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# Stabilization and Fiscal Empowerment: The Twin Challenges Facing India's States

**Volume II (Detailed Report)**
**May 10, 2004**

Poverty Reduction and Economic Management Unit
South Asia Region

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## Explanatory Note

This report is written in three different versions to suit a variety of audiences:

- The **Executive Summary** (in Volume I) is 4 pages long and gives a quick overview.
- The **Main Report** (also in Volume I) is 26 pages long, and conveys the main findings.
- The **Detailed Report** (in Volume II) is 90 pages long, and provides the detailed analysis.

The executive summary and main report are brief on attributions and sourcing to save space. We have in fact drawn heavily on work by Indian and international experts. Full referencing and attribution can be found in the technical report.

This report was prepared by a team consisting of Stephen Howes, Rinku Murgai, Smita Kuriakose (expenditure issues), Marina Wes, Farah Zahir, Bala Bhaskar Kalimili (fiscal issues), Ronnie Das-Gupta (revenue issues) and V.J. Ravishankar, Bill McCarten and Anwar Shah (fiscal federalism), Vidya Kamath, Shahnaz Rana, Rita Soni, and Jyoti Sriram (report management).

The report has benefited greatly from inputs by the whole India PREM Team, and from many sectoral colleagues.

### Box 1: Definitions and Data

- If not indicated, the state-level data is aggregated for all states.
- Much of the report focuses on 14 major states, which make up 91% of the population of India.
- These 14 major states are further divided as *poor states* (those with a per capita income in 1999/00 of Rs. 10,000 or less at 1993/94 prices) and *other states*.
- The poor states are Bihar, Madhya Pradesh, Orissa, Uttar Pradesh and Rajasthan while the other states are Maharashtra, Punjab, Haryana, Gujarat, Kerala, Karnataka, Tamil Nadu, West Bengal and Andhra Pradesh.
- The data for the three newly created states (created in 2000/01) of Jharkhand, Chattisgarh and Uttaranchal have been aggregated with that of the states of Bihar, Madhya Pradesh and Uttar Pradesh respectively in order to maintain consistency over time. However, data for Jharkhand is not available for 2000/01 and so is not included in the analysis for 2000/01.
- New- state debt as published by the RBI is included in the old -state debt for 2000/01 (actuals) and 2001/02 (revised estimates).
- India's Gross Domestic Product (GDP) at *market prices* is used while referring to All States.
- Gross State Domestic Product (GSDP) at *factor cost* is used for ratios involving the 14 major states, or individual states.
- Revenues receipts and expenditure are expressed net of lottery expenditures; other indicators are as reported by the Reserve Bank of India.
- The latest available actuals are used. This is 2001/02 for all states combined and 2000/01 for individual states (only revised estimates for 2001/02 are available for individual states; since we know at the aggregate level there is a large deviation for 2001/02 between revised estimates and actuals, we do not use the revised estimates). The revised estimates for 2002/03, which are available for all states, are used sparingly, and as indicated.
- For Bihar and Nagaland, 2000/01 figures are revised estimates.
- 1990 and 1990/91 both refer to the Indian fiscal year 1 April 1990-31 March 1991. Debt-stock is measured at the end of the fiscal year.
- The source for tables and figures, unless mentioned in the text is the World Bank State Fiscal Database, which is built up from RBI published state-finance data.

## DETAILED VOLUME
## TABLE OF CONTENTS


**CHAPTER 1: THE STATE- LEVEL FISCAL CRISIS OF THE LATE NINETIES; EVOLUTION AND IMPACT**

I Introduction........ 1
II India's states........ 1
III Genesis........ 3
IV Impact........ 6
V Response........ 10
VI Challenges........ 13

**CHAPTER 2: EXPENDITURE REFORMS**

I Overview and introduction........ 16
II Salaries and pensions........ 16
III Subsidies........ 22
IV Public enterprise and debt restructuring........ 27
V Reforms to improve the quality of spending........ 29

**CHAPTER 3: REVENUE REFORMS**

I Introduction........ 34
II State own-revenue structure and reforms........ 35
III Reforms to tax institutions........ 47
IV Conclusion........ 50

**CHAPTER 4: FISCAL FEDERALISM AND THE INCENTIVE FRAMEWORK FOR STATE-LEVEL REFORM**

I Introduction........ 52
II Borrowing regime........ 53
III Revenue transfers (grants)........ 60
IV Conclusion........ 71

**CHAPTER 5: CONCLUSIONS AND PROSPECTS**

I Introduction........ 76
II A no-reform scenario: what will happen if reforms stop?........ 76
III A states' reform package........ 77
IV Reform scenarios: do the reforms add up?........ 80
V Scenarios for the poor states........ 81
VI Risks........ 82
VII Implications for the central government........ 83

**ANNEX TO CHAPTER 2: CASE STUDIES IN REFORMS TO IMPROVE EXPENDITURE QUALITY**........ 85

**ANNEX TO CHAPTER 3: INSTITUTIONS FOR REVENUE COORDINATION**........ 92

**REFERENCES**........ 94

## TABLES


| | | |
|---|---|---|
| Table 1.1 | Average real per capita growth rates.......... | 2 |
| Table 1.2 | Fourteen large states: key social and economic indicators.......... | 2 |
| Table 1.3 | Fiscal indicators: poor states and others (1999/2000).......... | 6 |
| Table 1.4 | Average real growth rates of expenditures in some key sectors (14 major states) | 9 |
| Table 1.5 | Average real growth rates of expenditures in some key sectors (low-income states and others of the 14 major states) .......... | 10 |
| Table 1.6 | The paradigm transition at the state level.......... | 11 |
| Table 2.1 | Ratio of average wages in the public and private sector, 1993/94 and 1999/00 | 17 |
| Table 2.2 | Starting basic salary of primary school teacher.......... | 17 |
| Table 2.3 | Enterprise restructuring by state.......... | 27 |
| Table 2.4 | Total redundancy compensation by state.......... | 29 |
| Table 2.5 | Average tenure of managing directors of Rural Women's Empowerment and Development Project (1998-2001).......... | 31 |
| Table 2.6 | Deviation of actuals from budget estimates, 1998-99 to 2001-02.......... | 32 |
| Table 2.7 | Institutions for effective departmental governance.......... | 32 |
| Table 3.1 | Structure of state's own tax revenue: 1985-86 to 2001-02.......... | 36 |
| Table 3.2 | Revenue from sales tax and transport taxes per vehicle versus road costs, 2000-01.......... | 45 |
| Table 4.1 | Per-capita transfers among India's states (average for 1995-2000).......... | 63 |
| Table 5.1 | Fiscal indicators in the no-reform scenario.......... | 77 |
| Table 5.2 | Key revenue reform recommendations.......... | 78 |
| Table 5.3 | Key expenditure reform recommendations.......... | 79 |
| Table 5.4 | Fiscal indicators under three reform scenarios.......... | 81 |
| Table 5.5 | Fiscal indicators under three reform scenarios for the 5 low-income states... | 82 |


## BOXES


| | | |
|---|---|---|
| Box 1.1 | Was there really a fiscal crisis at the state level?.......... | 4 |
| Box 1.2 | State government expenditures and poverty reduction.......... | 8 |
| Box 1.3 | Fiscal responsibility legislation at the state-level in India: the story so far....... | 11 |
| Box 1.4 | International experience with fiscal adjustment.......... | 15 |
| Box 2.1 | Experience with para-teacher schemes in India.......... | 18 |
| Box 2.2 | Tamil Nadu pension reforms.......... | 22 |
| Box 2.3 | Attempts to increase the agricultural tariff: a history of repeated failure......... | 24 |
| Box 2.4 | Food subsidy reforms in Tamil Nadu.......... | 27 |
| Box 2.5 | Public enterprise reforms in Andhra Pradesh.......... | 28 |
| Box 2.6 | Mid-day meals: an example of productive, additional expenditure.......... | 33 |
| Box 3.1 | Tax structures in major federations.......... | 35 |
| Box 3.2 | Tax administration recommendations for Tamil Nadu's commercial tax department.......... | 39 |
| Box 3.3 | Haryana's VAT- going it alone.......... | 40 |

