearing public debt of the Central Government (excluding discharge of cash management instruments *viz.*, 14-day Treasury Bills, 91-day Treasury Bills and Ways and Means Advances) witnessed a steady rise from Rs.31,171 crore in 1991-92 to Rs.86,962 crore in 1997-98. This would further rise to Rs.1,08,091 crore in 1998-99. The repayment obligations arising out of high levels of domestic debt have accordingly assumed larger proportion of gross borrowings. In 1998-99, repayment liabilities of the Central Government absorbed 33 per cent of the gross debts raised from the market as against only 16 per cent in 1991-92.

4.38 An important aspect of the debt management operations has been to minimise the interest cost of market borrowings by choosing a suitable maturity structure in the face of a significant rise in the share of market borrowings in the total borrowing from 20.7 per cent in 1991-92 to

62.6 per cent in 1998-99. This has resulted in compression of average maturity of market debt, with significant increase in the share of short-term loans in the total outstanding debt. This is evident from the fact that the share of long-term loans in total outstanding market debt has declined sharply from 75.8 per cent at end-March 1992 to 18.2 per cent at end-March 1998. A higher share of short-term debt in total debt poses the problem of frequent roll-over and creates difficulties for the monetary policy in the management of liquidity in the money market. Recognising this problem, debt management operations during 1998-99 were aimed at lengthening the maturity structure of market debt so as to balance the objectives of interest cost and roll-over. Of the total gross market borrowing of Rs.93,953 crore raised during the year, Rs.11,324 crore or 12.1 per cent was raised through long-dated paper (over 10-year maturity).

4.39 While the yield difference between the 5-year stock and 20-year stock was 82 basis points, that between 2-year and 20-year was 120 basis points. This margin was much less for the 10-year paper with the yield difference compared to the 5-year and 2-year paper at 47 and 85 basis points, respectively. Notwithstanding the tilt towards long-term stock in 1998-99, the existing maturity structure is still heavily loaded towards short-term loans, which has increased the annual repayment amount to a high level starting from 2000-2001.

4.40 The schedule of market loans issued up to end-March 1999 and due for redemption during the next five years shows that repayment obligations would reach the maximum of Rs.31,252 crore during 2003-2004 from Rs.16,353 crore in 1999-2000 (Table 4.4). Unless the net borrowing requirements fall commensurately with the rise in repayment obligations, the gross borrowing requirement would rise at a significantly higher rate, which would strain the absorptive capacity of the market and the interest rate structure.

Table 4.4 : Repayment Schedule for Market Loans of the Central and State Governments issued up to end-March1999 P

(Rupees crore)

Year	Central Government	State Governments
1	2	3
1999-2000	16,353	1,301
2000-2001	28,321	420
2001-2002	28,260	1,446
2002-2003	28,263	1,789
2003-2004	31,252	4,145
2004-2005	28,159	5,123
2005-2006	24,473	6,274
2006-2007	24,394	6,551
2007-2008	24,651	11,554
2008-2009	27,223	14,354
2009-2010	12,195	2,559
2010-2011	12,109	2,569
2011-2012	8,610	3,349
2012-2013	1,755	-

2013-2014	4,691	-
2014-2015	4,088	-
2015-2016	4,173	-
2016-2017	-	-
2017-2018	-	-
2018-2019	2,632	-

P Provisional. - Nil.

4.41 The aggregate debt-GDP ratio of States at end-March 1999 stood at 19.5 per cent, higher than that of 18.1 per cent at end-March 1998. The State governments' debt has remained almost stagnant at a level of around 18 per cent of GDP during the period end-March 1992 to end-March 1999. Notwithstanding a near constant debt-GDP ratio, the interest burden of States' debts has steadily risen from 13.6 per cent to 19.5 per cent of revenue receipts between 1991-92 to 1998-99, reflecting the higher conversion costs arising from the substitution of low-cost market loans with high-cost ones and the rising share of such loans in total debt from 15 per cent to 17.7 per cent during this period. Due to increasing exposure of State governments to market-related interest rates, the nominal average borrowing cost has risen to 13.1 per cent in 1998-99 from 9.9 per cent in 1991-92. An important concern regarding the prevailing debt situation of State governments relates to the lack of adequate adjustment in their primary deficit. Reduction in primary deficit is an important step as this would pave the way towards reducing their debt servicing expenditure over a period of time, and release additional resources for other vital areas of expenditure. Since States' revenue deficits have risen significantly, pre-empting 53.8 per cent of their borrowed funds (GFD) during 1998-99 (29.9 per cent during 1991-92) and severely affecting their investment outlay, the relationship between interest payments and revenue deficit has posed adverse long-term growth implications for them.

Public Account

4.42 Public account constitutes an important element of Government budget where the Government plays the role of a banker. It includes transactions relating to provident funds, small savings, other deposits *etc*., where the funds collected have to be paid back to public. Because of their very nature as public deposits, borrowings through public account by the Government form a liability similar to market borrowings.

