

UNAUTHORISED OVERDRAFTS

24. Paragraph 4(j) of the Order of the President requires us to make recommendations regarding the problem of unauthorised overdrafts of certain States with the Reserve Bank of India and the procedure to be observed for avoiding such overdrafts.

Nature and magnitude of the problem

25. We shall first set out the present arrangements between the State Governments and the Reserve Bank of India and indicate how unauthorised overdrafts arise. All the States except Jammu and Kashmir have entered into agreements with the Bank under Section 21-A of the Reserve Bank of India Act to enable it to handle their monetary transactions. Section 17(5) of the Act provides that the Reserve Bank may make advances to State Governments repayable in each case not later than three months from the date of the advance. The limits of such advances are specified in the letters exchanged in pursuance of the agreements. Upto 1953, the limits laid down were equal to the minimum cash balances that the State Governments were required to maintain with the Reserve Bank, and since then they have been fixed as a multiple of such balances. Besides the normal ways and means advances for which no cover is necessary, the Reserve Bank gives special advances to the State Governments against Central Government securities. Table 1 gives the position regarding the limits as obtaining since the 1st March, 1967, under which the States can obtain normal ways and means advances upto Rs. 18.75 crores in all and special advances of a further amount of Rs. 37.5 crores. The Reserve Bank also sanctioned additional *ad hoc* limits for secured advances. Such limits as on the 10th August, 1968 stood at Rs. 12.7 crores. "Unauthorised overdrafts" arise either because the limits agreed to between the States and the Reserve Bank are exceeded or because the overdrafts are not repaid within the period of three months.

26. The monetary transactions of State Governments go on simultaneously at over 2,000 treasuries, sub-treasuries and banks. Owing to this large number of places it is not possible for the Bank to ensure beforehand that payments on behalf of a State Government do not exceed the balance held by it by more than the limit specifically agreed to. The Government transactions occurring at all such places are allowed to proceed without any reference to the actual position of a State Government's cash balance, the accounts of which are maintained only at the Central Accounts Section of the Reserve Bank. The agency Banks transfer the net amount of debit or credit to the State's cash balance account every day. The non-Banking treasuries have separate balances belonging to the State Governments outside the cash balances maintained with the Reserve Bank. Such treasuries are permitted to draw on currency chests kept with them

by the Reserve Bank as a resource for making payments whenever the State's own balance at the treasury gets depleted, as well as to deposit surplus receipts in the currency chests from time to time. The net transfers of funds to or from the currency chests are taken to the credit or debit of the cash balances of the States. When on the compilation of accounts each day it is found that the debit against a State Government exceeds the limit of the ways and means advance, an unauthorised overdraft results. This happens unobtrusively and the Reserve Bank comes to know of it only after the event. / At that point the agreement entered into by the State Government under the Reserve Bank of India Act is contravened. Further, in view of the fact that all the State Governments are indebted to the Centre, there is also a contravention of Article 293(3) of the Constitution, which provides that a State Government may not, except with the consent of the Government of India, raise any loan if there is outstanding any part of a loan to the State by the Government of India or a loan guaranteed by it. / When the fact of an unauthorised overdraft comes to the knowledge of the Reserve Bank, it issues a notice to the State to make arrangements to clear the overdraft within three weeks with a warning that in case of default the Bank will consider itself free to stop payments without any further notice. Some State Governments have taken these notices seriously and have complied with their requirements, mostly with the help of the Central Government. Others have just ignored them. Where the overdraft is not cleared, it is open to the Reserve Bank to refuse to honour any further cheques of the State Government. It is, perhaps, incumbent on it to do so, as a body constituted for securing monetary stability. The Reserve Bank has, however, desisted from this course in the past, in view of the extremely adverse effect that such action may have on the credit and financial stability of the State Government with all its serious implications including the possible emergence of a situation envisaged in Article 360 of the Constitution. To avert such a crisis, the Central Government has been giving *ad hoc* loans or other form of assistance to the State Governments to enable them to clear their unauthorised overdrafts before the end of the year.

27. The prevalence and magnitude of these overdrafts have become serious in recent years. Upto about 1950, the State Governments were able to manage their financial transactions within the specified limits of their ways and means advances. The first overdraft of an appreciable size arose in that year. In April, 1953, in order to meet the increasing requirements of the States, the Reserve Bank increased the limits of ways and means advances for all the States from Rs. 1.85 crores to Rs. 7.88 crores in all. Special ways and means advances of Rs. 2 crores for each State were also permitted against Government of India securities. In spite of these increased limits, the Government of India had to provide during the Second Plan period *ad hoc* loan assistance aggregating to Rs. 128 crores to seven State Governments to clear their unauthorised overdrafts. Eleven States had to be given such assistance amounting to Rs. 286 crores during the Third Plan period. The problem has become even more serious since the end of the Third Plan period. During 1966-67, the Central Government had to sanction *ad hoc* loans amounting

to Rs. 149 crores. Although there was a further upward revision in the limits of ways and means advances in March, 1967, *ad hoc* loans amounting to Rs. 128 crores had to be given during 1967-68 (*vide* Table 2).

