Reserve Bank and State Governments as Partners in Progress

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Y.V.Reddy*

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* Address by Dr. Y.V.Reddy, Governor, Reserve Bank of India at the Madras School of Economics, Chennai on September 23, 2007

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I am thankful to Dr. C.Rangarajan, Dr. R.J.Chelliah, and Dr. D.K.Srivastava for giving me the opportunity to participate in the annual day activities of the Madras School of Economics. It is an honour and privilege to be associated with the activities in a distinguished gathering such as this one.

Reserve Bank and State Governments as Partners in Progress

There are several reasons for selecting the subject of my address today. First, in the Indian federation, relative to the Centre, the States have taken centre-stage in reform process since the areas of highest national priority now fall essentially within the purview of States. Agriculture, Education, Public Health, Sanitation and much of physical infrastructure are primarily within the jurisdiction of State Governments. Second, Dr. C. Rangarajan and Dr. Srivastava were Chairman and member of Twelfth Finance Commission, which made historic contribution to Centre-State relations. It is also noteworthy that they addressed the Sixteenth Conference of State Finance Secretaries at RBI. Third, it was Dr. C. Rangarajan who initiated a process of active interface between Reserve Bank and State Governments a decade ago, in 1997, when he inaugurated, as Governor of RBI, the first conference of State Finance Secretaries. Finally, there is very little literature on theory or practice of role of central banks in sub-national governments. Hence, there may be merit in recording our experience in this regard. I am taking this opportunity to chronicle the unique and productive partnership between the RBI and the State Governments in the progress of our economy, as part of economic reforms.

On November 8, 1997, in his inaugural address to the First Conference of the State Finance Secretaries convened by RBI, the then Governor, Dr. Rangarajan, flagged the issues that needed to be focussed upon in management of state finances. These included: alternative methods for states' borrowings, statutory limit on debt, consolidated sinking fund and the issue of government guarantees. I would like to report that most of his expectations have been substantively achieved, as will be explained now.

I would also like to place on record the continued priority given to this process by Dr. Jalan who succeeded Dr. Rangarajan as Governor. For instance, in his inaugural address to the Tenth Conference of State Finance Secretaries, on June 7, 2002, stressing on the cooperative framework between the Centre and the States, Dr. Jalan pointed out that there are lessons to be learnt from the coordinated approach adopted by some large federal governments in managing their finances successfully in contrast with some of the Latin American nations. He noted that although the Centre's large deficit limited its ability to support the States, the harmonious relation between the States, the Centre and the RBI, who are involved in management of finances in India, have strengthened the stability and integrity of India's financial system. He also reiterated the problems associated with automatic debit mechanism, stating that a State cannot manage its finances if such mechanism pre-empts a large portion of its available funds.

Mutual Trust

Reserve Bank of India and banking are listed in the Seventh Schedule of the Indian Constitution and are hence, in the exclusive jurisdiction of Central Government. The Reserve Bank of India Act, 1934 provides that the Central Government shall entrust the RBI with all its money, remittance, exchange and banking transactions in India and the management of its public debt, and shall also deposit all its cash balances

with the RBI free of interest. On the other hand, the RBI may, by agreement with any State Government, take over similar functions on behalf of that Government. Accordingly, the RBI is the common banker to the Central Government and all the State Governments in the Indian Federation, with two exceptions.

The RBI also manages the open market borrowings of the Central Government and all the States. The market borrowing programme of the State Governments is finalised by Government of India and Planning Commission, keeping in view Article 293(3) of the Constitution of India, whereby a State may not, without the consent of the Government of India, raise any loan if there is still any loan outstanding to the Government of India.

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

The Reserve Bank of India 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 policy initiatives on State finances and debt management taken by the State Governments themselves, 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.