Box 3.4 International experience with value-added taxes in a federation – lessons for India........ 41
Box 3.5 State taxation of services: expert group versus advisory group........ 42
Box 3.6 Five principles for improved cost recovery........ 46
Box 3.7 Performance measurement in the commercial tax department, Andhra Pradesh.. 48

Box 4.1 International perspective on India's fiscal federalism........ 53
Box 4.2 Borrowing restrictions on sub-national governments: principles and practice..... 58
Box 4.3 HIPC – what is it, and has it worked?........ 60
Box 4.4 Econometric studies of the determinants and impact of India's fiscal federal Transfers........ 66
Box 4.5 RTS approach to fiscal equalization........ 68
Box 4.6 Design of conditional grants: international experience........ 69
Box 4.7 Fiscal reform facility (FRF)........ 70
Box 4.8 Problems in the financing of the state plan........ 74

Box 5.1 Key assumptions and methodology underlying the no reform scenario........ 76

## FIGURES

Figure 1.1 State revenue receipts and expenditures........ 3
Figure 1.2 State deficits and debt levels........ 4
Figure 1.3 State fiscal deficit including power........ 5
Figure 1.4 State fiscal deficit: poor states and others........ 5
Figure 1.5 Own and total state revenues: poor states and others........ 6
Figure 1.6 Salaries, pensions and interest payments for India's states as a percentage of GDP........ 7
Figure 1.7 Aggregate expenditure trends for India's states as a percentage of GDP........ 7
Figure 1.8 Non-salary operating recurrent spending per rupee of salary spending (14 major states)........ 10

Figure 2.1 Power sector losses (pre-subsidy) and budget subsidies to the power sector... 23

Figure 3.1 Trends in revenues as a percentage of GDP........ 34
Figure 3.2 Share of central transfers in state total revenue........ 34
Figure 3.3 Trends in states' own revenues as a percentage of GDP........ 36
Figure 3.4 Trends in states' own revenues as a percentage of GSDP, 2000-01........ 37
Figure 3.5 Tax collection costs........ 37
Figure 3.6 Real growth in sales taxes for the 14 major states: the impact of floor rate introduction (%)........ 38

Figure 4.1 Borrowing sources for state governments........ 54
Figure 4.2 Debt to revenue ratios for major states & GoI, 2001-02........ 59
Figure 4.3 Central transfers to states, 1985-2000........ 61
Figure 4.4 Trends in GoI revenues and transfers to states........ 62
Figure 4.5 Per capita revenues normalized, 2000/01........ 63
Figure 4.6 Transfers from GoI to the 5 large poorest states as a percentage of total transfers........ 62
Figure 4.7 State revenues before and after transfers (formal and FCI)........ 63

Figure 4.8 Actual vs. equalizing transfers for India's states.................................. 67
Figure 4.9 Resources other than own-revenue used by states to finance expenditure..... 72

Figure 5.1 All state debt-to-GDP ratio under three different fiscal targets................ 80

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# CHAPTER 1
# THE STATE-LEVEL FISCAL CRISIS OF THE LATE NINETIES: EVOLUTION AND IMPACT

## I INTRODUCTION

1.1 India, home to one billion people, is a federation of 28 States and 7 Union Territories. The largest (Uttar Pradesh) is populous enough to be the fifth largest country in the world; the smallest (Sikkim) has a population of less than half a million. Among the 14 major states, the richest has a per-capita income that is five times that of the poorest state. Infant mortality ranges from a low of 14 per 1000 in Kerala, on par with east European countries, to 96 for Orissa, more typical of Sub-Saharan African nations. In an era of liberalization, a state's own policies and quality of government is increasingly critical for a state's development. Since the second half of the nineties, when the slow secular deterioration in fiscal performance of Indian states over the eighties and nineties was catalyzed into a crisis by the fifth pay commission awards, no area of state policy has been more important to development than its fiscal health.

1.2 The fiscal stress of the late nineties gave rise to an intense state-level reform effort. Six years on, this report documents the many initiatives undertaken by the states to restore fiscal sustainability, and become more effective agents of development. It outlines successes, lessons learnt, and highlights further challenges, on both the expenditure side (Chapter 2) and the revenue side (Chapter 3). It also looks at the incentive framework within which the states operate (Chapter 4), and asks whether there is a feasible reform package that will take the states not only out of fiscal crisis, but strengthened to meet the development challenges which confront them.

1.3 This chapter provides the context for what follows by outlining the role and increasingly divergent performance of the state governments (Section II), and then in turn, the genesis of the fiscal crisis (Section III), its developmental impact (Section IV), the reform response of the state and central governments (Section V), and the reform challenges facing the states today (Section VI).

## II INDIA'S STATES

### States in India play an increasingly important role in devising and implementing policies to reduce poverty, promote human development, and stimulate growth.

1.4 Under the Indian constitution, state governments are assigned significant responsibilities in sectors such as agriculture, industry, infrastructure, education, health, and social welfare. India's state governments are key financiers of a number of areas critical for enhancing growth and reducing poverty: in 2000/01, 57% of India's total government capital expenditure was financed by the states, as was 97 % of irrigation maintenance, 39% of road maintenance, 90% of public health expenditures, and 86% of public education expenditures. In fact, India's states are responsible for a higher proportion of general government spending than in any other developing country, except China. Moreover, the states' increasingly large fiscal deficits mean their fiscal policy is not only an important determinant of their own developmental performance but of India's overall macroeconomic and fiscal sustainability.

1.5 One of the striking features of Indian States prior to the 1990s was the relative uniformity of policies across states. The policy environment changed significantly after 1991 with the central government's liberalization of the trade and investment regime, and the growth of regional political parties. These developments allowed the states a larger role in determining their development paths and attracting investment.

### The performance of India's states is increasingly divergent

1.6 Balanced regional growth has been an objective of India's development strategy since independence, and is supported by a system of redistributive transfers to the states. Of the 14 major states, the 5 poorest have

a per capita income of Rs 10,000 (in 1993/94 constant prices) or less: Bihar, Madhya Pradesh, Orissa, Rajasthan and Uttar Pradesh. These are classified throughout this report as the poor or low-income states. They are home to over 40% of India's population, and nearly 50% of India' poor. These states are also slower growing than the other states (Table 1.1). In particular, following the liberalization of 1991, most of the middle and high income states were able to take greater advantage of the changes, because of better initial conditions, governance, infrastructure and human resources than the poorer states. Moreover a number of the poorer states failed to improve their state-level policies to offset their initial disadvantage in attracting new investment. As a result, the average per capita income in the poor states relative to the others has decreased from 71% in 1980/81 to 54% in 1999/00.

**Table 1.1: Average real per capita growth rates**

| | 1980/81-1989/90 | 1990/91-1999/00 |
|---|---|---|
| Poor states | 2.4 | 2.5 |
| Other states | 3.1 | 4.8 |

1.7 The low-income states rank well below the other states on broader economic indices, such as on infrastructure, and investment climate (Table 1.2).[1] They also have much worse social indicators than the other states, for example, infant mortality is almost twice as high. Although human development indicators improved in all states, progress on these broader indicators was also generally faster in the fast-growing states, except for literacy, where there was some catch-up. In some cases human development indicators actually worsened in the poor states. For instance, the number of underweight children increased over the nineties for all poor states, whereas it declined for the other states (except Kerala and Maharashtra). Unless the poor states improve their performance, it will become increasingly difficult to accelerate poverty reduction and development in India.