28. Of the seventeen States, six or seven States have been having persistent unauthorised overdrafts. As ranked by the *per capita* incomes of their inhabitants, such States were not those with the lowest ranks. Some of the less prosperous States did not get into unauthorised overdrafts while some relatively better-off States had done so.

Consequences

29. The persistence and large size of unauthorised overdrafts are a matter of very serious concern. Apart from the contravention of Article 293(3) of the Constitution and the agreements entered into under Section 21-A of the Reserve Bank of India Act, the occurrence of such overdrafts and their practically automatic clearance by the Centre through *ad hoc* loans have grave effects on the national economy. In all federations, it is the sole responsibility of the Central Government to take decisions regarding the need for and the extent of deficit financing in the context of overall economic considerations. No country with a unified currency system can afford to have more than one independent authority taking measures which result in increase of money supply. Unauthorised overdrafts violate this fundamental principle of sound monetary management. The benefits of this violation go to a few States which draw on the national resources at their own will without any scrutiny of their needs at the national level, while the burdens are borne by all, including the States which are less prosperous. There is a serious danger that the example of having recourse to such unauthorised overdrafts by certain States, followed by their almost routine clearance by the Centre, may prove infectious. The States which have avoided such overdrafts by prudent fiscal management are very critical of this practice. They strongly represented to us that this extremely undesirable state of affairs should be immediately ended.

30. In our discussions with the State Governments we found that all of them, including those which had got into unauthorised overdrafts, were agreed that such overdrafts are untenable in principle and undesirable in practice and that there is an urgent need of stopping them. There is thus general unanimity that the practice of unauthorised overdrafts is harmful and undesirable, and that effective measures should be taken to put an end to it in the interest of national economy. The Commission agrees with this view.

States' difficulties

31. We shall now examine the reasons given by the States for the emergence of unauthorised overdrafts. The State Governments which have had persistent overdrafts have explained to us that they have been forced to have recourse to them due to various difficulties which they have to face. The State Governments have to strive to meet the ever growing needs of the people in a welfare State, parti-

cularly for social and economic development, and many of them have special problems and difficult situations to deal with. The steep rise in prices in the last few years has also added considerably to their financial difficulties. If the problem is to be tackled at its source, these difficulties must be considered in their proper context and, to the extent they are genuine, removed.

32. We may classify the difficulties explained by the States into two groups according to their nature:

- (a) Temporary difficulties arising from the uneven flow of receipts or expenditure and the inadequacy of limits of ways and means advances with which they could be met; and
- (b) Relatively more chronic imbalances between their resources and functions, inadequate devolution and the absence of suitable mechanism to deal with unforeseen difficulties.

The first group can only explain temporary unauthorised overdrafts which should get cleared as soon as progressive receipts reach up to progressive expenditure. The second group of difficulties can lead to persistent unauthorised overdrafts. It is the latter which we shall consider first.

Imbalance between resources and functions

33. The States have complained of the great disparity between their resources and functions under the Constitution. The distribution of resources and functions between Central and State Governments varies from one federal Constitution to another. Recent technical and economic developments leading to integration of the national economy have, however, resulted in an effective centralisation of a number of more productive taxes. A growing degree of imbalance between the revenues of State Governments and the expenditure needed for the efficient discharge of their functions has, therefore, proved to be inescapable in most federations. The Indian Constitution, drawing upon the experience of the working of other federations and recognising the need of the times, has given the Central Government the exclusive power to levy and collect some important direct taxes. On the other hand, it has left a considerable field of direct taxation, such as land revenue, taxes on agricultural income and duties in respect of succession to agricultural land, entirely to the States. The power to levy taxes on commodities, excluding customs duties, is divided between the Centre and the States. Besides, the Constitution has assigned to the States the entire proceeds of some taxes levied and collected by the Central Government under Article 269 and a share in the proceeds of income tax under Article 270. The proceeds of Union Excise duties may also be shared under Article 272. Article 275 provides for grants-in-aid of the revenues of States which may be in need of assistance. The shares of these taxes and the amount of grants are decided on the recommendations of the Finance Commissions which are appointed at least every fifth year. The recommendations of the Finance Commissions have been

making provision for the requirements of States for non-Plan revenue expenditure. Revenue grants as well as loan assistance for the Plan are disbursed by the Central Government on the recommendation of the Planning Commission. The Central Government generally accepts the recommendations of these Commissions and large and increasing amounts are being transferred to the States accordingly. The State Governments have a full opportunity to state their cases and explain their requirements to the two Commissions. In the nature of things it cannot be expected that the States will be fully satisfied with the decisions. However, once the decisions are taken, it is the duty of the States to manage their affairs within the resources available to them including the devolution and assistance from the Centre. They must regard it as a matter of necessary fiscal discipline to balance their budgets, and to take in their stride the normal vicissitudes in their financial position.