It is noteworthy that the interface between RBI and State Governments is not only arising out of statutorily mandated obligations but also voluntarily, based on mutual trust. The mechanism of bi-annual conference of State Finance Secretaries formalised and strengthened the process of partnering for progress, based on mutual respect through a process of continuing consultations, with the States retaining their freedom. Apart from the State Finance Secretaries, senior functionaries of the Government of India, the Comptroller and Auditor General of India, the Controller General of Accounts and the Planning Commission as also heads of select departments of the Reserve Bank are invited to the Conference. There are occasions when fiscal experts such as Mr. A. Premchand, Mr. M.S. Ahluwalia from Planning Commission, leading commercial bankers and representatives of rating agencies are invited to participate on specific issues on the agenda.

Open Market Borrowings

The normal procedure followed for open market borrowings until the first half of the nineties was that the RBI would complete the combined borrowing of all States in one or two tranches at a predetermined coupon, which was common to all States and was on par with that of the Central Government. After announcement of the loan, the RBI would write to banks indicating their expected contribution, mainly based on their market-share of deposits, with a request to invest in the State Government bonds.

Thus, high statutory pre-emptions in the form of Statutory Liquidity Ratio (SLR) in respect of banks and the tie-up of the loans by the RBI ensured a captive market in banks for these loans and the successful completion of the allocated borrowing programme.

With the substantial increase in the market borrowing programme of the Central Government, progressive reduction in SLR, increasing sophistication of debt markets offering diversified portfolio choices to banks, mark-to-market valuation norms, changes in risk weighted capital and the deteriorating financial position of States, it was becoming increasingly difficult to complete the market borrowings through the tranche system of pre-announced coupon.

To reflect these new realities, including the market perception of the status of State Governments, in 1997, the coupon rate for all the borrowing programme for all States was fixed broadly on the basis of a mark-up (which was initially 25 basis points and later increased to 50 basis points) over the yield rate of ten-year stock of Central government. Apart from the fact that banks showed increasing reluctance to voluntarily invest in State Government paper, the market had started discriminating among States in terms of their perceived strengths and weaknesses; thus adversely affecting completion of approved borrowing programme for the States.

The Central Government had switched over to the auction method for its open market borrowing programme since 1993 and in view of the experience described above, it was felt necessary for the State

Governments to explore the possibility for adopting a flexible approach with regard to interest, maturity, etc. It was also felt that in view of inter-State disparities, a gradual and cautious approach was necessary. Based on the consensus in the first Conference of the State Finance Secretaries, an option was made available to the State Governments to enter the market through a flexible approach on their own to the extent of 5 to 35 per cent of their gross borrowings. The timing and volume of issues for auction were to be decided by RBI, in consultation with State Governments, taking into account the market and liquidity conditions. This enabled well managed States to take advantage of market conditions and raise loans at finer rates and the smaller States to protect their interest by replacing the totally pre-announced coupon approach.

The auction system was experimental from the year 1998-99 with one State adopting the auction route in January 1999. The number of States adopting the auction route increased gradually in subsequent years.

With the implementation of the recommendations of the Twelfth Finance Commission (TFC), the year 2005-06 marked a watershed in the evolution of the finances and the (open market) debt management operations of State Governments. Spurred by moderation in fiscal imbalances and progressive enactment of Fiscal Responsibility Legislation by the States – induced in some measure by the incentivised debt relief scheme recommended by the TFC – the market perception regarding the fiscal position of the States seemed to have improved considerably. As many as 24 States opted for the auction route during 2005-06 as compared with only three States in the previous year. The States raised

48.5 per cent of their total borrowings through the auction route during 2005-06. The cut-off yields in the auctions were in general lower than 50 basis points (the spread in the case of tap issues).

The market borrowings during 2006-07 and 2007-08 so far have been raised entirely through the auction route with a general decline in spreads. In brief, movement from an administered borrowing programme to auction method in respect of the States was achieved gradually and through a consultative process between the States and the RBI.

Consolidated Sinking Fund

At the request of the State Governments, the Reserve Bank prepared a model Consolidated Sinking Fund (CSF) scheme and circulated it among the State Governments. By the time of the ninth Conference in November 2001, eleven States had set up the CSF, which is being administered by RBI.

