Shyamala Gopinath: Sub-national fiscal reforms and debt management – Indian experience

Paper by Ms Shyamala Gopinath, Deputy Governor of the Reserve Bank of India, presented at the workshop on "Sub-national Fiscal Reform and Debt Management", organised by the Economic Policy and Debt Department, World Bank, Washington, 29 April 2009.

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It gives me great pleasure to be here amongst you and address the World Bank Sub-national Fiscal Reform and Debt Management Forum. There is more than one reason on my part to accept this invitation, but more importantly, to share with you the turnaround story at the sub-national level in India. The relevance of fiscal reforms and creation of fiscal space even at the sub-national level can hardly be over-emphasised in the context of the on-going slowdown the world over. Indeed, contrary to the general perceptions, we find in India that even the sub-national authorities have important counter-cyclical role to play. Interestingly, the Reserve Bank of India as the debt manager of Governments – federal and provincial – has all through been closely associated with the task of putting in place a reformed fiscal architecture in the country. Let me now share with you the details, which run into eight sections, the first being the Constitutional position of the sub-national Governments. In the absence of firm data on local bodies (the third tier of government in India), the analysis is confined to the level of provincial governments.

I. Constitutional provisions and debt management

The Constitution of India has adopted a federal system of polity and governance, originally envisaging a two-tier structure: Central (i.e., federal) Government and State (i.e., provincial) Governments. With the Constitution (73rd and 74th) Amendment Acts, 1992, Local Self-Government Institutions (LSGIs), i.e., rural and urban local bodies have been accorded constitutional status as the third-tier of Government. The Constitution provides for preparation of annual budgets and borrowings by the Centre, respectively, under Articles 112 and 292 and by the States under Articles 202 and 293.

The Constitution assigns important responsibilities to the States in many sectors such as agricultural development, infrastructure, poverty alleviation, water supply and irrigation, public order, public health and sanitation. States have also concurrent jurisdiction in areas like education, electricity, economic and social planning and family planning. In addition to provision of general administration, State Governments thus provide various social and economic services and also transfer resources to the third tier of government – rural and urban local bodies such as municipalities. In keeping with larger responsibilities assigned to the States, their expenditure accounts for a substantial portion of the Government sector expenditure (Centre *plus* States) in India and stands higher than in several other countries such as Australia, Denmark, Argentina, USA and Germany (World Bank, 2005). While the State Governments collect about one-third of the total Government sector receipt, they incur more than three-fourths of the total expenditure on social services and more than half of that on economic services.

The States' ability to undertake and perform the developmental functions adequately and effectively is critically predicated on their fiscal position, which is a function of their own efforts in generating resources – tax, non-tax receipts and borrowings as also the resource transfer from the Central Government.

Sub-national borrowings

Article 293 of the Indian Constitution imposes certain restrictions on the borrowings by State Governments. The Article stipulates that a State may not, without the consent of the Government of India, raise any borrowings if it has any loan outstanding, which is repayable to the Government of India. Furthermore, under the Constitution, State governments, unlike the Centre, cannot borrow externally. The Centre plays the role of an intermediary in the transfer of external borrowings to States. Because of these controls exercised by the Centre, there is not much scope for fiscal profligacy at the State level and accordingly, there have been no instance of bankruptcy by any State Government. This also represents the largely unitary structure of the Indian federal polity despite the significantly important Constitutional roles that have been assigned to the sub-national Governments.

The major heads of borrowings by States include: (i) open market borrowings, (ii) special securities issued to National Small Savings Fund (NSSF), (iii) loans from banks and financial institutions (negotiated loans), (iv) loans from the Centre, (v) State Provident Funds, (vi) deposits and advances and (vii) reserve funds.

Loans from Centre

"Loans from the Centre", which used to be a major source of State finances have since lost its significance.