Difficulties due to changed circumstances

34. Many states have drawn our attention to the fact that while the size of State Plans and Central Plan assistance are reviewed and revised from year to year, the recommendations of Finance Commissions remain in force for longer periods without any such review. If due to changed circumstances, such as increase in prices requiring provision for dearness allowance to their employees, the States have to incur substantially larger non-Plan expenditure there is no machinery at present for providing increased devolution of resources to them. They have represented to us that it is necessary to have some reviewing agency like a permanent Finance Commission which could look into their difficulties on such occasions and recommend suitable additional assistance. We have given very careful thought to the demand of the States for such a mechanism. We are, however, of opinion that it would not be very useful to set up any standing arrangements for this purpose. We think that the case for a permanent Finance Commission has to be judged on grounds much wider than the occasional need for providing additional non-Plan assistance to States during the period covered by the existing devolution arrangements. Having regard to the nature of its functions it would be inappropriate to require a Finance Commission to look only into the requirements arising from some isolated causes affecting the States' revenue or expenditure, or to look into the financial needs of a few States only. In considering any modification of the scheme of devolution of resources from the Centre to the States or their distribution among the States, the Finance Commission would have to take into account the overall needs and resources of the Central and State Governments in the changed circumstances, including the commitments already made on the basis of the existing scheme of devolution. Such a review would not be practicable for the purpose of dealing only with the additional needs of States due to particular reasons.

35. When a State Government finds itself unable to balance its budget having regard to its existing resources including the proceeds of additional taxation undertaken after the last Plan period, its difficulties may be either due to circumstances beyond its control, such

as natural calamities, or due to other new developments necessitating substantial additional expenditure. We note that the Central Government already has a scheme for assistance to States in case of natural calamities under which, after obtaining the report of a team of Central officers, it provides assistance by way of grants and loans as well as necessary ways and means advances to cover the entire approved expenditure required to meet such calamities. We consider that in all cases where a State Government experiences difficulties due to unforeseen developments, it should make serious efforts to raise further resources or to reduce its expenditure as far as possible instead of incurring unauthorised overdrafts. If, in spite of all possible measures, the State finds itself unable to meet the additional expenditure which is immediately necessary, it may apply to the Centre for temporary assistance to tide over the difficulty by a short-term loan on suitable terms. We recommend that in such cases the Central Government should provide necessary assistance to the State after satisfying itself regarding the need of the State, the efforts made by it to adjust its resources and expenditure and the steps it is prepared to take to provide for repayment of the loan.

36. After the immediate requirements have been provided for in this manner, the State should be able to devise suitable measures for balancing its budget in the succeeding year. The Planning Commission which annually reviews the estimated non-Plan receipts and expenditure of the States, should take into account the adverse effect of the new developments, and if necessary, modify the size of the annual Plan of the State concerned. This may result in some States having to curtail their annual Plans, but we think that proper fiscal discipline requires that they should make such necessary adjustments in their Plan programmes until the whole question of devolution is reviewed by the next Finance Commission.

Plan finance

37. Some State Governments have represented to us that they have been led to overestimate their resources and underestimate their non-Plan expenditure in their eagerness to have larger Plans and to secure greater Plan assistance which has been allocated on a basis of matching resources. We consider that both resources and expenditure should be estimated in a realistic manner. At the same time we recognise that to some extent the States have to be prevailed upon to maximise their resources and to economise on non-essential expenditure. We understand that the Planning Commission is engaged in revising the principles for distribution of Plan assistance in future, and that it is likely to give less importance to the basis of matching resources. We consider it fundamental that there should be no deficit financing at the State level, and that the size of the State Plans should be regulated strictly within the States' own resources and such Central assistance as may be available. For this purpose, ways and means advances should not be considered as a resource.

Repayment of Central loans

38. Besides the requirements of unforeseen circumstances which have led to difficulties in the States' revenue budgets, the volume of

repayment of loans has in recent years resulted in a considerable strain on the capital side. In this respect there is a serious lacuna in the present arrangements for fiscal assistance to States to which we would like to draw the attention of the Central Government. The repayments of loans by States have been growing very steeply (*vide* Table 3) while non-Plan capital receipts have not shown any such growth. It has not been possible for us to consider the various items of capital receipts and expenditure individually, but taken together they have resulted in substantial non-Plan capital deficits (*vide* Table 4) which have been largely responsible for unauthorised overdrafts in several States. At present, there is no arrangement for dealing with the problem of these capital deficits. In order that unauthorised overdrafts are avoided, we suggest that whenever such deficit is anticipated, the State Government should carefully consider how far its non-Plan capital expenditure can be reduced, and also make efforts to increase its capital receipts including better recovery of loans given by it. If in spite of such efforts, the capital budget for the year cannot be balanced, the State may represent its case to the Central Government which may, if satisfied that the State needs relief in order to avoid unauthorised overdrafts, consider deferring the repayment of Central loans falling due during the year to the necessary extent.