The Twelfth Finance Commission had recommended that the CSF may cover repayments in respect of all loans of the State Governments (and not just open market loans). Furthermore, the Bezbaruah Committee on Ways and Means Advances (WMA) to States had recommended that States would be entitled to Special WMA to the extent of their net incremental annual investment in CSF, subject to prescribed ceilings. Against this backdrop, the Reserve Bank circulated revised model scheme of CSF amongst the State Governments in May 2006. As on June 30, 2007, of the eighteen State Governments that had set up the CSF, eleven had established the revised CSF scheme. Many more States have intimated their intention to set up the revised CSF scheme, as administered by RBI.

Prepayment of debt

In the context of build up of cash balances, two States proposed to utilize their surplus cash to pre-pay a part of their outstanding open market debt. In this connection, the modalities of buyback auctions were finalised by the Reserve Bank in consultation with these State Governments and the Government of India. General issues relating to the pre-payment of debt were discussed in the 18th conference held in August 2006. Two rounds of buyback auctions have been conducted by RBI in February and March 2007.

State Government Guarantees

Issues relating to State Government guarantees have also been discussed in almost every conference of State Finance Secretaries. Against the imperative of infrastructural development, the States have been under pressure to provide guarantees for facilitating the flow of funds to the priority sectors, state public sector enterprises, developmental institutions and local bodies, for commercial as well as non-commercial activities and urban development. The element of risk associated with such guarantees, transparency with regard to the guarantee policies and the magnitude of guarantees extended by the State governments have raised concerns regarding the optimal or sustainable level of such guarantees. It is well recognised that while guarantees do not form part of debt, as conventionally measured, these have, in the eventuality of default, the potential of exacerbating an apparently sound fiscal system.

In the first meeting of the State Finance Secretaries in November, 1997, the issue of government guarantees was deliberated upon at length

and the view taken was that, in the interest of prudent financial management and the credibility of the guarantees issued, there was a need for a policy on guarantees for each State government within certain national parameters. Accordingly, a Technical Committee was constituted to examine the issue of State government guarantees in all its aspects. The Report of the Committee was discussed in the third conference held in January 1999 and several States have taken initiative to fix a ceiling on guarantees, pursuant to the recommendations of the Committee.

The devolvement probabilities of various guarantees are not identical and consequently, all guarantees cannot be treated as uniform in terms of their fiscal impact. There was, thus, a need to evolve a methodology for classifying guarantees into categories having broadly similar fiscal impact so as to assess the fiscal risk arising out of guarantees in a more realistic and objective manner. This, in turn, was expected to facilitate the fixing of ceiling on guarantees in a non-mechanistic fashion to better reflect the risk inherent in guarantees, and enable adoption of better provisioning techniques to cover these liabilities. In this backdrop, it was decided to constitute a Group to examine the fiscal risk of guarantees extended by the State Governments. The Report of the Group was discussed in the tenth Conference held in June 2002.

The general consensus was to place the Report of the Group of Finance Secretaries on the Fiscal Risk on State Government Guarantees in the public domain. It was also agreed to explore the possibility of extending the scope of the concerned RBI circular addressed to banks, to financial institutions also so that they would also undertake due diligence and proper appraisal in financing projects rather than merely relying on guarantees to institutions. It was also proposed that States could be provided technical assistance on providing risk weights to guarantees.

The Reserve Bank organises workshops on the evaluation of fiscal risk of guarantees for the benefit of State Government officials. Representatives of credit rating agencies are also invited to give presentations at the workshops. So far, four such workshops have been organised. It was also decided that the State Governments would be encouraged to seek credit ratings by a rating agency for internal use so that they could initiate appropriate measures to improve their financial performance when they approach the market to mobilize resources.

The Reserve Bank circulated a draft scheme on Guarantee Redemption Fund (GRF) among the State Governments for voluntary adoption. As an incentive to build up the Consolidated Sinking Fund (CSF) and GRF, the Bezbaruah Committee (2005) recommended that net incremental (i.e. new investment less redemption/liquidation) annual investment of States in CSF/GRF is to be made eligible for availing Special WMA, but up to a ceiling equivalent to the Normal WMA limit. Keeping this in view, the Reserve Bank circulated revised draft GRF scheme amongst State Governments in May 2006. As on June 30, 2007, eight State Governments had set up the GRF, of which three had put in place the revised scheme.