Special Securities issued to National Small Savings Fund (NSSF)

The Central Government has set up the NSSF, which is akin to a Special Purpose Vehicle (SPV) providing an autonomous source of finance for the Governments. It mobilises small savings through post offices and banks and lends against special non-tradable securities issued by the States and the Centre as per the proportion fixed by the latter. The loans have a maturity of 25 years with an initial moratorium of five years in the repayment of principal. One-twentieth of the amount is repaid every year beginning from the sixth year. The special securities currently carry a rate of interest of 9.5%, as fixed by the Centre, resulting in a spread of around 1.5% for the Centre. While repayments to the NSSF are generally made out of fresh accretion, net outflows since 2007-08 have exposed the NSSF to ALM mismatches.

Open market borrowings

The market-borrowing programme of the State Governments (as also borrowings by way of negotiated loans and Central loans) is finalised by the Government of India and the Planning Commission, keeping in view the provisions of Article 293(3) of the Constitution of India. Once the Government of India indicates, generally at the beginning of the fiscal, the size of State-wise net allocation of market borrowings to the Reserve Bank, the Bank decides on the timing and volume of issues, taking into account the market and liquidity conditions and the cash needs of the States.

Debt management in 1990s

In terms of the Reserve Bank of India Act, 1934, the Bank acts as the fiscal agent and the debt manager to the State Governments by way of mutual agreement. Accordingly, the RBI is the banker to 26 States while it is the debt manager to all the 28 States. During the 1990s, the Reserve Bank used to complete the combined borrowing programme of all the States generally in two or more tranches through issue of bonds with a pre-determined coupon and pre-notified amounts for each State (*Traditional Tranche Method*). High statutory pre-emption in the form of statutory liquidity ratio (SLR) and the small size of State Government borrowings ensured the success of these primary issues.

In 1997, State Governments were given the option to enter the market individually to raise resources using the *tap method* or the *auction method*. In 1999, States began to adopt the auction method and some States were able to mobilise loans at competitive rates, whereas other States had to pay higher rates. The spreads in tap tranches were subsequently raised to around 50 basis points in 2001-02 from 25 basis points earlier with the introduction of *Umbrella Tap Tranche* for a total targeted amount at a predetermined coupon. The tap used to be normally kept open for 1-3 days. With the deterioration in the State fisc and defaults in State guaranteed securities, the spread over secondary market yield of Central Government security increased steadily. The market seemed to have ceased to differentiate amongst States in terms of their fiscal performance. The share of market borrowings by auctions declined from 15.0 per cent during 2001-02 to 2.3 per cent in 2004-05 and the Reserve Bank had to play an active role in convincing some of the leading players to subscribe to State Government securities.

II. Fiscal decline of the states in late 1980s

During the 1970s and the first half of the 1980s, States had a relatively healthy fiscal position. The buoyant growth in States taxes particularly sales tax contributed to a surplus in the revenue account between the mid-1970s and the mid-1980s. Although the States slashed their investment activities faced with revenue deficit from 1987-88, their debt and debt servicing burden soared with the high cost borrowing financing current expenditure amidst growing fiscal imbalances during 1986-87 to 1997-98. Fiscal imbalances worsened after 1998-99 following a sizeable pay hike of the employees in sequel to the implementation of the Fifth Pay Commission's recommendations at the State level. States faced mounting pension burden which in case of many States increased at a faster rate than salaries. Interest burden also grew steadily warranting increasing borrowings to bridge the GFD. The GFD of States deteriorated sharply from 2.9 per cent in 1997-98 to 4.6 per cent in 1999-2000 before declining marginally to 4.4 per cent in 2003-04. By 2003-04, the aggregate liabilities of States peaked at 33.2 percent of GDP from 20.9 per cent in 1996-97. The burgeoning fiscal gap fed on itself as the ratio of interest payments to revenue receipts of States deteriorated sharply from 13.0 per cent in 1990-91 to 26.0 per cent in 2003-04.