4.43 An important source of potential debt problem for the Central Government is the steady increase in non-marketable debts which arises out of the public account operations in the budget. While the intended purpose of the public account operations has been to enable the Government to intermediate funds flow between the public and itself with a view to serving some special distributive or social security related objectives, in actual practice such borrowings have been used to enhance the resource base of the Government to finance the growing amount of fiscal deficit. Moreover, resources mobilised under ‘other liabilities' like small savings, provident funds and special deposits are serviced at high effective cost. While the nominal interest rates offered on these instruments are kept attractive, some of these are also eligible for special tax rebates, under Sections 88 and 80L of the Income Tax Act. Consequently, the effective cost of borrowings to the Government, taking into account both explicit and implicit costs from these sources, is far higher than that on market loans. In 1998-99, resource mobilisation through small savings, provident funds and special deposits together increased to Rs.43,588 crore from Rs.33,360 crore in 1997-98, constituting 42.0 per cent of fiscal deficit as compared with 37.5 per cent in the previous year.

Contingent Liabilities of Government Sector

4.44 The conventional debt statistics reported in the budget take into account explicit liabilities of the Governments arising from their own budgetary transactions, and exclude the implicit liabilities, which Governments may have assumed while providing guarantees to private sector or their own parastatals. While the conversion of an implicit liability into an explicit one at a later date depends on the financial status of the beneficiary of the guarantee, its exclusion from the conventional debt statistics is based on the presumption that all contingent liabilities are eventually vacated by the solvent borrower with no implication for government's financial health. But a clear idea of the magnitude of contingent liability is essential for accurate reflection of the net worth and strength of the public sector. The declining Government investment during the process of fiscal consolidation juxtaposed with the growing need for infrastructure requiring large investments with greater participation of the private sector has brought the issue of guarantees to the centre stage. The guarantees given by the Central Government in nominal terms has risen from Rs.50,575 crore to Rs.73,877 crore between end-March 1992 and end-March 1998 (Table 4.5). Recognising the implications arising from growing guarantees on the fiscal health, the Union Budget for 1999-2000 has proposed to establish a *Guarantee Redemption Fund* with a view to promoting transparency and moderating the growth of contingent liabilities.

4.45 At the State level, the demand for extending guarantees for developmental projects has been increasing on account of shrinking capital expenditure of States, on the one hand, and limited borrowing capacity along with the rapidly rising demand for basic infrastructure to achieve a higher growth trajectory, on the other. As a result, the guarantees given by States increased in nominal terms from Rs.40,159 crore at end-March 1992 to Rs.79,625 crore at end-September 1998. Most of the guarantees extended by States are concentrated in favour of financial institutions, which could be discouraging proper risk assessment of credit by such institutions, involving a moral hazard problem. Excessive counter guarantees by Governments to public financial sector, especially to enterprises which are not viable, could raise concern due to its potential adverse implications for the financial sector balance. In this context, the recent Technical Committee on State Government Guarantees has recommended the setting up of a limit on guarantees, ensuring greater selectivity in calling for and providing of guarantees, adherence to transparency in reporting guarantees and constituting a Contingency Fund for guarantees to meet any eventual obligations. Although the Committee confined its recommendations only to States, the recommendations are also relevant for the Central Government, given the similarity of issues and problems (Box IV.3).

Table 4.5 : Outstanding Government Guarantees (as at end-March)

(Rupees crore)

Year	Centre	States*	Total
1	2	3	4

1992	50,575 (7.5)	40,159 (6.0)	90,734 (13.5)
1993	58,088 (7.6)	42,515 (5.5)	1,00,603 (13.1)
1994	62,834 (7.2)	48,866 (5.6)	1,11,700 (12.7)
1995	62,468 (6.0)	48,479 (4.7)	1,10,947 (10.7)
1996	65,573 (5.4)	52,631 (4.3)	1,18,204 (9.7)
1997	69,748 (4.9)	63,409 (4.5)	1,33,157 (9.4)
1998	73,877 (4.7)	79,625$ (5.1)	..

* Pertains to 17 major States up to 1996, 16 for 1997 and 18 for 1998.
$ At end-September 1998.

Note: Figures in brackets are ratio to GDP at current market prices (Base: 1993-94).
Source: Finance Accounts, Government of India, CAG Reports and Budget Documents of State Governments.

Box IV.3
Guarantees of States - Report of the Technical Committee on State Government Guarantees

The contractual obligations to provide for any eventuality of default by borrower either on principal amount borrowed or interest payment or both, are defined as contingent liabilities. The distinction between Government's contingent and non-contingent liabilities (e.g., interest bearing debt) is that the nominal obligation and the settlement date of the latter are fixed at the date of issue, whereas with contingent liabilities, the contractual obligation is dependent, in its timing and amount, on the occurrence of default by borrower.