Ways and Means Advances, and cash management

The Reserve Bank of India (RBI) has been extending Ways and Means Advances (WMA) to State Governments since 1937 with the objective of covering temporary mismatches in the cash flows of their receipts and payments.

The WMA Scheme has been periodically revised, beginning from the early 1950s, in the light of perceived requirements of the State Governments, keeping in view the evolving fiscal, financial and institutional developments as well as the objectives of monetary and fiscal management. 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 overdraft have been specified; these limits have also been revised periodically. Payments on behalf of the State Governments are suspended in case the OD limits are breached.

Up to the late 1990s, the Normal and Special WMA limits of State Governments were fixed in terms of specified multiples of their minimum balances with the RBI. Both the minimum balances and the ‘multiples’ to obtain the Normal WMA limits, were revised upwards a number of times (though not necessarily at the same time) over the years.

There has been pressure from several States, from time to time, for upward revision of WMA limits. RBI had taken the view that WMA is meant for temporary mismatches and hence upward revision to meet structural deficits is inappropriate. The matter remained a contentious issue for some time.

The initiation of the Conference of State Finance Secretaries in 1997 induced a transformation in the approach to formulate changes in the WMA Scheme. Distinct from the past, Advisory Committees were periodically constituted by the Reserve Bank to review the prevailing WMA arrangements and recommend changes as considered appropriate in the light of evolving circumstances. The involvement of experts from outside the Reserve Bank in such Advisory Committees helped to strengthen and broad-base the modalities for effecting appropriate changes in the WMA Scheme. In fact, three Advisory Committees that have been constituted so far have been chaired by experts from outside the Reserve Bank and have included other 'external' experts apart from senior functionaries from the Reserve Bank, as members.

The first informal Advisory Committee on the WMA to State Governments was constituted in 1998, under the chairmanship of Shri B.P.R. Vithal. As a major break from past practices, the Vithal Committee recommended the de-linking of the size of the Normal WMA limit with the minimum balance held by the States on the grounds that "fixing the WMA limits as multiples of an unchanged minimum balance, as in the past, does not capture the differing needs of the States in line with the different growth in their budgetary transactions. This has resulted in wide inter-State variations in the WMA limits in relation to the size of the Budget, and this needs to be corrected." The Vithal Committee instead

proposed linking the normal WMA limit to the cash flows of the State. The recommendations were implemented in the light of further consultations with the States and the Centre.

Subsequently, similar committees (Ramachandran Committee, 2003 and Bezbaruah Committee, 2005) have refined and improved upon the WMA arrangements. It is noteworthy that WMA arrangements have ceased to be contentious matter between Centre, States and RBI in view of the arrangements being finalised on the basis of advise from outside experts and intensive consultations among the stakeholders.

The upsurge in the surplus cash balances of some of the State Governments since the middle of 2004-05, in contrast to the liquidity pressures witnessed in the earlier period, has posed newer challenges to financial and cash management of State Governments. The issues relating to investment of cash balances of the States were discussed in the 18th conference held in August 2006 and also in the 20th Conference of State Finance Secretaries held in August 2007. Taking note of the discussions, the Reserve Bank is in the process of formulating plans in consultation with the Centre and the States.

Advice on fiscal management

Importance of fiscal transparency has been emphasised in recent years after Government of India subscribed to the Special Data Dissemination Standards (SDDS). In this light, it was decided to constitute a Group of State Finance Secretaries to suggest various measures of disclosures, which could be introduced in the budgetary exercise of State

Governments. It was also decided that the Group could lay down a model budget for the States, which would enable the Legislature and the public to enhance their understanding of State finances. The Group suggested, inter alia, that it would also be useful, if State Governments could bring out a document akin to the Budget at a Glance of the Central budget giving the estimated levels of GFD and PD (including its ratio to the SDP). It could also incorporate time-series data on important fiscal variables of the State. The levels of outstanding debt, guarantees, wages and salaries and subsidies could also be explicitly indicated. Many States have, in the light of these deliberations, modified their budget related documents to enhance transparency