The structural imbalance in State finances stemmed from their limited resource base vis-à-vis growing expenditure. The narrow tax base of the States with greater reliance on indirect taxes such as sales tax and the lack of harmonised inter-State tax structure allowed distortions and rigidities to emerge in late 1980s. The States' own tax revenue which financed 32.2% of the total expenditure in 1980s has shown only a marginal rise to 34.5% in 1990s. The internal resource mobilisation by the States was further constrained by stagnant user charges as also the fact that the State PSUs such as the State Electricity Boards (SEBs) and State Transport Undertakings were running into losses. Given the relatively higher responsibility for the States for social and economic development, the resulting fiscal gap is financed, among others, by vertical resource transfer from the Centre to the States. However, the resource flow from the Centre decelerated from 15.2% in 1980s to 14.5% in 1990s following the fiscal reforms initiated by the Centre. The deceleration in transfers emerged despite an increase in the proportion of tax transfers recommended by various Finance Commissions. This reflected the low level of buoyancy in both income tax and union excise duties, the then two components of shareable taxes with States.

III. Sub-national fiscal reforms

Reflecting the fiscal stress, the expenditure for developmental activities, which are directly related to growth, has suffered; on the other hand, expenditure on non-developmental purposes, largely committed, has witnessed a steady rise. Fiscal adjustment based predominantly on expenditure reduction may have adverse implications for growth, particularly when government expenditure in India is lower than that in the OECD countries. It was felt that fiscal strategy based on revenue maximisation could provide necessary flexibility to the pattern of expenditure. Thus, sub-national fiscal adjustment started in late 1990s as follows, motivated, among others, by the reform-linked assistance (i) from the Centre as part of the Medium-Term Fiscal Reform Programme in line with the Eleventh Finance Commission and (ii) from the multilateral agencies.

(i) Tax reforms

States initiated several measures towards enhancement/restructuring of the taxes within their fold, such as, land revenue, vehicle tax, entertainment tax, sales tax, electricity duty, tax on trades and professional tax. It was recognised that competitive sales tax reductions for attracting investment led to revenue losses without commensurate gains. With a view to harmonising inter-State taxes and ultimately switch over to State-level value added tax (VAT), States initially introduced uniform floor rate during 2000 before finally switching over to the Value Added Tax (VAT) in *lieu* of sales tax between April 2005 and January 2008, which has been an unqualified success in raising the tax revenue for the States.

(ii) Non-tax measures

States also undertook measures to enhance non-tax revenues by reviewing/rationalising the royalties payable to them, including those on major and minor minerals, forestry and wildlife, revision of tuition fees, medical fees, irrigation water rates and tariffs on urban water supply. The issue of user charges since not in commensurate with the cost of public services continues to be a concern.

(iii) Expenditure management

The State Governments' measures to contain expenditure, *inter alia,* include restrictions on fresh recruitment/creation of new posts, review of manpower requirements and cut in establishment expenses and reduction in non-merit subsidies through better targeting.

(iv) Public sector restructuring

Several States have shown interest in undertaking a comprehensive review of the functioning of the State Public Sector Undertakings (SPSUs), including the possibility of closing down of non-viable units after providing for suitable safety-nets to the employees including VRS. States encouraged private sector participation in the transport and power generation sectors, set up the State Electricity Regulatory Commission (SERC) and pursued with unbundling or corporatisation of the SEBs. One of the major tasks entrusted to the SERC is to rationalise tariff rates. Further, the States have signed Memorandum of Understanding (MoU) with the Union Ministry of Power to undertake reforms in a time-bound manner.

(v) Institutional reforms

Faced with mounting deficits and market fatigue in States' borrowings, States embarked on a rule-based pursuit of fiscal reforms by enacting the fiscal responsibility legislation (FRL), first by Karnataka (2002) and followed by Kerala, Punjab and Tamil Nadu (all in 2003). Uttar Pradesh enacted FRL in 2004. The enactment of FRL was incentivised by the Twelfth Finance Commission (TFC) and all but two States have enacted FRLs by May 2007. Following the recommendations of the Core Group on Voluntary Disclosure Norms for State Governments (2001), States are being sensitised to the principle of transparency in Government operations so as to ensure macro fiscal sustainability and fiscal rectitude. States have since enhanced transparency in State budgets. Some of the States also provide details on outstanding guarantees. In addition, a few States have started disseminating information on consolidated budgetary position, which are inclusive of off-budget borrowings.