**Table 1.2: Fourteen large states - Key social and economic indicators**

| | Population (in Millions) | Per capita income[b] (Rs) | Composite performance index[a] | Investment climate index[a] | Infrastructure penetration index[a] | Financial sector strength index[a] | Literacy rate[c] | Female literacy rate[d] | Under-weight children[e] | Infant mortality[f] |
|---|---|---|---|---|---|---|---|---|---|---|
| **Medium / High income states** | 495 | 13471 | 2.4 | 2.4 | 2.5 | 2.7 | 75.8 | 66.7 | 41.9 | 47.0 |
| Andhra Pradesh | 76 | 10598 | 2.1 | 2.3 | 2.1 | 1.6 | 61.1 | 70.9 | 37.7 | 65.8 |
| Gujarat | 51 | 15768 | 2.5 | 2.4 | 2.3 | 2.2 | 70.0 | 58.6 | 45.1 | 62.6 |
| Haryana | 21 | 15304 | 2.3 | 2.5 | 2.0 | 1.7 | 68.6 | 56.3 | 34.6 | 56.8 |
| Karnataka | 53 | 12614 | 2.4 | 2.7 | 2.4 | 2.0 | 67.0 | 57.5 | 43.9 | 51.5 |
| Kerala | 32 | 11360 | 2.8 | 2.8 | 2.5 | 2.1 | 90.9 | 87.9 | 26.9 | 16.3 |
| Maharashtra | 96 | 17107 | 2.8 | 2.3 | 2.8 | 3.5 | 77.3 | 67.5 | 49.6 | 43.7 |
| Punjab | 24 | 16659 | 2.7 | 2.9 | 2.5 | 2.2 | 70.0 | 63.6 | 28.7 | 57.1 |
| Tamil Nadu | 62 | 13756 | 2.7 | 3.1 | 2.6 | 2.4 | 73.5 | 64.6 | 36.7 | 48.2 |
| West Bengal | 80 | 10226 | 1.7 | 1.2 | 2.0 | 2.0 | 69.2 | 60.2 | 48.7 | 48.7 |
| **Low income states** | 429 | 7211 | 1.1 | 1.4 | 1.0 | 0.9 | 58.8 | 44.3 | 52.7 | 83.2 |
| Bihar | 83 | 4846 | 0 | 0.4 | - | 0.3 | 47.5 | 33.6 | 54.4 | 72.9 |
| Madhya Pradesh | 81 | 9037 | 1.3 | 1.8 | 1.2 | 1.1 | 64.1 | 50.3 | 55.1 | 86.1 |
| Orissa | 37 | 6602 | 0.9 | 1.7 | 0.8 | 1.0 | 63.6 | 51.0 | 54.4 | 81.0 |
| Rajasthan | 56 | 9716 | 1.5 | 1.6 | 1.3 | 1.2 | 61.0 | 44.3 | 50.6 | 80.4 |
| Uttar Pradesh | 172 | 7149 | 1.2 | 1.4 | 1.0 | 0.9 | 57.4 | 43.0 | 51.7 | 86.7 |

*Notes:* a: Confederation of Indian Industry (CII), 2002; b: 1999/00, in 1993/94 constant prices; c: 2001, percent of population 7 years and older; d: 2001, percent of population; e: 1998/99, percent of children under 3 years of age; f: 1998/99, per 1000 live births. *Sources:* CII, 2002; 2001 Census, 1998/99 National Family and Health Survey.

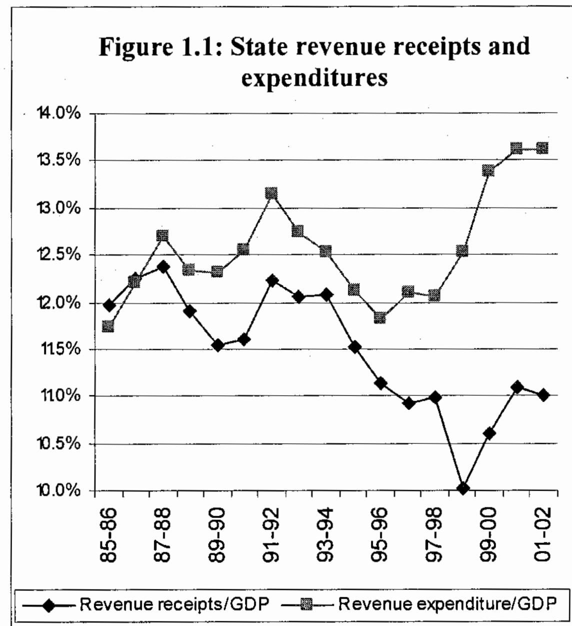
[1] A "composite performance" index (based on state performance in different categories, including investment climate, infrastructure penetration, finance, work force quality, social well-being, agricultural performance, and law and order) calculated by the Confederation of Indian Industries (CII, 2002) gives the poor states an average of 1.1 and the other states a score of 2.4. The index is strongly correlated with GSDP per capita, suggesting that focusing on GSDP per capita to capture regional variations in development and performance is reasonable.

## III GENESIS

**A slow secular deterioration in fiscal performance over the eighties and nineties was catalyzed into a state-level fiscal crisis by the Fifth Central Pay Commission pay awards in the late 1990s.**

1.8 We use the term "fiscal crisis" not to be alarmist, or to suggest faltering macroeconomic performance but to convey the sharp deterioration in state-level fiscal performance witnessed in the late nineties – deficits rose, the state-level debt-stock, which had been declining, started rising rapidly, and off-budget liabilities also grew quickly. (See Box 1.1 for a discussion as to whether or not there really was a fiscal crisis.) There was also a liquidity crunch, not on the economy, but on state-governments themselves, who started to find it much more difficult to pay bills, and even salaries. State governments themselves certainly perceived that they were facing a crisis. Many wrote White Papers, such as the Government of Tamil Nadu did in August 2001, to apprise legislators and the public "of the extent and causes of the serious financial crisis confronting the state". Finally, there is a close parallel with the balance of payments crisis of the early nineties, not in the nature of the crisis, but in its impact: just as the BoP crisis of 1991 gave rise to a decade of central government reforms push, so did the state-level fiscal crisis give an enormous impetus to reforms at the state level.

**Figure 1.1: State revenue receipts and expenditures**




1.9 The Fifth Pay Commission awards, phased in by the states starting in 1997-98, resulted in real wage increases of about 30%. Pensions, which had been growing slightly faster than the rate of GDP through the nineties started to grow much more rapidly in the late 1990s as the Commission ruling indexed pensions to real wages. Although the salary bill is now starting to fall again – relative to GDP – due to a hiring freeze, state governments continue to pay the price of the Fifth Pay Commission: the salary bill is about 1 percentage point of GDP higher than it would have been without the pay-rises, and the salary-intensity of expenditure is higher than it was in the mid-nineties, despite zero net hiring.

1.10 While the large pay awards were the immediate cause for the sharp fiscal deterioration, the secular worsening in the revenue (current) balance of the state governments can be traced back as far as the past two decades (Figure 1.1), and is related to the growth of populist policies, symbolized by rapid growth in public employment, and the introduction in many states of free power to farmers in the eighties. The growing revenue deficit was prevented from translating into a higher fiscal deficit until the second half of the nineties only because capital expenditures were compressed. On the expenditure side, the interest burden grew over the nineties initially due to a hardening of interest rates as the old regime of financial repression and subsidized rates for government borrowing was brought to an end in the nineties, and subsequently due to a rising debt-stock. By contrast, revenues fell over the nineties. The state-level revenue/GDP ratio fell from around 12% in the late eighties and early nineties to 10% in 1998/99. Both own-revenues and GoI transfers fell, though the latter more so, as its share in total revenue declined from slightly above 40% up to 1993/94 to 36% in the late nineties.

**Box 1.1: Was there really a fiscal crisis at the state level?**

Does what is described in this report amount to a "fiscal crisis" or is this sensationalism? There was clearly no macro crisis (hyper inflation, or a foreign exchange shortage), but there was a fiscal crisis. There are three reasons we call what happened a fiscal crisis.