A Group was constituted in February 2003 to study pension liabilities of State Governments and make suitable recommendations. The Group observed that if pension payments of the States would grow at the historical average growth rate, pension payments alone would pre-empt about 20 per cent of total revenue receipts of States and as much as 30 per cent of the revenue receipts in 2010-11. Purely from the angle of fiscal sustainability of the States and the magnitude of the problem, structural alteration in the existing pension scheme thus appeared to be necessary. The Group recommended introduction of contributory pension scheme/s for the new employees of the State Governments in place of the existing non-contributory defined benefit pension scheme. Three alternative pension models were recommended. These are to be acted upon by States as they consider appropriate. As per available information, nineteen State Governments have notified a defined contributory pension scheme for their new employees.

Recognising the absence of unanimity about the exact level, composition, and methodology for compiling the liabilities of State Governments in India, it was decided in August 2004, to constitute a working group to evolve a methodology. The Group recommended that the compilation of data on the budgetary liabilities should be consistent with those in respect of the Gross Fiscal Deficit and accordingly specified the constituent items. It also emphasized the need to exclude implicit/contingent liabilities from the definition of budgetary liabilities keeping in view the widely differing views on the inclusion of various items of implicit liabilities. The Group recommended specified formats for timely release of data on the liabilities in the budget documents of the State Governments. The Group also recommended that Reserve Bank should compile and publish the data on liabilities in its annual study on State budgets; this has already been implemented.

Fiscal Responsibility legislation

RBI had provided detailed and comprehensive technical inputs to Government of India to frame a Fiscal Responsibility and Budget Management Law. In view of this successful outcome, State Finance Secretaries expressed a desire for similar advice to them from RBI. Accordingly, a group was constituted in October 2003 with select State Finance Secretaries and a representative from the Government of India, Ministry of Finance, as members, to prepare a model fiscal responsibility legislation. The draft Report was discussed in the 14th Conference of the State Finance Secretaries held in August, 2004 and the final report was submitted to Reserve Bank in January 2005. The Group decided that the model legislation would generally follow the Central FRBM Act, and build upon the State fiscal responsibility legislations enacted so far. The Group also took into account international best practices available in the area as well as the recommendations of the Committees on issues related to voluntary disclosure of information by State Governments and fiscal transparency. The Group felt that the model bill would provide guidance to the States for enacting their fiscal responsibility legislations with reference to certain benchmarks.

The objective was to design a template for the fiscal responsibility legislation for the States on the basis of "workability" and enforceability taking into account the diverse requirements of various States. It was considered desirable to allow individual States to take a view on sequencing adoption of the various provisions, fixing the actual targets and time frame thereof for implementation and allocating the provisions between the Act and the Rules depending on their fiscal capabilities and further refining the provisions given in the model bill within the overall framework of fiscal prudence and sustainability. Various dimensions of the fiscal legislative framework, such as, the choice of targets, the road map for achievement of the targets, need for a detailed set of illustrative rules, independent evaluation criteria, prioritisation of capital expenditure, treatment of contingent liabilities including guarantees, computation of pension liabilities, etc. were deliberated upon to arrive at a consensus.

All State Governments, except two, have already enacted fiscal responsibility legislation.

New Arrangements for Borrowings by the States

According to the TFC, it would be appropriate for States to take advantage of market rates and avoid the spread charged by the Centre. The pattern of central assistance involved a major element of loan in respect of general category States, which was implicitly funded by borrowings by the Centre and hence terms of loans reflected centre's cost of borrowings. To the extent these arrangements prevailed there was, in effect, intermediation of Centre in the loans to State as part of central assistance. 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 are unable to raise funds from the market, the Centre could borrow for the purpose of on-lending to such States, but the interest rates should remain aligned to the marginal cost of borrowing for the Centre. This approach was accepted by the Government in principle, to be implemented in phases, in consultation with the Reserve Bank.