IV. Finance Commissions and state finances

Under article 280 of the Constitution, the President of India appoints a Finance Commission every five years. The Commission is charged with making recommendations to the President on the distribution of the taxes between the Centre and the States and the consequent distribution among the States themselves. It also recommends grants in aid to States and suggest measures to strengthen the functioning of the third tier governments comprising of *Panchayati Raj* (for rural areas) and Municipal bodies (for urban areas).

11th Finance Commission

In pursuance of the recommendations of the Eleventh Finance Commission (EFC), the Central Government set up an Incentive Fund for State fiscal reforms. Each State was given the target of a minimum improvement of 5% in the revenue deficit as a proportion of their revenue receipt each year till 2004-05. For States with a revenue surplus, 3% improvement in the balance in the current revenue was required for release of funds under this facility. Accordingly, several State Governments drew up Medium-Term Fiscal Reforms Programme (MTFRP) and entered into MoUs with the Union Ministry of Finance. The MTFRP of States covered various areas such as fiscal consolidation, public sector enterprises reform, power/irrigation sector reforms and fiscal transparency.

12th Finance Commission

The subsequent Twelfth Finance Commission (TFC) felt that it would be appropriate for the States to take advantage of the prevailing market rates and avoid the spread charged by the Centre on the assistance provided by it. The pattern of Central assistance included loan as a major element in respect of general category States, which was implicitly funded from borrowings by the Centre and hence, the terms of loans extended to the States reflected the Centre’s cost of borrowings. The TFC, therefore, 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 were 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. This approach was accepted by the Central Government, in principle, to be implemented in phases, in consultation with the Reserve Bank.

Second, the TFC recommended back-to-back transfer of external assistance to the States from the Centre with the States having to bear full exchange rate risk. Third, the TFC recommended a fiscal restructuring plan based on the enactment of fiscal responsibility legislation, *inter alia*, including (i) elimination of revenue deficit (RD) by 2008-09 and (ii) containment of gross fiscal deficit (GFD) to 3.0 per cent of GSDP. If the States are able to fulfil these requirements, they would be entitled to debt relief including debt write-off in respect of Central loans.

Implementation of 12th Finance Commission's recommendations

In order to operationalise the new arrangements, the Government of India constituted a Technical Group under my chairmanship, which submitted its report in December 2005 and made several recommendations. Accordingly, there has been progress in adoption of the auction method for borrowing by the States. In addition, State Development Loans (SDLs) were made eligible for repo transactions under the liquidity adjustment facility of the RBI in April 2007 and it has been decided to introduce the non-competitive bidding facility in respect of the primary auctions of SDLs.

The Central Government, on its part, initiated several measures to ease the debt burden of States: (i) the Debt Swap Scheme (2002-03 to 2004-05), (ii) Debt Consolidation and Relief Facility (DCRF) (effective fiscal 2005-06) that allowed rescheduling of central loans at a reduced rate of interest of 7.5 per cent and debt waiver (subject to enactment of FRL and adherence to revenue deficit reduction targets) and (iii) reduction of interest rate on securities issued to NSSF during 1999-2000 to 2001-02 carrying interest rate of 11.0-13.5 per cent to 10.5 per cent (effective fiscal 2007-08). Further, in accordance with the decision of the National Development Council, the obligatory share of the States in the NSSF has been reduced to 80 per cent from 2007-08.