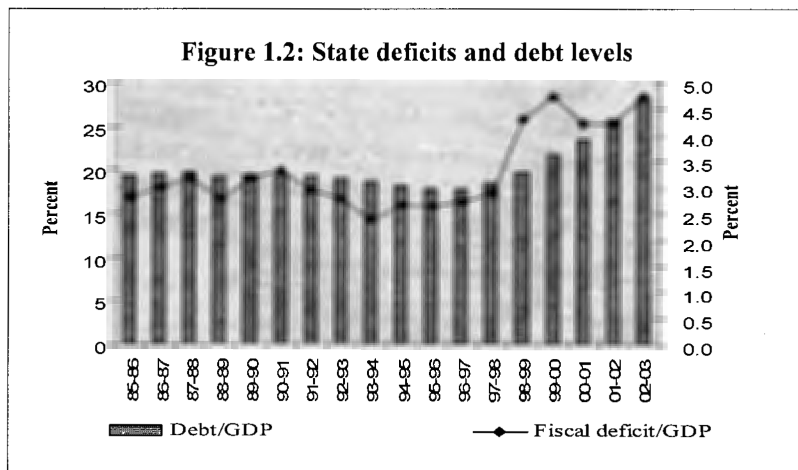
- First, the sharp deterioration in fiscal indicators, as indicated in Figure 1.2, which, as we note below, would look worse if off-budget liabilities were included, and reversed a mild fiscal improvement.
- Second, the liquidity shock, as state governments struggled to pay the salary increases they had agreed to. State governments, with limited borrowing sources, experienced severe liquidity problems in the late nineties. The Reserve Bank of India runs an emergency overdraft facility for state governments. In 1997/98, the average number of days in overdraft for a state was 32. This rose to 88 in 2000/01 and 117 in 2001/02. There were numerous reports in the late-90s of state governments "closing the treasuries" since they no longer had the cash to pay bills. State-government distress is also evident from their borrowing from their employees through the impounding of salary increases to the provident fund. Borrowing from the provident fund tripled in nominal terms between 1997/98 and 1999/00 (reaching 0.9% of GDP). Basically, state governments lacked the cash to pass on the promised increase to workers, and were only able to do so by promising part of the increase (with interest) when the employees retired. There were also several reported cases in which the Government of India provided states with medium-term loans basically as a bail out. Finally, one can also note a sharp accumulation of arrears. Para. 1.14 discusses the case of the power sector. Comprehensive data on arrears on salaries and other bills is not available. The Government of Tamil Nadu claims that, as of 2002, it faced unpaid bills of Rs 3,100 crore (2% of the states domestic product), including salary/pension arrears of Rs 1, 800 crore. (Government of Tamil Nadu, 2003).
- Third, the sense of crisis. The influential *India Today* in its February 14, 2000 issue titled its cover story: "States Going Broke: Bankruptcy Stalking a Collapse of Public Services". And it was not just a sensationalizing media. State governments used this language as well: see para. 1.8 and Box 4.8 for examples.
- Fourth, the impact of the crisis. just as the BoP crisis of 1991 gave rise to a decade of central government reforms push, so did the state-level fiscal crisis give an enormous impetus to reforms at the state level.

It is true that certain cyclical factors operated to make 1998/99, the worst year of the crisis a particularly bad year, with low revenue from both states' own sources and from the GoI. But the crisis can by no means be explained simply as a cyclical phenomenon. In 1998/99, state governments borrowed 68 percent more than they had the previous year. Since then, borrowing has not decreased, and the debt stock has continued to rise.

**Deficits and debt levels rose sharply in the late-nineties.**

1.11 The sharp increase in expenditures in the latter half of the nineties alongside declining revenues could only be supported by greater borrowing by state governments. The aggregate fiscal deficit of the states jumped from 2.9% of GDP in 1997/98 to 4.3% in 1998/99, and has remained above 4% of GDP since (Figure 1.2). At least half of the fiscal deficit is accounted for by the

**Figure 1.2: State deficits and debt levels**



revenue deficit, implying that at least half of states' borrowing is to finance current expenditure.

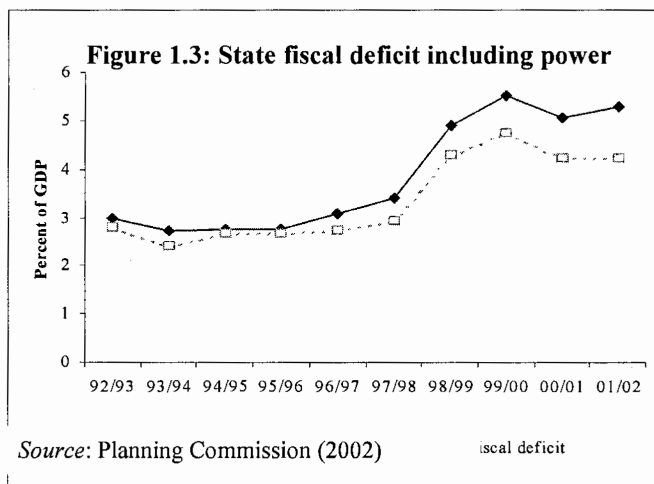
1.12 Despite Government of India (GoI) control over state government borrowings being enshrined in the constitution, state governments were able to increase their borrowing in the late nineties by largely drawing on sources over which GoI exercises no active control: there was a boom in "small savings" loans, a relatively expensive form of debt with high administratively-determined interest rates; and state governments borrowed from their own employees by impounding promised salary increases into their provident funds.[2] States also used non-debt sources of deficit financing, such as cash balances and public account borrowing (para. 4.5).

1.13 As a result, the state-level debt stock which was actually falling in the first half of the nineties reversed its downward course in 1997/98 and has been rising every since (Figure 1.2). A 10 percentage point increase in the ratio of debt to GDP over a span of six years poses a serious threat to debt sustainability. The severity of the situation can also be seen from the fact that almost one quarter of revenues were pre-empted by interest payments in 2001/02.

**Off-budget liabilities also increased rapidly.**

1.14 The most significant off-budget liability is in the power sector. Over the course of the nineties, cash-strapped governments were unable to meet their rapidly rising subsidy obligations to their electricity companies. Thus an increasing proportion of power sector losses, which reached over 1.4% of GDP by 2000/01, were met off budget, in large part through arrears to central utilities. If the full amount of the loss, or subsidy obligation, were included, the fiscal deficits of the states would rise by an average of 30% and the combined states' fiscal deficit would increase even more sharply over the crisis period by an additional 1.0-1.5 percentage points of GDP (see Figure 1.3).

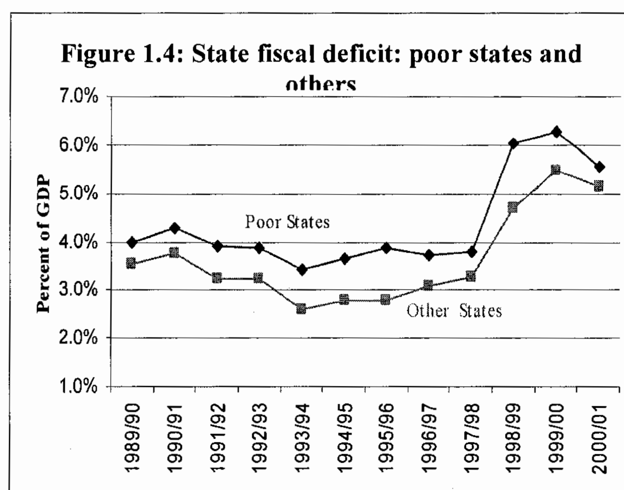
**Figure 1.3: State fiscal deficit including power**




*Source*: Planning Commission (2002)

1.15 State-government guarantees have also risen sharply since 1996, and their quality has declined because an increasing proportion of government guarantees go to back borrowing by government-owned special purpose vehicles whose debt servicing will revert entirely to the budget. Such liabilities, albeit off budget, are thus in the nature of actual rather than contingent state government liabilities. In 2000, outstanding guarantees of state governments were estimated at Rs 1661 billion, equivalent to 7.2% of GDP, up from Rs 526 billion in 1996 (equivalent to 4.4% of GDP).

**Figure 1.4: State fiscal deficit: poor states and others**




**The poorer states saw the most severe fiscal deterioration.**

1.16 The degree of fiscal deterioration has been worse in the poorer states (Figure 1.4). They are more reliant on central transfers (in poor states central transfers account for about half of all revenues, versus about a quarter in the other states), and so they have suffered more from the reduction in these transfers. They have also experienced greater variability in

[2] In 1998/99, state governments as a whole borrowed 68% more than they had the previous year. During that year, borrowings from 'small savings' (i.e., from post office and other savings' schemes for individuals) rose by 53%, provident fund borrowing by 92%, and GoI controlled borrowing by 18%.

revenues, including in their own revenues. (Figure 1.5 and Table 1.3).[3]

1.17 On the expenditure side, with higher initial debt stocks and salary bills (relative to total spending), poorer states also suffered more from the shocks of the nineties. As a result, some of the fiscal indicators have experienced greater deterioration in poorer than in richer states, and have reached alarming levels in the poor states. In 1999/00 the debt to GSDP ratio was over 32.5% in poor states, versus 22.6% in other states. Interest payments as a share of own revenues are nearly twice as high in poor states than in other states, and are still increasing. In Bihar and Orissa, debt service preempts more than 90% of own revenues.