The new arrangements for ensuring disintermediation of Centre in respect of States' borrowings was deliberated in the Conferences of State Finance Secretaries and in the Monitoring Group on Cash and Debt Management of the Government of India and RBI. In the light of these discussions and in order to operationalise the new arrangements, the Government of India constituted a Technical Group with Smt. Shyamala Gopinath, Deputy Governor, RBI as chairperson and by drawing members from the Government of India, select States and the Reserve Bank. The Technical Group submitted its report to the Government of India in December 2005.

The Technical Group made several recommendations and there has been noticeable progress in regard to the calendar, re-issuance and the auction method. In addition, on the lines of the recommendations of the Working Group on Liquidity of State Government Securities (Chairman – Shri. V.K.Sharma), 2005, State Development Loans (SDLs) have been made eligible for repo transactions under the liquidity adjustment facility and it has been decided to introduce the non-competitive bidding facility in respect of the primary auctions of SDLs. As far as sharing arrangements of NSSF are concerned, in accordance with the decision of the National Development Council, the obligatory share of the States has been reduced to 80 per cent with effect from 2007-08.

Loan Council

The TFC had also recommended that "…..States, like the Centre, must decide their annual borrowing programme within the framework of their respective fiscal responsibility legislations…. The overall limit to their annual borrowings from all sources should be supervised by an independent body like a Loan Council with representatives from the Ministry of Finance, Planning Commission, Reserve Bank of India and the State Governments. The Council may, at the beginning of each year, announce the annual borrowing limits for each State, taking into account the sustainability considerations….." (Para 15.7).

It was, however, felt that setting up of a new institution, like the Loan Council, would entail additional cost in terms of physical and human resources and would take time. Furthermore, a large majority of States

are currently seized with the task of addressing structural problems in managing government finances which, if carried on to their logical conclusion, could usher in an era of debt sustainability over the medium-term of the TFC period. The Loan Council could lose its rationale for existence once the fiscal situation becomes tractable, as seems to have been the case with the Australian Loan Council, which provides the international best practice in respect of coordinated borrowings by the Federal and State Governments. Against this backdrop, the Technical Group felt that an arrangement for coordinated borrowings between the Centre and the States on the one hand and between the States on the other could be best served by the setting up of a Standing Technical Committee (STC) with representation from the Central and State governments and the RBI.

The Terms of Reference of the STC are to make annual projections of borrowing requirements of the State Governments; build alternative scenarios and suggest alternative strategies and instruments for raising resources of States; advise a mechanism for annual allocation of market borrowings among the States; take note of actual borrowings of the State Governments during the year vis-à-vis the budgeted GFD and develop an appropriate database that would facilitate the monitoring exercise; assess fiscal risks from issuances of State Government guarantees; and advise State Governments on various issues relating to their borrowings.

The first meeting of the STC was held in the 20th Conference of the State Finance Secretaries in August 2007.

Management of Foreign Exchange Risk

The external assistance by multilateral agencies to States has traditionally been funded through the Central government as part of the Central assistance. As part of the policy of disintermediation of Centre in borrowings by States, it was decided by Central Government that there should be back-to-back transfer of external assistance. In the 16th Conference, some State Finance Secretaries suggested that RBI could play an advisory role in assisting States to hedge their exchange rate risks arising from the policy of back-to-back transfer of external assistance.

In the context of the TFC recommendations and following the discussions in the 19th Conference held in January 2007, the first workshop on the management of foreign exchange risk by the States through the financial markets was organized by the Reserve Bank in May 2007, for the benefit of State Government officials.

States have proposed alternative mechanisms for providing for foreign exchange risk by setting aside funds in their budgets, where the Reserve Bank is expected to play a role in managing these funds on the lines of the CSF. These proposals were discussed in the 20th Conference held in August 2007.

Selective Broadening and Deepening of Relationship

There are many areas in which there has been close coordination between RBI and States. For this purpose, there are standing institutional mechanisms also at State level for some important areas of RBI's responsibilities with which regional offices of RBI and concerned officials

of State governments are associated. The more important areas of close coordination relate to overall security for banking system, matters relating to coins and currency and responses to natural calamities.