Deprivation of States' share of taxes

39. Some of the State Governments have represented to us that the inadequacy of their resources has been accentuated by the unilateral actions taken by the Central Government which have deprived them of their legitimate shares out of proceeds from advance collection of income-tax, income-tax on companies and tax on railway passenger fares. We may point out that while the Constitution gives the States a right to share in certain taxes when they are levied by the Centre, it is the responsibility of the Central Government to decide what taxes are to be levied as well as the manner in which and the rates at which they should be levied. The machinery of Finance Commissions has been provided to ensure that the States receive an equitable share of the proceeds of divisible taxes and duties after periodical review. A cause for complaint regarding deprivation of the States' due share can therefore arise only if the Central Government made a change adversely affecting the States without providing for suitable compensation during the period between two Finance Commissions. Such has not been the position in any of the cases mentioned by the States in this connection. Whatever view might be taken as to the correctness of the procedure for determining the net proceeds of income-tax, the fact is that the present practice of excluding advance collection of income-tax from the divisible pool pending finalisation of assessments has been in existence since a time prior to the appointment of the first Finance Commission and even before the commencement of the Constitution. All the Finance Commissions have framed their recommendations regarding devolution of taxes and grants after having due regard to the size of the divisible pool of income-tax estimated on the basis of the existing procedure. The change in the Income-tax Act whereby the income-tax paid by companies was brought into the category of cor-

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poration taxes was made in 1959. This resulted in contraction of the divisible pool immediately, but the Central Government gave the States a compensatory grant to make good the loss. When this matter was dealt with by the Third Finance Commission, it pointed out that there were other measures available for taking account of the shrinkage in the divisible pool. On this and other considerations it increased the States' share in the proceeds of income-tax to 66-2/3 *per cent* and also made other recommendations to increase the volume of devolution. The Fourth Finance Commission also took due note of the States' representations in this regard and eventually increased the States' share of income-tax to 75 *per cent*. An *ad hoc* grant was provided by the Centre in lieu of the repealed tax on railway passenger fares. We do not therefore consider that the contention of some States that these measures have led to unauthorised overdrafts is justified.

Delays in receipt of devolution and Plan assistance

40. We now come to temporary difficulties arising from fluctuations in the flow of receipts and expenditure. In this connection the States have complained of delays in the receipt of their shares of tax devolution, statutory grants and Plan assistance. We have gone into this question in some detail. We find that the States' shares of the Union Excise and Additional Excise Duties are paid to them in monthly instalments and grants under Article 275 are disbursed quarterly in advance. The States' share of income-tax is paid quarterly—10 *per cent* in July, 20 *per cent* in October, 25 *per cent* in January and the rest in March. It is seen that the income-tax collections follow the same pattern (*vide* Table 5), and obviously the Central Government cannot be expected to pay the States' share in advance. Since, however, large portions of this share involving considerable sums are at present being paid to the States in January and March, we suggest that the Central Government may consider whether the releases could be made more frequently during the last two quarters.

41 Under the existing arrangement for release of Plan assistance, except for expenditure on multi-purpose river projects where quarterly payments are made on the basis of estimated expenditure, monthly ways and means advances are made to State Governments during the first ten months of the year on the basis of annual budget estimates and the residual amount is released in March on the basis of departmental figures of actuals for nine months and departmental estimates of expenditure for the last quarter. The Plan assistance actually due for the year is finally adjusted on the basis of audited figures which generally become available long after the close of the year. This procedure, we understand, follows a recommendation of the Central Public Accounts Committee. We think that the delay in the final adjustment of Plan assistance should not normally result in any ways and means difficulty, unless there have been large increase in Plan expenditure actually incurred as compared with the departmental actuals for nine months and estimated expenditure for the last quarter. The disparity between the two could be substantially narrowed down, if the State Governments arrange for

speedy reconciliation of departmental actuals with the accounts maintained by the Accountants-General during the course of the year. Efforts should also be made to reduce the time taken for completion of audit.

Payments on behalf of Central and other State Governments

42. Some State Governments have suggested a change in the existing accounting arrangements for transactions in a State on behalf of the Central Government and other State Governments which are initially met from State balances. The Central Government transactions at banking treasuries and sub-treasuries do not affect the cash balance of a State as they are met directly from the Central Government's cash balance. Central transactions at non-banking treasuries are initially met from the State's own balances, but they are adjusted on a weekly basis. Transactions of other State Governments at all treasuries and banks are met from the cash balance of the State where they occur and they are settled monthly. Their effect on the ways and means position of most States is, however, small and the States have also the benefit of their own transactions in other States being met from the balances of those States. We therefore think that no change in the present arrangements is called for.

Consolidation of Plan loans

43. According to existing arrangements large repayments of Central loans have to be made by the States in the month of October. This results in ways and means difficulties for some States during that month and the succeeding few months. It has been represented to us that the repayments falling due in October may be evenly spread over the last six months of the financial year. We think that such modification would not be helpful since in most cases the repayments due in March are also substantial (*vide* Table 6). In view, however, of the difficulties experienced by the States, we suggest that the Central Government may consider the possibility of suitably modifying the procedure for consolidation of loans to States so that their repayment may be in instalments which correspond generally with release of Central funds to the States and the usual time of flotation of their market loans.