**Figure 1.5: Own and total state revenues: poor states and others**

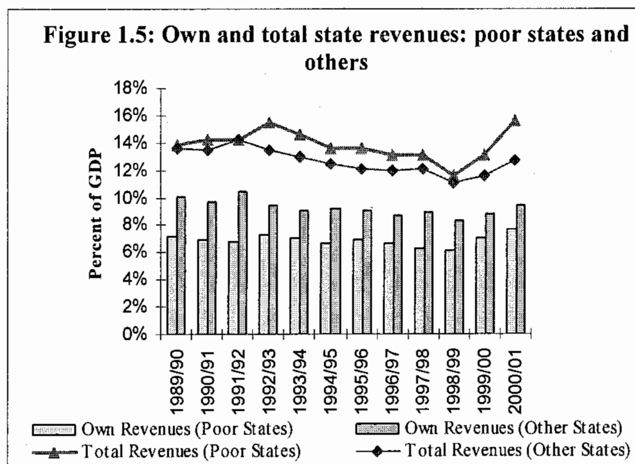



**Table 1.3: Fiscal indicators: poor states and others (1999/2000)**

| | GoI transfers /GSDP | Own revenues /GSDP | Fiscal deficit/ GSDP | Revenue Deficit / GSDP | Interest payments / own revenues | Debt/ GSDP |
|---|---|---|---|---|---|---|
| Poor states | 6.1 | 7.0 | 6.3 | 4.1 | 46.5 | 32.5 |
| Other states | 2.9 | 8.8 | 5.5 | 3.3 | 29.4 | 22.6 |

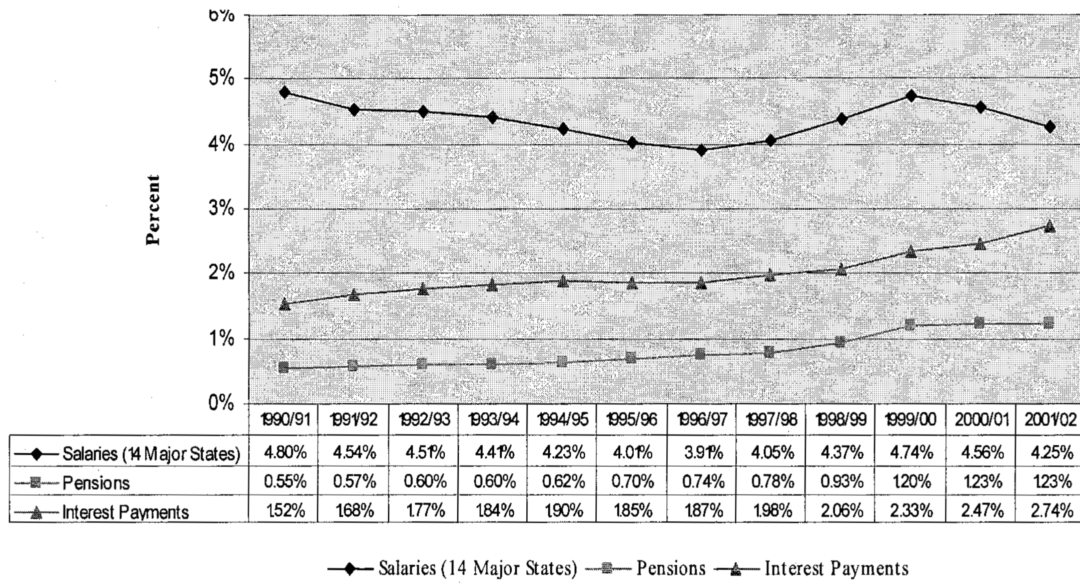
## IV IMPACT

**Although associated with an increase in public spending, the fiscal crisis weakened the developmental and poverty impact of state governments, especially in the poorer states; it also called into question India's overall fiscal sustainability.**

1.18 Various studies have showed the importance of both the quantity and quality of state government expenditures for poverty reduction in India, and drawn attention to their low levels, especially in the poorer states (Box 1.2). Although the fiscal stance was expansionary in the late nineties, the impact on expenditure quantity and quality was largely negative. This is because all of the increase is accounted for by the rise in interest, pensions, and the average salary.

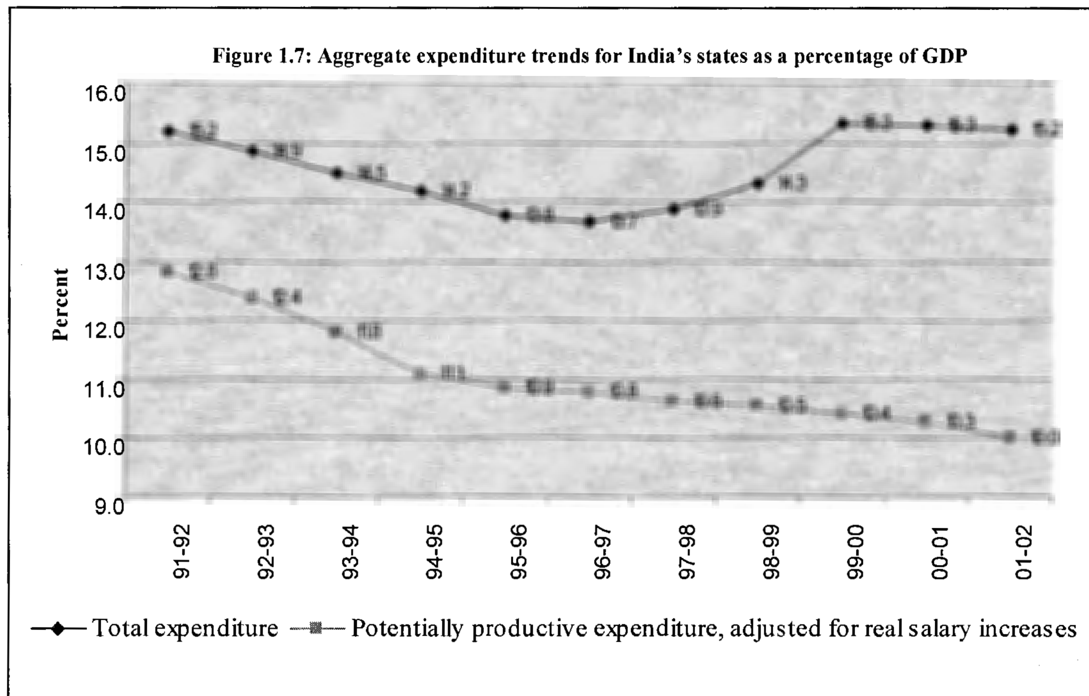
1.19 Figure 1.6 shows trends in these three variables at the state level over the nineties. The salary bill as a whole has started to adjust, but this reflects the lack of net hiring in the late nineties, which has compensated for the large average wage increases. Once one adjusts for the large increases in interest and pension payments, and for the large real salary increase in the second half of the nineties, "adjusted" aggregate expenditure has continued the downward trend observed through the first half of the nineties (Figure 1.7).

[3] This is related to the recommendations of the Tenth and Eleventh Finance Commissions. Revenue deficit grants to the poorer states, recommended by the Tenth Finance Commission, came to an end in 1997/98. Similar grants were resumed in 2000/01, on the recommendation of the next Finance Commission. As a consequence, transfers to the poor states reached a low of 5.4% of GSDP in 1998/99 and then increased to 8.5% by 2000/01 – for the other states central transfers as a share of GSDP have been roughly constant since the mid-1980s.




|  | 1990/91 | 1991/92 | 1992/93 | 1993/94 | 1994/95 | 1995/96 | 1996/97 | 1997/98 | 1998/99 | 1999/00 | 2000/01 | 2001/02 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Salaries (14 Major States) | 4.80% | 4.54% | 4.51% | 4.41% | 4.23% | 4.01% | 3.91% | 4.05% | 4.37% | 4.74% | 4.56% | 4.25% |
| Pensions | 0.55% | 0.57% | 0.60% | 0.60% | 0.62% | 0.70% | 0.74% | 0.78% | 0.93% | 1.20% | 1.23% | 1.23% |
| Interest Payments | 1.52% | 1.68% | 1.77% | 1.84% | 1.90% | 1.85% | 1.87% | 1.98% | 2.06% | 2.33% | 2.47% | 2.74% |

*Notes and source:* Salary data has been provided by N.J Kurian and is only for the 14 major states. Other data is for all states. 2001/02 data are actuals for interest payments, but revised estimates for the other variables.