As regards borrowings from banks and financial institutions (negotiated loans), it is our view that such borrowings, negotiated by States on a bilateral basis with lenders, overlap with open market borrowings as the lenders belong to the same set of market participants. The Reserve Bank is the debt manager for all the 28 State Governments by entering into voluntary agreement with them and the States should, therefore, confine their banking requirements with the Reserve Bank and not borrow from other banks**.**

Consolidated Sinking Fund

At the request of the State Governments, the Reserve Bank had prepared a model Consolidated Sinking Fund (CSF) Scheme and circulated it amongst them for adoption / consideration in 1999. The Twelfth Finance Commission had recommended that the CSF may cover repayments in respect of all the loans of the State Governments (and not just open market borrowings). Against this backdrop, the Reserve Bank circulated a revised model scheme of CSF amongst the State Governments in May 2006 and of the 18 States that have set up CSF, 14 States adopted the revised CSF scheme. As at end-March 2009, the outstanding balance of the State Governments in CSF is Rs.240 billion accounting for about 1.5 per cent of the outstanding liabilities of the State Governments.

Prepayment of debt

The upsurge in the surplus cash balances of the State Governments since the middle of 2004-05, in sharp contrast to the liquidity pressures witnessed in the earlier period, posed newer challenges to the financial and cash management of the State Governments. In the context of build up of cash balances which involve a negative carry, a few States proposed to utilise their surplus cash to pre-pay a part of their outstanding open market debt. Accordingly, the RBI conducted two rounds of buyback auctions in respect of two States in 2006-07. During 2007-08, buy-back of securities was carried out for a State using the anonymous electronic trading (NDS-OM) platform.

Thirteenth Finance Commission

The Thirteenth Finance Commission (ThFC) since constituted in November 2007 is expected to submit its report by October 2009. Its recommendations would be applicable for five years

(2010-11 to 2014-15). The Commission would make recommendations on the distribution of the taxes between the Centre and the States and among the States, grants in aid to States, and suggest measures to strengthen the functioning of the third tier governments. The ThFC will also consider, *inter alia*, the impact of the proposed implementation of Goods and Services Tax (GST), the need to improve the quality of public expenditure and the need to manage ecology, environment and changed climate consistent with sustainable development. The Commission shall review the state of the finances of the Union and the States, and suggest measures for maintaining a stable and sustainable fiscal environment consistent with equitable growth. The Commission may also review the present arrangements as regards financing of Disaster Management with reference to the National Calamity Contingency Fund and the Calamity Relief Fund and make appropriate recommendations thereon. The ThFC may also suggest a roadmap for 2010 to 2015 with a view to maintaining the gains of fiscal consolidation after bringing the liabilities of the Central Government on the deficit targets. It is expected that the ThFC, like its predecessors, would do justice to the issues related to vertical and horizontal equity even as taking the process of fiscal consolidation further.

State Finance Commission

The Constitution (73rd and 74th) amendment Acts, 1993 have respectively, accorded constitutional status to rural and urban local bodies as the third tier of Government. The Amendments provide for constitution of State Finance Commissions every five years. Following the recommendations of the State Finance Commissions (SFCs) and taking into account the devolutions made by the Central Finance Commission (CFC), the State Governments are required to devolve resources to their local bodies. Not all States have constituted SFCs. and a fewer States have submitted action taken reports (ATRs) on the recommendations made by the SFCs as noted by the Twelfth (Central) Finance Commission (TwFC). The TwFC, inter alia, recommended that SFCs should follow a normative approach in the assessment of revenues and expenditure in order to arrive at the gap that may be considered by the CFC and that the principal recommendations of the SFCs may be accepted without modification as in the case of CFC.

V. Role of the Reserve Bank of India in sub-national finances

The RBI has, over the years, closely interacted with the State Governments in its developmental role – particularly in areas of development of agriculture, and small industries. The RBI was specifically entrusted with an important promotional role, since its inception, of financing agricultural operations and marketing of crops. In fact, the Agricultural Credit Department was created simultaneously with the establishment of the RBI in 1935.

Study of State Finances

The Reserve Bank prepares and publishes an annual Study on the State Government Finances. This is a unique study since it compiles, consolidates and analyses detailed data on the budgets of all the State Governments. It also documents the policy initiatives on State finances and debt management by the State Governments, the Government of India and the Reserve Bank. The study has been well received by policy makers and academicians, both in India and abroad, and is an important reference document.