Inadequacy of limits of advances

44. Several State Governments represented to us that in view of large increases in their revenue receipts and expenditure in recent years, the limits of ways and means advances allowed to them are no longer sufficient and they should be suitably increased. At this stage, we wish specially to emphasise that the facility of ways and means advances from the Reserve Bank is intended only for enabling the States to meet their temporary day to day requirements and it is not meant to be used as a resource for financing their general budgetary needs. It is vitally important that this basic position is accepted. Difficulties have often arisen because some States have been taking advantage of this facility to incur expenditure beyond their resources with the result that such advances are no longer available to them as a cushion for meeting temporary imbalances.

Balanced budgets and expenditure control

49. In the context of over-all shortage of financial resources available to the Central and State Governments and rising demands for expenditure in a welfare State, it is inevitable that the State Governments, even after receiving all possible devolution of tax shares and grants as well as Plan assistance from the Centre, will not find themselves in a position to meet their needs in full. If the evil consequences of unauthorised overdrafts are to be avoided, it is a matter of vital importance that, in spite of the relative inadequacy of their resources, the State Governments must have balanced

45. As an authority responsible for monetary management the Reserve Bank has to determine the overall limits of ways and means advances for the States having regard to the prospect of timely repayment and their general effect on monetary expansion. The limits have been revised recently in March 1967 when they were substantially enhanced. Besides, the States are authorised to meet their requirements on account of trading schemes, such as purchase of food-grains and fertilizers, by taking separate advances from the State Bank of India and other commercial banks. The adequacy of the limits of ways and means advances from the Reserve Bank can be judged only with reference to the seasonal disparities between the

budgets and they should not embark upon any expenditure in excess of their available resources. Where, after the adoption of a balanced budget, there are fresh developments likely to result in lower receipts or higher expenditure, the responsibility for restoring the budgetary balance must necessarily lie on the State Government and it should take timely steps to mobilise sufficient additional resources or curtail its expenditure to the necessary extent. Table 7 gives the overall budgetary position of the States for the years 1965-66 to 1968-69. It shows that several States had substantial deficits at the initial stage of budget estimates and in many cases the deficits continued even at the time of revised estimates. In some cases, though the budgets had been balanced initially, the revised estimates showed considerable deficits. This practice of unbalanced budgets has inevitably led to persistent overdrafts. We therefore recommend that every State should adopt the policy of having overall balanced budgets both at the beginning of the year and at the time of revised estimates.

50. Even when there is a balanced budget, it is necessary that a careful watch is maintained on the flow of receipts and expenditure throughout the year. We consider it an indispensable ingredient of sound financial administration that every State should have an effective ways and means section in its Finance Department. Such sections already exist in several States, and we recommend that all States should have them. They should evolve a system of preparing every month a forecast of the ways and means position for at least three months ahead. On the basis of such forecasts, corrective measures should be taken where necessary and suitable directions issued to controlling officers for restricting expenditure, so as to ensure that the total disbursements do not exceed anticipated resources during each period. The States may also consider the introduction of a system in the nature of "letters of credit" in the case of major spending departments, such as Public Works, Irrigation, Electricity, Forests, etc., which generally draw money by cheques on the treasuries and banks. The monetary limit upto which each disbursing officer can incur expenditure may be fixed periodically and any withdrawal in excess of such limit should be refused by the treasury or bank. We understand that a system on these lines has been introduced in one State and has led to a definite improvement in its overdrafts position. This system may be adopted by other States with advantage.

51. With the adoption of balanced budgets and an effective system of control over expenditure, the States should be able to avoid any difficulties in their ways and means position. We have already dealt with the question of unforeseen developments requiring heavy expenditure or reduction of revenues, while considering the question of imbalance between the States' resources and functions. We consider that if the suggestions we have made in that regard are properly followed, the States should be able to arrange for meeting the essential expenditure on such occasions. Where necessary, they should represent their case to the Central Government in good time for obtaining suitable assistance. We have no doubt that the Central Government would give careful consideration to the difficulties

experienced by the States due to unforeseen circumstances and would give them such assistance as is possible, instead of allowing them to get into unauthorised overdrafts and having to clear them later.

Procedure for dealing with unauthorised overdrafts

52. If the arrangements envisaged in the preceding paragraphs are implemented and worked in their proper spirit, there should not be any occasion for a State to run into an unauthorised overdraft. If, however, any such overdraft still occurs, it could only be due to lack of fiscal discipline on the part of the State. We consider that it would not be proper for the Reserve Bank to treat its notice to a State Government for clearing its overdraft as a routine measure. It should be the duty of the State Government to take all possible steps for clearing the overdraft, failing which the Reserve Bank must proceed to stop payment of the State's cheques.