*Notes:* See Table 1.4

**Box 1.2. State government expenditures and poverty reduction**

In the aggregate, state government development expenditures appear to have been growth promoting and poverty reducing. Using state-level poverty measures spanning 1960 to 1994, and controlling for other factors such as agricultural and non-farm productivity growth, Ravallion and Datt (2002) find that poverty declined more in states that had higher development expenditure. Linking individual items of expenditure to poverty reduction and growth provides some tentative evidence of which types of government expenditures matter the most. There is evidence that infrastructure spending by the government crowds in private investment (Gulati and Bathala, 2002; RBI, 2002) and that spending on infrastructure can be particularly effective in alleviating rural poverty (Fan et al., 2000). The connection between public spending and health outcomes is more complex and econometric investigations have drawn conflicting results. Kingdon (1996) and Filmer and Pritchett (1999) both demonstrate the importance of quality, in their case that education outcomes appear to be much more responsive to non-salary inputs than salaries.

Quality of expenditure by state governments is undermined by various problems, including: skewed composition of spending skewed towards salaries even though outcomes appear to be much more responsive to non-salary inputs (Kingdon, 1996; Filmer and Pritchett, 1999), a regressive distribution of benefits, especially in health (World Bank, 1998; Mahal et.al., 2001); low civil-service productivity, as evidenced, for example, by very high absence levels of service providers (Devarajan and Shah, 2004); an ineffective spread of funds over too many projects; and duplication of services provided by the private sector.

Quantity is also low in key areas. Public and private investment in infrastructure is about 4% of GDP which is low compared to levels of about 5% of GDP invested in infrastructure up to the mid-nineties, and 6-8% in the East Asian countries (Mody, 1997), to whose rapid growth rates India aspires. Infrastructure maintenance is also very low, despite very high returns (World Bank, 2004b). Education and health funding is inadequate: a study of public primary schools points to large, overcrowded classrooms (with an average pupil-teacher ratio of 50, but higher than 150 in some cases), inadequate infrastructure (84% of schools lacked a toilet, 54% lacked drinking water), and a lack of teaching aids (PROBE, 1999). Rural health centers are often dilapidated, and lacking in basic facilities, such as electricity, drugs and basic medical equipment, making them dysfunctional and disused (Dreze, 2004). India's level of public expenditure on health, at about 1% of GDP, is among the lowest in the world, even in South Asia. (Combined private and public expenditure is much higher, but much of the private expenditure on health is also of low quality.)

Finally, both quantity and quality of expenditure are particularly low in the poorer states. The greater salary intensity of expenditure is demonstrated in Section IV of this chapter. Using 2000/01 data, on an average per capita basis, low income states spend only 57% as much as middle- and high-income states on health and education, 54% as much on capital expenditure, 64% on roads maintenance, and 42% on irrigation maintenance. The differences between individual states can be even more striking. There are five states which spend at least twice as much on health per capita as the two lowest spending states, Bihar and Madhya Pradesh (MP). Nine states spend two times or more on education per capita than MP and Bihar: the two lowest spending states; Punjab and Maharashtra's spending is more than three times. Differences in public expenditures across states are reflected in much lower access to public services in the poorer states. Even more striking is the finding that the poor in the richest six states have better access to basic services than even the non-poor in the bottom five states (Paul et. al., 2004). Jean Dreze (2004) illustrates this difference by a comparison between the health centres of Tamil Nadu and the (poorer) northern states:

> *Last year, I .. visited health centres in three districts of Tamil Nadu. They were clean, lively and well staffed. Plenty of medicines were available for free, and there were regular inspections. The walls were plastered with charts and posters giving details of the daily routine, available facilities, progress of various programmes, and related information. Patients streamed in and out, evidently at ease with the system. It was a joy to see this, in contrast with the bare, deserted, gloomy, hostile premises that pass for health centres in north India.*

To summarize, the messages that emerge the most clearly from the large, and sometimes conflicting, literature on this subject are that both the quantity and the quality of certain types of state government expenditures matter for poverty reduction, and that both are on average low, especially in the poorer states.

1.20 The fiscal crisis also weakened the developmental and poverty impact of state governments by slowing down real growth of expenditure in education and halting real growth in health expenditure. At first glance, health and education spending appear to have done very well in the last years from 1996/97 to 2000/01 with average real increases of 9.6% and 5.9%, compared to 3.1% and 2.5% in the six years leading up to 1996/97 (Table 1.4). However, deflation simply by price indices ignores the impact of the Fifth Central Pay Commission real wage increases in these labor-intensive sectors. Factoring in wage increases alters the picture dramatically. Now education shows an average real spending increase of only 1.6% in the five years post 1996/97, and health of –0.7%, both significantly less than the pre-1996/97 rates of growth.

**Table 1.4: Average real growth rates of expenditures in some key sectors (14 major states)**

| | **1990/91- 1996/97** | **1996/97- 2000/01** | |
|---|---|---|---|
| | | **Adjusting for price increases only** | **Adjusting for price and wage increases.** |
| Education | 3.1% | 9.6% | 1.6% |
| Health | 2.5% | 5.9% | -0.7% |
| Irrigation maintenance | 4.8% | 2.4% | --- |
| Roads maintenance | 0.9% | 3.5% | --- |
| Capital expenditure | 0.5% | 5.9% | --- |

*Notes:* To avoid downward bias of growth rates, we add expenditure levels in the three new states back into the old states from which they were created in 1999/00. Jharkhand however has not been included in the analysis as there is no data available on it for 2000/01 This causes downward bias in the second period. If we take out Bihar, however, the slow-down in the second period is even greater. Maharashtra is excluded from the maintenance calculations since the data appears unreliable. We assume that the ratio of salary to total current spending in education is 90% and in health 75%. We calculate wage inflation using data from Figure 1.6 on the assumption that there was no net hiring post 1996-97 and that any excess in the increase of the wage bill over the rate of inflation is due to increases in real wages. 1996-97 is the dividing year, since implementation of the Fifth Central Pay Commission wage hikes began in 1997-98.

1.21 The only positive fiscal development in the post-1996/97 period is an increase in real growth in state-level capital expenditure. Capital investment by state governments was virtually flat in real terms in the first half of the nineties, but resumed growth in the second half of the nineties with an annual average real growth rate of 5.9%. This contrast between the two halves of the nineties may be overdrawn. Capital expenditure is lumpy and volatile, and the dividing year 1996/97 was an unusually low year for capital expenditure figures.[4] There is also evidence that in 1998/99 and 1999/00, recorded expenditure on capital payments was inflated.[5] At the same time, however, the growth in guarantees probably also allowed increased capital spending by government enterprises. While the news about capital spending is good, in terms of volume of expenditure, capital expenditure is only about 10% of total expenditure, and slightly less, on average, than education expenditure, for example. Maintenance spending shows a mixed picture: average roads maintenance growth increased from 0.9% to 3.5%, while average irrigation maintenance growth fell from 4.8% to 2.4%.

1.22 The poorer states in particular suffered. The poor states show negative real spending growth post-crisis in health, education, and irrigation maintenance, and much lower expenditure growth rates for the other two categories of capital investment and road maintenance spending (Table 1.5).

[4] State capital expenditure as a ratio of GDP was 2.0%-2.1% of GDP for 1991/92 to 1996/96 but fell to 1.6% in 1996/97. From 1997/98 to 2001/02 the ratio was in the range of 1.6%-1.8% of GDP.

[5] Public account borrowing increased rapidly, from 0.3-0.5% of GDP pre-1998/99 to 1.0% of GDP in 1998/99 and 0.8% in 1999/00. This mechanism is often used at a time of fiscal stress to prevent the need to show deep cuts in areas such as capital expenditure (see para 4.4). This suggests that the official capital expenditure figures exaggerate growth in capital expenditure at least in the worst years of the fiscal crisis, 1998/99 and 1999/00.