Model fiscal responsibility legislation

The RBI played a facilitating role in the States' endeavour for rule-based fiscal reforms by providing the Secretariat support to a group of State Finance Secretaries for preparing a model fiscal responsibility legislation for the States. The final report was submitted to the Reserve Bank in January 2005. The Group recommended that the model legislation would generally follow the pattern of the Central FRBM Act, and build upon the State fiscal responsibility legislations already enacted. The Group also took into account the international best practices available in the area as well as the recommendations of the various committees on fiscal transparency and on the issues related to voluntary disclosure of information by the State Governments. Various dimensions of the fiscal legislative framework, such as, the choice of targets, the road map, independent evaluation criteria, prioritisation of capital expenditure, treatment of contingent liabilities including guarantees and computation of pension liabilities were deliberated upon to arrive at a consensus.

State Finance Secretaries Conference

Clearly, the Reserve Bank has gone beyond its statutorily mandated obligations and has provided the platform for interface between the RBI and the State Governments based on mutual trust on issues related to State finances where the other stakeholders – including representatives from the Government of India, Comptroller and Auditor General and the Planning Commission – are also invited to participate in the Conference. There are occasions when fiscal experts, leading commercial bankers and representatives of credit rating agencies were also invited to participate and contribute to the specific issues on the agenda. Since 1997, 21 such conferences have been held and decisions have been arrived at, in a consensual manner, on many critical issues such as revisions in limits on Ways and Means advances and Overdraft Regulation Scheme, adoption of auction method for market borrowing, setting up of Consolidated Sinking Fund, ceiling on guarantees and establishment of Guarantee Redemption Fund, disclosure and transparency in budget-making, and model fiscal responsibility legislation at the State level.

Standing Technical Committee on States' borrowings

The Bank's Annual Policy Statement for 2006-07 proposed to constitute a Standing Technical Committee (STC) under the aegis of the State Finance Secretaries Conference with representation from the Central and State Governments and the Reserve Bank to advise on the wide-ranging issues relating to the borrowing programmes of Central and State Governments through a consensual and cooperative approach. The STC was, accordingly, constituted in December 2006 with the concurrence of the Government of India and in consultation with States. All States, the Central Government and the Reserve Bank are members of the Committee.

VI. State Government Guarantees and fiscal risk management

Against the imperative of infrastructural development on the one hand and resource constraint on the other, the States resorted to provision of guarantees mainly to third tier sub-national entities and State level public sector (but also private sector) bodies, to promote capital formation for economic development without regard to fiscal capacity for debt servicing in the event of devolvement of guarantees on State Governments.

The Reserve Bank has sensitized the States about the fiscal risk associated with such guarantees, need for transparency with regard to the guarantee policies and the magnitude of guarantees. The Reserve Bank provided the forum in the form of State Finance Secretaries Conference where the issues related to guarantees were discussed. Further, the Reserve Bank provided the technical expertise and provided the Secretariat to the various Groups on State Guarantees. Pursuant to the recommendations of a Technical Committee, several States have since fixed a ceiling on guarantees to be issued by them. Further, a Group of State Finance Secretaries on the Fiscal Risk on State Government Guarantees

(2002) underlined the importance of according appropriate risk weights in respect of devolvement of guarantees and suggested estimation of risk weighted guarantees so as to make adequate budgetary provisions for honouring these guarantees once they devolve on the States. Since 2003, the Reserve Bank has been also organising workshops on the evaluation of fiscal risks of guarantees for the benefit of State Government officials. The Report of the Fiscal Responsibility Legislation at the State Level (2005) recommended fixing a limit on annual incremental risk-weighted guarantees in relation to their GSDP/total revenue receipts. Many States have incorporated this recommendation in their FRL although this was not mandated by the TwFC for receiving debt relief. Consequent to the improvement of the fiscal position of States, the record of honouring of guarantees by the State Governments has significantly improved.