53. In view of the serious consequences which would ensue from the stoppage of payment of a State's cheques, we are of opinion that in such a situation it is the duty of the Central Government to help the State to regain a position of budgetary balance and to achieve fiscal discipline. To do so, it would be necessary for the Central Government to assist the State to clear its overdraft. It must, however, be recognised that this would be possible only where the State does not persistently follow policies resulting in financial difficulties and that the Central Government cannot be expected to clear unauthorised overdrafts of the State Government repeatedly. The Central Government would therefore have to consider, whenever an unauthorised overdraft occurs, whether the situation resulting from stoppage of cheques should be allowed to take place or whether the State should be given necessary assistance to clear the overdraft. For this purpose we suggest that the Reserve Bank, whenever it issues a notice to the State Government, should also bring the matter to the attention of the Central Government. The Central Government should take up the matter with the State Government and ascertain what steps it proposes to take to clear the overdraft. If the State Government is not in a position to do so, it should urgently approach the Central Government for special assistance. The Central Government should, where it decides to assist the State, release as a matter of urgency so much of the share of devolution or Plan assistance payable to the State during the remaining part of the year as may be needed for covering the portion of the overdraft which the State Government is not able to clear by itself. If the amount due to the State during the year is not sufficient for this purpose, the Central Government should provide further assistance to the State by giving an *ad hoc* loan to be adjusted against its share of devolution or Plan assistance falling due during the next year.

54. The Central Government should at the same time initiate necessary consultations with the State Government with a view to finding out the causes responsible for its difficulties and the measures necessary to ensure that a similar situation does not recur. The Central Government should for this purpose depute a team of its

officers, including a nominee of the Planning Commission, to visit the State for assessing the situation and to make suitable recommendations, after consulting the State Government, regarding the measures necessary for removing the disparity between the State's resources and expenditure, and for ensuring an effective system of control over expenditure. The team may also examine whether any further temporary loan assistance would be required by the State for tiding over its immediate difficulties. The Central Government should, after considering the recommendations of the team of officers, call upon the State to adopt such measures as the Central Government may deem necessary. In this connection it should be open to the Central Government to arrange for the association, to ensure beforehand that payments on behalf of a State Government in an advisory capacity, of an officer nominated by it with the Finance Department of the State, to secure effective control over expenditure so as to keep it within actual receipts. The State Government should comply with these requirements as they are part of the arrangements for getting special assistance from the Centre. We have carefully considered whether such requirements could be regarded as an infringement of the State's autonomy. We consider that in view of the fact that such measures would be required only for the purpose of giving assistance to the State for clearing its unauthorised overdraft, they cannot be regarded as in any way affecting the State's autonomy. We discussed this point with the State Governments and many of them expressed agreement with this view. In fact, some of them stated that such action would be nothing more than the fulfilment of the Centre's responsibility.

55. If a State Government persists in incurring an unauthorised overdraft, we are of opinion that it would not be proper that the Central Government should clear it. The consequences of the State's failure to clear the overdraft will then have to be faced. If a persistent overdraft occurs, or if it is not found possible to clear an overdraft in accordance with the procedure that we have suggested, the Central Government would have to take a view within the period of notice given by the Reserve Bank whether the crisis resulting from the stoppage of payments of the State's cheques should be allowed to develop or it would be expedient to forestall it by the invocation of its constitutional powers. It is obvious that such an important decision would be taken by the Central Government only after full consideration of all the facts and circumstances of a particular situation. It would not be proper for us to make any suggestion in this regard.

Summary of recommendations

56. We therefore recommend the following measures for avoiding unauthorised overdrafts :

- (1) The State Governments must accept the basic position that the facility of ways and means advances is meant only for meeting temporary requirements and not for financing general budgetary needs. (Para. 44)
- (2) The States should, as a matter of necessary fiscal discipline, balance their budgets and manage their affairs within the resources available to them. They should adopt the policy

of having overall balanced budgets both at the beginning of the year and at a time of revised estimates.

(Paras 33 and 49)

- (3) There should be no deficit financing at the State level and the size of the State Plans should be regulated strictly within the States' own resources and available Central assistance. Ways and means advances should not be considered as a resource.

(Para 37)
- (4) While the present position regarding limits of ways and means advances does not call for any immediate change, periodical reviews of the limits should be made by the Reserve Bank.

(Para 45)
- (5) The State Governments which do not have sufficient Central Government securities may, in special difficulties, avail themselves of such further clean advances as the Reserve Bank can allow subject to being satisfied about repayment in time.

(Para 46)
- (6) The Central Government may consider more frequent releases of the States' share of income tax during the last two quarters.

(Para 40)
- (7) To avoid ways and means difficulty due to delay in the final adjustment of Plan assistance, the State Governments should arrange for speedy reconciliation of departmental **actuals with the accounts** maintained by the Accountants General during the course of the year. Efforts should also be made to expedite completion of audit.

(Para 41)
- (8) The Central Government may consider suitably modifying the procedure for consolidation of loans to States so that their repayment in instalments may correspond with release of Central funds to States and the usual time of floatation of their market loans.

(Para 43)
- (9) Where a State Government experiences difficulties due to **unforeseen developments, it should make efforts** to raise further resources or to reduce expenditure, instead of incurring unauthorised overdrafts. If in spite of all possible measures it cannot meet the additional expenditure which is immediately necessary, it may apply to the Central Government for a short-term loan to tide over the difficulty. The Central Government should in such cases provide the necessary assistance to the States.

(Para 35)

- (10) The Planning Commission should, in their annual Plan review, take into account the adverse effect of the new developments and if necessary modify the size of the annual Plan of the State concerned.