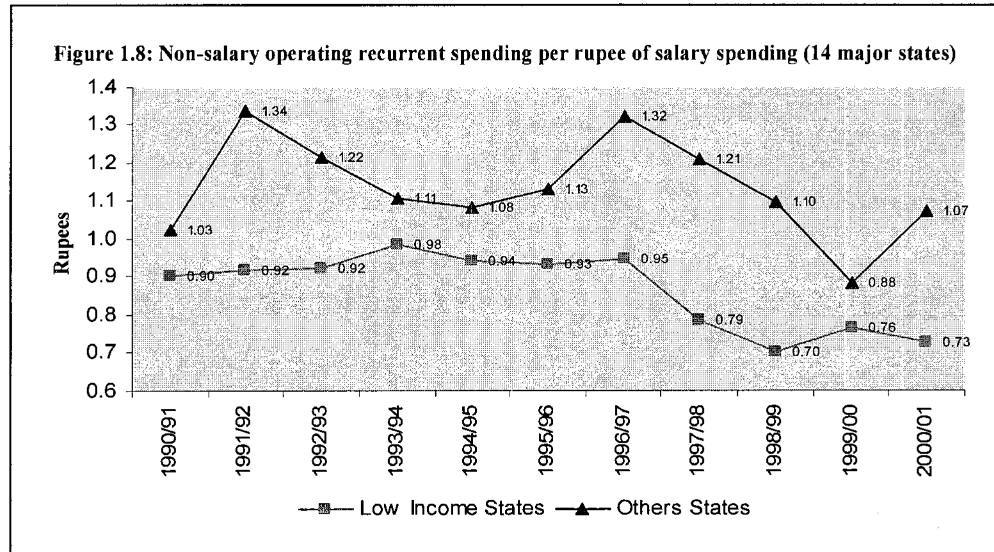
**Table 1.5: Average real growth rates of expenditures in some key sectors (Low-income states and others of the 14 major states)**

| | Low Income States | | Other States | |
|---|---|---|---|---|
| | 1990/91- 1996/97 | 1996/97- 2000/01 | 1990/91- 1996/97 | 1996/97- 2000/01 |
| Education | 2.8% | -0.2% | 3.3% | 2.6% |
| Health | 2.2% | -2.6% | 2.8% | 0.3% |
| Irrigation maintenance | 2.6% | -2.0% | 6.0% | 4.5% |
| Roads maintenance | 1.5% | 1.0% | 0.4% | 5.0% |
| Capital Expenditure | -4.4% | 2.9% | 3.8% | 7.6% |

*Notes:* See Table 1.4.

1.23 Quality of spending also suffered, as expenditures became much more salary-intensive, particularly in the poorer states (Figure 1.8). In 1990/91, rich and poor states alike spent about Rs. 0.9-1 on non-salary operating recurrent expenditure for every rupee of salary expenditure. By 2000/01, this ratio for the better off states at 1.11, was marginally better than at the start of the nineties, but for the poor states it had fallen precipitously to 0.73, a roughly 20% fall from the early nineties. Given that there was virtually no hiring in the second half of the nineties, it is ironic that all states, but especially the poorer ones, should, nevertheless, at the end of the nineties, have at their disposal significantly fewer non-salary resources relative to their salary bill than they had midway through the nineties. There are indeed many anecdotal accounts from the late nineties of teachers without chalk, and doctors without drugs (Saxena, 1999).

**Figure 1.8: Non-salary operating recurrent spending per rupee of salary spending (14 major states)**




1.24 The deterioration in state finances also significantly weakened India's overall macroeconomic performance, which, with the exception of the burgeoning fiscal deficit was strong in the nineties. Almost half of the consolidated fiscal deficit is now made up of the state-level deficits.

## V Response

**The sharp fiscal deterioration gave rise to an intense state-level reform effort.**

1.25 The sense that "business-as-usual" was not an option gave enormous momentum to reform efforts at the state level. Many states have now adopted reform programs, albeit to differing degrees of strength and credibility, to return deficits to sustainable levels, and more broadly to improve government efficiency and effectiveness.

1.26 These reform programs go way beyond the realm of fiscal space, and have objectives far more ambitious than fiscal correction. Although, to keep it manageable, the scope of the study is restricted to fiscal reforms, this is not because sectoral reforms are seen as less important. Indeed, even fiscal adjustment confronts serious sectoral issues, and we do try to grapple with some of these in subsequent chapters. One key set of

reforms, even from a fiscal perspective, which we do not tackle here, are reforms to improve the investment climate, and thus accelerate growth. For a recent survey, see World Bank (2003, 2004c). An attempt to contextualize fiscal reforms in the broader paradigm shift underway at the state level is undertaken in Table 1.6 below.

**Table 1.6: The Paradigm Transition at the State Level**

| GOVERNMENT RESPONSIBILITY | OLD PARADIGM: *Government as...* | NEW PARADIGM: *Government as...* | EXAMPLES OF THE SHIFT |
|---|---|---|---|
| Economic management and growth | Central planner | Facilitator and regulator of largely private, market economy | Privatization and closure of public enterprises; establishment of power sector regulators; business deregulation |
| Provision of employment opportunities | Provision of employment through public sector hiring. | Facilitator of employment opportunities | Freeze on public sector hiring |
| Financial management | Cash-flow manager | Fiscal manager | Development of medium term fiscal frameworks; passage of fiscal responsibility legislation; fiscal adjustment through tax and expenditure reform |
| Policy role | Implementer of Central policies | Policy-maker and implementer | Variation in policies now seen across states. |
| Service provision | Broadening scope of services | Improving quality and access of existing services, as well as expanding their scope | Greater attention to education quality, rather than just on increasing the number of schools |

*Source:* Howes, Lahiri and Stern (2003)

1.27 A key part of the reform programs of most states is the adoption of medium-term fiscal plans, frameworks or reform programs. Five states have provided statutory backing to these plans through the passage of fiscal responsibility legislation, which mandates the achievement of prudent fiscal targets within a fixed period, and several other states have announced their intention to follow suit. Box 1.3 below summarizes the emerging experience with fiscal responsibility legislation in India's states. As in other countries, the experience has been mixed. Agencies external to the state governments, such as GoI bodies and official funding agencies, can help increase the impact of Fiscal Responsibility Acts by holding the states to account for achieving the targets which they themselves have set.

**Box 1.3: Fiscal Responsibility Legislation at the State-level in India: the story so far**

Federations have two choices when it comes to implementing fiscal policy rules at the sub-national level (Kopits, 2001). Either these rules can be imposed from above (the "co-ordinated" approach – followed by Brazil and by the EU for its member states), or by the sub-national entities themselves (the "autonomous" approach – followed by US, Australia, Canada and Argentina). India has taken the latter approach.

Whether adopted at the national or sub-national levels, there are also a great range of FRAs to choose from: they range along a spectrum from "prescriptive" – with quantitative, time-bound targets – to "non-prescriptive" – which legislate policy principles, rather than targets. For a low-credibility, pre-adjustment government, international experience points to the former approach – which has been the one taken in India, where are all Acts passed at the central and state level do have, though to differing degree of detail and tightness, quantitative, time-bound targets.

The general consensus on fiscal responsibility legislation – in both unitary and federal nations – is that it is neither necessary nor sufficient for fiscal adjustment, but can be useful.

At the time of writing, five states, as well as the Government of India, have passed fiscal responsibility acts (FRAs): Karnataka, Kerala, Punjab, Tamil Nadu (TN), and Uttar Pradesh (UP). Other states, such as Andhra Pradesh, Madhya

Pradesh, Maharashtra, and Orissa have drafted a bill, or otherwise signaled their intention to move in this direction. While no two states have passed identical legislation, all the state bills share some common features. They all impose quantitative and time-bound targets on the revenue and fiscal deficit, and they all mandate the production of multi-year budget forecasts in line with these targets, and at least bi-annual reporting requirements of performance against these targets. Some states consolidate off-budget with budget liabilities and some include caps on guarantees, or have separate legislation for this.

What so far has been the experience with these fiscal responsibility acts? Of course, it is too early to make a definitive assessment: the first FRA was passed in Karnataka in August 2002 and UP has just passed its FRA. Nevertheless, a number of lessons can be learned.