Considerable decentralization of powers and responsibilities to regional offices has been brought about by RBI to facilitate locally relevant solutions to the problems, as they arise. The empowerment of regional offices has been combined with promoting State specific initiatives, both in policy and implementation. The regional offices play a facilitator role in bringing together contending parties when some tensions arise, that affect the financial system. One of the examples relates to resolution of stand-off between a State Government and microfinance institutions on the terms of loans and methods of recovery of dues. Similarly, considerable latitude is exercised, to suit local conditions, in the deliberations of State Level Bankers Committees, and there are many instances of Finance Ministers and Chief Ministers presiding over such meetings.

In the broad area of banking, an innovative mechanism has been designed to resolve the issue of dual control in regard to urban cooperative banks. Several States, together accounting for over seventy percent of such activity, have signed Memorandum of Understanding with RBI to constitute in each State a Task Force on Urban Co-operative Banks to ensure co-ordinated actions to revive and strengthen this sector. This has been, by all accounts, an outstanding success. Similarly, Empowered Committees have been constituted in all States to reorganize and strengthen and expand Regional Rural Banks. In the matters relating to revival of rural cooperatives also, State specific packages are considered.

Special plans for coordinated actions for select States where the spread and depth of banking services are poor have been mounted, examples being north-east States, Uttarakhand and Bihar.

More recently, a vigorous programme of financial inclusion has been taken up to ensure offer of banking services to the whole population. RBI plays the lead role in each State, while State government participates in the movement, for operationalising the approach. States have particular interest in this programme to ensure efficient and inexpensive disbursal of funds under several social security related and rural employment programmes. The recent developments in technology are facilitating this process. Simultaneously, some States have shown enthusiasm for extending financial literacy and RBI is encouraging its Regional Offices to respond, preferably in the local language, (and we have about fifteen of them) and websites of RBI attempt to disseminate information in most of these languages.

We do recognize that we should avoid overstretch, but should be willing to interact and respond positively to the genuine demands of State governments, that are legitimate concerns of RBI. No doubt, State-specific considerations would govern State-specific responses, subject to overall policy of RBI. There are many areas, particularly of greater relevance to Central government than RBI, in which States seek RBI's involvement but we do carefully distance ourselves. Sometime ago, there was a strong appeal from several States that RBI should give a rating to fiscal management of all the States, which would carry greater

weight and foster greater response from political leadership of States concerned. RBI had politely refused since, as an institution, it should not appear to be passing judgments on or ranking States.

Outcomes and Challenges

Having described the efforts and the processes of collaboration between the States and RBI, it is appropriate to briefly narrate outcomes and recognize critical challenges in matters of concern to State finances and RBI.

First, the progressive enactment of Fiscal Responsibility Legislations (FRLs) by as many as 26 State Governments has indeed strengthened fiscal consolidation initiatives at the State level.

Second, the gross fiscal deficit of States which had increased from an average of 2.8 per cent of GDP in the first half of the 1990s to an average of over 4 per cent of GDP in the first half of the present decade, was placed at 2.5 per cent of GDP in 2005-06 and is expected to be brought down to 2.4 per cent in the budget estimates for 2007-08. The revenue deficit, which had increased to an average of 2.2 per cent of GDP in the first half of the present decade, has remained at less than 0.1 per cent since 2005-06. In fact, an aggregate revenue surplus (of 0.4 per cent of GDP) has been budgeted for 2007-08. All States, except eight, have budgeted for a revenue surplus during 2007-08.

Third, open market borrowings of the State Governments have been conducted entirely through the auction route during 2006-07 and

2007-08 (so far). The spreads for almost all the States over the yields of Central Government securities of comparable maturity during 2006-07 and 2007-08 so far, has remained well below 50 basis points (spread fixed in the case of tap issuances), reflecting favourable market perception.