(Para 36)

- (11) Whenever a deficit on non-Plan capital account is anticipated, the State Government should consider reducing its non-Plan capital expenditure and make efforts to increase its capital receipts including better recovery of loans. If the capital budget cannot be balanced in spite of such efforts, the Central Government may consider deferring the repayment of Central loans falling due during the year to the necessary extent.

(Para 38)

- (12) Every State should have an effective ways and means section in its Finance Department. Forecasts of the ways and means position should be prepared, on the basis of which necessary corrective measures should be taken.

(Para 50)

- (13) The States may consider the introduction of a system in the nature of 'letters of credit' in the case of major spending departments and a monetary limit of expenditure may be fixed for each disbursing officer.

(Para 50)

- (14) The Reserve Bank should keep a continuous watch over the ways and means position of each State and the ways and means advances should not be allowed to continue beyond three months automatically. The Bank should formally renew an advance only where it is satisfied that its continuance is not due to a long-term imbalance in the State's budgetary position. In other cases the State should be called upon to repay the advance and in case of default it should be dealt with as an unauthorised overdraft.

(Para 48)

- (15) Where an unauthorised overdraft takes place, the Reserve Bank should issue a notice to the State Government as at present, and at the same time inform the Government of India. It should be the duty of the State Government to take immediate steps for clearing the overdraft within the notice period, failing which the Reserve Bank must proceed to stop payments.

(Paras 52 and 53)

- (16) In view of the serious consequences which would ensue from stoppage of payments, the Government of India should help the State to regain a position of budgetary balance and to achieve fiscal discipline. To do so it should assist the State to clear the overdraft. It must be clearly recognised that this would be possible only where the State

does not persistently follow policies resulting in financial difficulties and that the Central Government cannot clear unauthorised overdrafts repeatedly.

(Para 53)

- (17) For this purpose the Government of India should, as soon as it is informed by the Reserve Bank about issue of notice to the State, ascertain from the State what steps it proposes to take to clear the overdraft. If the State Government is not in a position to clear the overdraft it should urgently approach the Central Government for special assistance. The Central Government should, where it decides to assist the State, release in advance the State's share of devolution or Plan assistance payable during the year. When the amount due to the State during the year is not sufficient for the purpose, further assistance should be given as an *ad hoc* loan to be adjusted against the devolution or Plan assistance falling due during the next year.

(Para 53)

- (18) The Central Government should also have consultations with the State Government to ascertain the causes of its difficulties and to ensure that the situation does not recur. It should depute a team of its officers, including a nominee of the Planning Commission, to visit the State for assessing the situation and recommending remedial action, and also considering whether any further temporary loan assistance is necessary for tiding over the immediate difficulties of the State.

(Para 54)

- (19) The Central Government should call upon the State to adopt such measures as it may deem necessary. For the purpose of securing effective control over expenditure so as to keep it within actual receipts, it should be open to the Central Government to nominate an officer to be associated with the Finance Department of the State. The State Government should comply with these requirements.

(Para 54)

- (20) If a State Government persists in incurring an unauthorised overdraft it would not be proper that the Central Government should clear it and the consequences of failure to clear it will have to be faced. In such a case, or where an overdraft cannot be cleared in accordance with the procedure we have suggested, the Central Government would have to take a view whether the crisis resulting from stoppage of Payments of the States' cheques should be allowed to develop or it would be expedient to forestall it by invoking its Constitutional powers.

(Para 55)

CHAPTER 5

DEVOLUTIONS AND GRANTS FOR 1969-70.

57. The Commission has been asked in paragraph 6 of the Presidential Order to make an interim Report, in particular in respect of the financial year 1969-70. In that connection, we obtained from the State Governments forecasts of their revenue receipts and expenditure for that year. We requested them to furnish particulars of their revenue receipts on the basis of the levels of taxation likely to be reached at the end of 1968-69, exclusive of devolutions of taxes and grants. On the expenditure side, we requested them to furnish details of their expenditure on revenue account including the maintenance of Plan schemes completed by the end of 1968-69, but exclusive of the requirements of the Fourth Five-Year Plan.

58. After a preliminary scrutiny of the forecasts furnished by the State Governments, we had discussions with their representatives on various dates from the 17th June to the 23rd August, 1968. These discussions revealed the necessity for obtaining additional information on a number of points, which the representatives of the State Governments were asked to furnish. We have not yet received complete information on these points from all the States.

59. In respect of devolutions of taxes and duties, we decided that for the purpose of the interim Report we would take up, for making final recommendations, only the distribution of the net proceeds of estate duty and the grant in lieu of the repealed tax on railway passenger fares. Our discussions with the States in regard to distribution of taxes and duties were confined to these two matters. Our recommendations on them are given in Chapters 2 and 3 of this Report and they cover the period from 1969-70 to 1973-74.

60. In their forecasts for the year 1969-70 the States have shown that on the basis of their own revenue receipts, they would have revenue deficits aggregating to Rs. 1,283.69 crores. If the transfer of funds to the States by way of devolutions of taxes and duties and grants under Article 275 (1) of the Constitution are continued during 1969-70 on the existing basis, the States would still have uncovered deficits of about Rs. 650 crores, and every State would continue to have a deficit. Obviously, it is not possible to make additional transfers of funds of this magnitude to the States. It is, therefore, necessary to examine the forecasts furnished by the State Governments very carefully in order to assess their reasonable requirements.