Conventional fiscal accounting treats contingent liabilities as obligations that occur primarily in future with the invoking of guarantee and subsequent generation of cash flow from budget. The International Monetary Fund in the *Manual on Government Finance Statistics* recommends that government guarantees on debts be excluded, unless Government is called upon to take over and service that debt. Thus, with regard to loan guarantees, only payments arising out of default by the borrower are treated as expenditure items. Contingent liabilities can be of two types - funded and unfunded. Funded liabilities are matched by a reserve or charge against profits equal to the actuarial value of the liability while unfunded liabilities do not have matching reserves. The significance of distinguishing the funded liability from an unfunded liability is to ensure that the liability could be extinguished in the eventuality of default due to failure of a guarantee programme.

State governments have been providing guarantees for facilitating the flow of funds to the priority sectors, State public sector enterprises, development institutions and local bodies, for commercial as well as non-commercial activities and urban development. The growing need for infrastructure at the State level and the recent initiatives to invite participation by the private sector in such projects requiring huge investments, has put further demands on State governments to stand guarantor for such projects. There is also increasing recourse to letters of comfort, which partake the character of government guarantee. The element of risk associated with such guarantees, the transparency with regard to guarantee policies and the present magnitude of guarantees extended by State governments have raised concerns regarding the optimal or sustainable level of such guarantees. In absolute terms, the outstanding State government guarantees increased from Rs.40,159 crore in March 1992 to Rs.79,625 crore in September 1998 representing an annual compound growth of 12.0 per cent. The growth in guarantees particularly since 1995 have been significant, the annual growth rate between March 1995 and September 1998 was 13.1 per cent whereas the growth in debt during the same period was 7.5 per cent. Guarantees accounted for 30 per cent of consolidated fund of all State governments in March 1996 and 46 per cent of revenue receipts in March 1997.

In the interest of prudent financial management and the credibility of the guarantees issued, there is a need for a guarantees policy for each State government on the basis of certain parameters. Accordingly, the Reserve Bank constituted a Technical Committee of State Finance Secretaries to examine the issues of State government guarantees in all its aspects.

The major recommendations of the Committee are summarised below:

Ceiling on guarantees

It will be desirable for State governments to fix a ceiling on guarantees and such a ceiling will have transparency, sanctity and operational relevance only if legislated, as explicitly enabled in the Constitution of India and as already being practised in some States.

Parameters and basis for the ceiling on guarantees

Four parameters that could be used for fixing the ceiling on guarantees are : (i) linking guarantees to a dynamic variable such as Net State Domestic Product (NSDP) so that total outstanding debt plus one-third of outstanding guarantees should not exceed, say, 50 per cent of the NSDP, (ii) linking guarantees to revenue receipts, (iii) linking the guarantee and debt to the consolidated fund itself and ensuring that guarantees plus debt together do not exceed twice the receipts in the consolidated fund, (iv) the ratio of incremental guarantees to incremental net market borrowings is kept constant or brought down.

There should be sufficient flexibility to each State government to choose the most appropriate parameter while ensuring transparency in respect of all the parameters.

Selectivity in calling for and providing of guarantees

Selectivity in calling for and providing of guarantees is sought to be achieved through laying down specific procedures to be followed in case of projects or units where State guarantee is involved and identifying a nodal officer in the finance department to co-ordinate the proposals involving guarantees.

Risk sharing

Instead of State governments providing guarantee for 100 per cent of the loan/bond, guarantee could be restricted to 75 per cent to start with and adjusted suitably depending upon the project with the concurrence of the investors/lender.

Honouring of guarantee

To ensure honouring of guarantee by States, whenever there is default, the Reserve Bank could be authorised to earmark or pre-empt a portion of the new loans towards arrears in payment of interest and principal on loans and bonds. Alternatively, special bonds could be issued to banks and financial institutions in *lieu* of the accumulated arrears of payment due from State governments under invoked guarantees.

Letter of comfort

State governments may eschew the practice of providing letter of comfort and where letter of comfort from State government is required, credit enhancement may be provided through explicit guarantees within the overall limit fixed for the purpose.

Disclosure transparency and reporting of guarantees

Comprehensive information on guarantees as also letters of comfort wherever issued should be disclosed by State governments in their major budget documents. Debit amounting to expenditure has to be authorised by State legislature in its budget. However, such automatic debits being uncertain cannot be specifically authorised. Recourse to automatic debit mechanisms should, therefore, be subjected to great circumspection.

Tripartite structured payment arrangements

Tripartite structured payment arrangements should be put in place including the same in the guarantees reported and subject to the limits fixed by the States.

Escrow mechanisms for independent power projects (IPPs)

State governments should encourage the State Electricity Boards to build up a risk fund to handle the contingent liability on account of exchange risk under escrow account arrangements provided to IPPs.

Guarantee fee and constitution of contingency fund for guarantees

Normally, the guarantee fee should be so structured that the receipts from such fees will take care of the devolvement.

Gujarat was the only State which had prescribed such limit under 'The Gujarat State Guarantees Act, 1963', amended in 1994 to enhance the guarantee amount. Pursuant to the Technical Committee Report, Karnataka government has announced a ceiling and Rajasthan government has set up a Guarantee Redemption Fund with an initial contribution of Rs.1 crore.

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