Fourth, as far as State Government guarantees are concerned, the volume is on a declining path: guarantees were placed at 6.5 per cent of GDP as of end-March 2005 as compared with 8.0 per cent as at end-March 2001. Many States have imposed administrative/ legislative ceilings on guarantees. Eight States have set up Guarantee Redemption Funds to provide for the possible invocation of guarantees.

Fifth, eighteen States have set up Consolidated Sinking Funds to provide for orderly repayments of their open market borrowings. Of these, eleven States have set up the revised CSF scheme which provides for repayments of all liabilities (and not just open market loans). Many more States have proposed to set up the revised CSF.

Sixth, the cash management of the State Governments has shown a marked improvement in recent years. The daily average utilization of Normal WMA, Special WMA and overdrafts by State Governments declined during 2006-07. During 2006-07, eight States availed WMA as against 12 States in the previous year. Only two States resorted to overdrafts during 2006-07 as against eight States in the previous year.

Notwithstanding the positive developments and prospects, there would remain a few areas of concern.

There are certain risks to the fiscal consolidation process such as the expected increase in expenditure from the revision of pay scales on the implementation of the recommendations of the Sixth Pay Commission. In this connection, State Governments would need to make their budgets robust enough to enable them to steadfastly adhere to the provisions of their Fiscal Responsibility Legislations. Fiscal empowerment through revenue augmentation holds the key to address such fiscal risks.

Initiatives by the States would be needed to develop a calendar for open market borrowings by the States, on the lines issued by the Government of India. This would enhance transparency, reduce uncertainty for the market participants and thereby help to further smoothen market borrowing operations. Re-issuance of State Government securities would also help to build up a critical minimum size of securities which would, in turn, help to enhance their liquidity.

The Reserve Bank continues to receive complaints from banks and financial institutions regarding defaults in respect of obligations under State Government guaranteed bonds. Such issues need to be addressed by the State Governments as this would impact on their credibility and market perception of their financial position.

At the same time, issues relating to the insistence of certain (re-financing) institutions for State Government guarantees, irrespective of the financial viability of projects, perhaps on account of legal requirements, also need to be addressed at an appropriate forum.

The State Government expenditures on education and health remain low at around 2.5 per cent of GDP and 0.7 per cent of GDP, respectively. These expenditures may need to be enhanced to make a long-term impact on the level of human development in the country, within the framework of Fiscal Responsibility Legislation. At the same time, issues relating to the quality and timeliness of such social sector services need to be expeditiously addressed. From the Reserve Bank's standpoint, initiatives relating to credit culture, financial literacy, financial inclusion and priority sector lending would continue to remain high on the policy agenda.

Concluding Remarks

RBI has considerable professional skills and States recognize these, and value them better when we are willing to consider State-specific orientation to our broader analysis. RBI, like most central banks, carries considerable credibility and good public image. RBI, as a public institution is considered relatively apolitical in viewing the vertical relations between the Centre and the States and horizontal ones among the States. The biannual Conference of State Finance Secretaries sponsored by RBI has proved to be an excellent forum for wide ranging discussions. The Technical Committees or Groups that are formed are entirely those of States, though Centre may occasionally be associated, but RBI provides secretarial and technical support. The Centre and each State concerned decides appropriate course of actions. The fact that some States have adopted a few but not all the recommendations of the Committees and Groups demonstrates the movement away from the perceived centralization of the past towards a participative process.

I am happy to submit that all States, though with varying degrees of enthusiasm, fully endorse the immense contribution of the process of partnering between RBI and the States in the cause of better financial sector and fiscal empowerment in the States.

Let me conclude with profuse thanks to the Madras School of Economics for provoking me to think aloud on this subject and share the thoughts with wider audience.

The School came into existence in 1995, but very soon, it could obtain 'A' Grade from the National Assessment & Accreditation Council. The Ministry of Environment and Forests has also designated the school as a Centre of Excellence in Environmental Economics.

I have no doubt that the School will be an internationally recognized Centre of Excellence in economic studies attracting the best of students and teachers from different parts of the country and other countries.

On our part, we in RBI are in close touch with the School with a view to obtaining their expertise in the process of monetary policy formulation.