61. The States' forecasts vary considerably in the methods and patterns adopted in regard to matters like reduction or avoidance of debt, earmarking of funds for special purposes, treatment of items like trading profits or losses, and classification between non-Plan and

budgets and they should not embark upon any expenditure in excess of their available resources. Where, after the adoption of a balanced budget, there are fresh developments likely to result in lower receipts or higher expenditure, the responsibility for restoring the budgetary balance must necessarily lie on the State Government and it should take timely steps to mobilise sufficient additional resources or curtail its expenditure to the necessary extent. Table 7 gives the overall budgetary position of the States for the years 1965-66 to 1968-69. It shows that several States had substantial deficits at the initial stage of budget estimates and in many cases the deficits continued even at the time of revised estimates. In some cases, though the budgets had been balanced initially, the revised estimates showed considerable deficits. This practice of unbalanced budgets has inevitably led to persistent overdrafts. We therefore recommend that every State should adopt the policy of having overall balanced budgets both at the beginning of the year and at the time of revised estimates.

50. Even when there is a balanced budget, it is necessary that a careful watch is maintained on the flow of receipts and expenditure throughout the year. We consider it an indispensable ingredient of sound financial administration that every State should have an effective ways and means section in its Finance Department. Such sections already exist in several States, and we recommend that all States should have them. They should evolve a system of preparing every month a forecast of the ways and means position for at least three months ahead. On the basis of such forecasts, corrective measures should be taken where necessary and suitable directions issued to controlling officers for restricting expenditure, so as to ensure that the total disbursements do not exceed anticipated resources during each period. The States may also consider the introduction of a system in the nature of "letters of credit" in the case of major spending departments, such as Public Works, Irrigation, Electricity, Forests, etc., which generally draw money by cheques on the treasuries and banks. The monetary limit upto which each disbursing officer can incur expenditure may be fixed periodically and any withdrawal in excess of such limit should be refused by the treasury or bank. We understand that a system on these lines has been introduced in one State and has led to a definite improvement in its overdrafts position. This system may be adopted by other States with advantage.

51. With the adoption of balanced budgets and an effective system of control over expenditure, the States should be able to avoid any difficulties in their ways and means position. We have already dealt with the question of unforeseen developments requiring heavy expenditure or reduction of revenues, while considering the question of imbalance between the States' resources and functions. We consider that if the suggestions we have made in that regard are properly followed, the States should be able to arrange for meeting the essential expenditure on such occasions. Where necessary, they should represent their case to the Central Government in good time for obtaining suitable assistance. We have no doubt that the Central Government would give careful consideration to the difficulties

Reserve Bank normally requires Central Government securities as cover against special advances, the Governor of the Bank told us that he did not see any difficulty in providing additional accommodation to States in special difficulties whenever necessary, by allowing further clean advances in cases where they did not have sufficient Central Government securities, subject to the Bank's being satisfied about repayment of the advances in time. We suggest that the State Governments may avail themselves of this facility which should meet their requirements.

Advances continuing beyond three months

47. In the preceding paragraphs we have examined the various difficulties explained by the State Governments and have made some suggestions which should help in removing these difficulties. We shall now proceed to consider more fully the question as to the measures which are necessary for avoiding unauthorised overdrafts and for dealing with such cases of overdrafts as may arise in spite of the measures we have suggested.

48. We may first consider the overdrafts which continue beyond the period of three months specified in section 17(5) of the Reserve Bank of India Act. We find that in fact a number of States have been having this type of overdrafts. The prolonged continuance of substantial ways and means advances is likely to result in their exceeding the permissible limits when there is a small time-lag in the inflow of receipts or unanticipated increase in expenditure. The Reserve Bank has been allowing such advances to continue beyond three months without renewal and without calling for their repayment on the view that the continuance of advances in this manner does not contravene section 17(5) of the Reserve Bank of India Act. We think that it is necessary to review such advances instead of allowing them to continue automatically. We suggest that the Reserve Bank should keep a continuous watch over the ways and means position of each State, and whenever any advance is found to continue beyond the period of three months, the Bank should examine whether it is due to a long-term imbalance in the State's budgetary position or any temporary reasons. Where the continuance of the advance is not due to a long term imbalance, it should be formally renewed by the Bank and treated as a fresh advance. In other cases the Bank should call upon the State Government to repay the advance, and in case of default, it should be dealt with as an unauthorised overdraft.

Balanced budgets and expenditure control

49. In the context of over-all shortage of financial resources available to the Central and State Governments and rising demands for expenditure in a welfare State, it is inevitable that the State Governments, even after receiving all possible devolution of tax shares and grants as well as Plan assistance from the Centre, will not find themselves in a position to meet their needs in full. If the evil consequences of unauthorised overdrafts are to be avoided, it is a matter of vital importance that, in spite of the relative inadequacy of their resources, the State Governments must have balanced