Guarantee Redemption Fund

The Reserve Bank, in its capacity as a regulator of banks and financial institutions, issued a circular in 2003 to the effect that they should exercise due diligence and proper appraisal to ensure project viability, irrespective of the provision of State Government guarantees. The Reserve Bank also circulated a draft scheme on Guarantee Redemption Fund (GRF) amongst the State Governments for voluntary adoption. As on March 31, 2009 the aggregate investments of the nine State Governments that have set up the GRF amounted to Rs.30.4 billion.

VII. Debt management in an era of fiscal consolidation

With the implementation of the TwFC's recommendations, the year 2005-06 marked a watershed in the evolution of State finances and debt management. During 2005-06, 48.5 per cent of the market borrowings were raised through the auction route as compared with 2.3 per cent in 2004-05. The moderation in fiscal imbalances and enactment of fiscal responsibility legislation facilitated the smooth transition to the conduct of entire open market borrowings by the auction route since 2006-07 as proposed by the Reserve Bank in its Annual Policy Statement 2006-07. This was notwithstanding the sharp increase in the net market borrowings from 0.3 per cent of GDP in 2006-07 to 1.9 per cent of GDP in 2008-09. Reflecting the maturity profile of State Governments as also the timing of issuances, the weighted average cost of States' borrowings was marginally higher than that of the cost of borrowings of the Centre. The spread over the Central Government Securities has declined from 34 basis points in 2004-05 to 16 basis points in 2008-09 (Table).

Table: Weighted Average Rate of Coupon on Market Borrowings

	Centre	States	Spread (bps)
2004-05	6.11	6.45	34
2005-06	7.34	7.63	29
2006-07	7.89	8.10	21
2007-08	8.12	8.25	13
2008-09	7.69	7.85	16

The interest rates on market borrowings continued to remain lower than 9.5 per cent charged for borrowings from the NSSF. The shift in borrowings from the NSSF and from the Centre to market borrowings has reduced the weighted average cost of borrowings of State Governments and at the same time, improved their maneuverability on the desired quantum of borrowings.

States' market borrowings have been by way of plain vanilla fixed coupon securities denominated in domestic currency which have several advantages. This has accorded certainty to the budgetary expenditure and reduced balance sheet risks. The uncertainties in the cost of borrowings arising from the frequent resetting of interest rates that are associated with floating rate bonds are absent.

The maturity of State Government security is usually 10 years although securities of 11-13 years have also been issued. The longish maturity of State Governments has protected the State Government balance sheet from refinancing risk. Since the 10-year segment is the most liquid segment of the yield curve reflecting demand from most segments of the market, the illiquidity premium is thus kept lower for the States.

Special Reserve Fund

Under the Constitution, States cannot raise market borrowings from abroad. States are thus protected from exchange rate risk. States, however, are exposed to exchange rate risk consequent to the acceptance of the TwFC recommendation relating to on-lending of external assistance loans to State Governments on a back-to-back basis. A few States had expressed difficulties in making budgetary provisions in respect of external assistance loans if the exchange rates are volatile. In this context, the Technical Group on Borrowings by State Governments, which was set up under my chairmanship, felt that States could consider setting up sinking funds for managing exchange rate risks which could be funded by the savings resulting from payment of lower rate of interest on external borrowings in favourable times**.** The modalities for setting up of the fund were subsequently discussed in the State Finance Secretaries Conference.

VIII. Ways and Means Advances to the State Governments

The Reserve Bank of India (RBI) has been extending Ways and Means Advances (WMA) to the 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 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. At present, RBI is the banker for 26 States (i.e. barring Jammu & Kashmir and Sikkim) and the Union Territory of Puducherry.

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.

In view of the significant improvement in the cash position of the State Governments, the normal WMA limits which were raised periodically – usually on an annual basis – have been retained at the level prevailing since 2006-07. The WMA limits for 26 States and the Union Territory of Puducherry stand at Rs.9,925 crore.

IX. Global financial crisis and the way forward

Fiscal outturn

The consolidated fiscal position of the State Governments witnessed significant improvement in the recent years reflecting the higher share in Central transfers as a follow-up of the recommendations of the TwFC, States' own efforts at revenue augmentation, rationalisation of revenue expenditure and the cyclical upturn in the global economy that had a ripple effect on State finances. States recorded a revenue surplus of 0.6 per cent in 2006-07 for the first time since 1986-87. For the fiscal 2008-09, 25 States presented a revenue surplus budget. Seventeen States budgeted their GFD at less than 3 per cent of GSDP.

The outstanding liabilities of States declined from the peak of 33.2 per cent in 2003-04 to 28.3 per cent in 2007-08 (RE) and were budgeted to decline further to 27.4 per cent in 2008-09 (BE). With the decline in the outstanding liabilities, the ratio of interest payments to revenue receipts was estimated to decline to 15.1 per cent in 2008-09 from a peak of 26.0 per cent in 2003-04. The States have thus achieved the targets of fiscal deficit and debt/GDP ratio at the aggregate ahead of the schedule recommended by the 12th Finance Commission. Faced with the global financial crisis, the States were thus on a relatively firm ground having left with some fiscal space and accordingly given additional allocation of open market borrowings equivalent to 0.5 percentage point of a State's GSDP as a part of the second fiscal stimulus package over and above the mandated 3.0 per cent during 2008-09.

Impact on States' borrowings

During 2008-09, the increase in net market borrowings of States has met with some investor fatigue reflecting the bunching of borrowings by States during the second half and the additional market borrowings by the Centre (Rs.1,16,000 crore or 2.1 per cent of GDP) over and above the budgeted amount. The spread increased to 102-236 basis points in auctions conducted during January 13, 2009 to March 24, 2009 from 30-98 basis points during the first half of 2008-09. Notwithstanding the increase in the spread, the cut-off yields ruled low at 6.65-8.89 per cent during January-March 2009 as compared with 8.39-9.90 per cent during the first half of 2008-09 in view of the reduction of the monetary policy rates, decline in inflation and flight to safety by investors.

Impact on States' receipts and way forward

The spill-over impact of on-going global financial crisis on State finances can be gauged from the revised estimates (RE) of 2008-09 as available in respect of 19 States in their budgets for 2009-10. A moderate growth in revenue receipts outstripped by a higher growth in revenue expenditure resulted in moderation in revenue surplus. There has been a decline in States' own tax revenue and share in central taxes during 2008-09 (RE) over the budget estimates (BE). Despite this, consolidated revenue receipts in the RE have shown some improvement over the BE mainly on account of increase in States' own non-tax revenues and grants from the Centre. During 2009-10 at the consolidated level, States are expecting some recovery on account of States' own tax revenue as well as in share in central taxes. However, States' own non-tax revenue is budgeted to decline during 2009-10.

As per the RE, aggregate expenditure of States for 2008-09 increased by 5.7 per cent over the BE largely on account of increase in capital outlay. However, during 2009-10, while revenue expenditure is budgeted to increase by 12 per cent, capital outlay is budgeted to decline by 6.6 per cent. As a result, total expenditure of States is budgeted to increase by 9.6 per cent.

Consolidated revenue surplus of 19 States as percentage of GDP has shown moderation in the RE of 2008-09, while it is budgeted to be wiped out and turn into deficit during 2009-10. The moderation in revenue surplus coupled with a decline in non-debt capital receipts and increase in capital outlay led to deterioration in gross fiscal deficit (GFD) in the revised estimates of 2008-09. In fact, to address the issue of slowdown, Central Government allowed the States to increase the limit of fiscal deficit to 3.5 per cent during 2008-09. Thus, States were allowed to raise the additional market borrowing to the extent of 0.5 per cent of GSDP. This additional fiscal space was to be utilized for making capital investment. In addition, some States have also introduced stimulus packages to boost investment particularly in infrastructure sectors. GFD as a percentage to GDP is budgeted to increase further during 2009-10.

We expect that once the global economy begins to recover, the sub-national governments would re-affirm their commitment to the fiscal responsibility and be back onto the path of fiscal consolidation. Meanwhile, the challenge for the governments and the RBI is to manage the transition with as little pain as possible.