Performance as measured by outcomes has been mixed. Kerala's 2003 FRA mandates the elimination of the revenue deficit by 2006-07; but the revenue deficit is budgeted to increase as a percentage of revenue receipts in 2004-05, and its latest MTFP only shows the elimination of the revenue deficit in 2007-08, and that too on the assumption of a big increase in resources from GoI. Karnataka is on track to meet its target of revenue deficit elimination by 2005-06, and has budgeted to achieve the 3% of GDP fiscal deficit target one year ahead of schedule, i.e. in the current year, 2004/05. Rajaraman (2003) estimates that many of the FRA targets are overly ambitious. Performance as measured by processes is also varied. Of the four other states, Tamil Nadu is the only state which has put out a six-monthly report, even though such reports are required by all the acts.

Generally, the extent to which the Acts are owned and valued by the various states varies enormously. Punjab's FRA seems to have disappeared without a trace: one cannot find an official reference to it. By contrast, at least in the three other states, the FRA is referred to in documents such as the budget speech, and medium-term fiscal plan. Karnataka's Chief Minister has referred to its FRA as a "fiscal constitution for the state".

One lesson is that perhaps the FRA should not be rushed in to. States should first of all start producing annual multi-year fiscal plans and strategies, and FRAs can then be introduced as ways to provide legal backing to these multi-year plans. FRAs without serious multi-year plans which translate targets into realistic strategies may be of very little value. The media and academic community have shown little interest in performance by states against FRA. Perhaps this reflects general skepticism about government commitments and performance. However, since the FRAs lack punitive provisions, without greater public scrutiny and attention, the FRAs will tend to fade into irrelevance. This is one area where agencies which interact with the states, such as the GoI Finance and Planning Departments, RBI, CAG, creditors, mulitaterals and bilaterals, and rating agencies can play an active role by judging state performance against FRA targets. FRAs are spreading through India. While a welcome trend, more attention needs to be given both by governments and by outside parties to compliance with FRA provisions post-adoption.

1.28 On the expenditure side (chapter 2), a number of states have contained spending by restricting recruitment, increasing wages at less than the rate of inflation, hiring new employees on a contract basis at much lower than the regular rates, and curbing the growth in administrative expenditures. Some states have cut the cost of their existing pension scheme, and are preparing for a shift to a new, cheaper contributory pension scheme. Power sector reforms, and other measures to cut subsidies, have also assumed critical importance in recent years. The closure and privatization of public sector enterprises has been accelerated. On the revenue side (chapter 3), reform measures have broadly aimed to enhance the revenue receipts through revision of tax rates, broaden the tax base, and improve tax compliance. Other important initiatives relate to the preparatory work for the introduction of a VAT and rationalization of user charges mainly relating to power, water and transport.

**The Government of India also moved swiftly to help states undertake fiscal and sectoral reforms, and the idea of "incentivizing reforms" has taken root.**

1.29 The fiscal deterioration gave rise to the birth of MoUs between GoI and some state governments in 1999/00, outlining medium-term strategies towards fiscal consolidation. This practice developed further into the Fiscal Reforms Facility (FRF) starting in 2000/01, following the recommendations of the Eleventh Finance Commission to link a portion of untied central grants to the fiscal correction performance of individual states. Although the funding attached to the FRF is small, it has had a significant impact, in particular through its requirement that states draw up medium term fiscal reform programs.[6]

[6] For a more detailed review and assessment of the FRF, see Box 4.7 and also Ministry of Finance, 2003.

1.30 A number of other reform facilities have since sprung up, and external funding agencies have also tied a portion of fund transfers to fiscal and sectoral reforms. In 2001 GoI announced a scheme to help restructure finances of the State Electricity Boards through a one-time arrears settlement linked with an arrangement that would ensure payment of current dues in the future – an important move to harden the budget constraints faced by state governments (para 4.7). Arrears and part of the accrued interest owed by SEBs to power generating public sector undertakings were settled in 2003 through the issue of 15-year tax-exempt state-government bonds worth 1.5%of GDP. The rest of the accrued interest was written off.[7] States qualify for funds under the Accelerated Power Development and Reform Programme (APDRP) on the basis of reform milestones improvements in the reduction of commercial losses. Other schemes for reform-linked assistance were also introduced in the 2002/03 budget, including the Urban Reforms Incentive Fund (URIF) and the City Challenge Fund.

1.31 The immediate concern about the increasing interest burden of the states has prompted the introduction of a debt-swap scheme. Recognizing the need to reduce the interest burden of the states, all loans from the center to the state governments bearing interest rates in excess of 13% are to be swapped with market borrowings and small savings proceeds at prevailing interest rates over a period of 3 years ending 2004-05.

1.32 Since 1997, the RBI has convened regular conferences of state finance secretaries, which have provided a forum for several state-level initiatives. A key initiative has been the establishment of the Technical Committee on State Government Guarantees (1999), which recommended placing limits to contain the further growth of guarantees. Statutory ceilings on guarantees have been placed by states such as Goa, Gujarat, Karnataka, Sikkim, and West Bengal, while the states of Assam, Orissa and Rajasthan have imposed administrative ceilings on guarantees. A few states have also set up guarantee redemption funds and have started charging guarantee fees.

1.33 The RBI has also assisted in advising state governments in areas such as cash management, funds management and budgetary practices. A core group has been set up on disclosure norms for state budgets to help improve the design and coverage of budget related documents. The ways and means arrangement, an RBI overdraft facility to assist states with temporary mismatches in cash flows, was also recently revised in consultation with the state governments (March 2003). RBI has also devised a consolidated sinking fund, helping states to achieve sustainable debt levels.[8]

## VI CHALLENGES

**Recent years have shown some signs of improved fiscal performance.**

1.34 The intensified revenue effort appears to be paying off: states' own-revenues have bounced back to pre-1998/99 levels as a percentage of GDP, though central government transfers are yet to follow suit. Economic growth of 6%-plus, and recovery from the industrial recession of the late-nineties, has also helped to boost revenues. The shock of the wage and pension increases associated with the Fifth Pay Commission is settling; there is no net hiring; states are also starting to benefit from lower interest rates – not just on fresh borrowing, but also through debt-swaps. As a result of all this, committed spending as a share of total revenues has begun to fall. The primary deficit of the states has been on a declining path since 2000, though the debt stock continues to rise. There are some early signs of a reduction in power sector losses. In 2002, outstanding guarantees of state governments fell to 7.2% of GDP, up from to 6.8% of GDP in 2000, but below the 2001 peak 8.1% of GDP. There are thus some tentative indications that the growth in off-budget liabilities is tapering off. The recourse to the RBI overdraft facility appears to have been falling reflecting an improved management of cash flows in the aggregate.

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[7] See Rastogi 2003 for a more in-depth discussion.

[8] For a more in-depth discussion and greater coverage see Reddy (2001) and RBI (2003a).

**But concerns about the level and composition of the fiscal deficit remain. States continue to borrow to finance current spending. Poor states show fewer signs of recovery than richer states.**

1.35 For all this progress, it has to be noted that the combined fiscal deficit of the states has stayed between 4-5% of GDP, and the revenue deficit between 2.5-3%: implying, among other things, that more than half of the states' borrowing is to finance current expenditures, and that the nation will fall far short of the Fiscal Reforms Facility goal of eliminating the states' combined revenue deficit by 2004/05. While some states have shown significant deficit reduction results, few have been able to sustain an improvement, and several have shown better results only by running up arrears. Many fiscal targets agreed to by the states have been missed, even by those adopting fiscal responsibility acts (Box 1.2). The debt and debt service burden of the states continue to increase and preempts a large share of available resources, especially in the poor states. The primary deficits of poor and rich states have converged, but the former continue to show higher revenue and fiscal deficits, as well as very high levels of salary-intensity in their expenditure. Despite promising recent numbers, the off-budget liabilities of states continue to be a serious concern. Large volumes of off-budget debt services are now becoming due and some states have shown their inability to service this debt. CRISIL (2003) has estimated that of the market borrowings by state-level entities guaranteed between 1995 and 2002, Rs 440 billion will be called over the next five years.

**A halt in reforms would hurt all states as the quality and quantity of productive expenditures would fall, and debt levels would steadily build.**

1.36 Whatever improvements have been made to date would be lost without further reforms. We simulate this in Chapter V by assuming that the combined states' fiscal deficit stabilizes roughly at its current level of 4.8%, that there are no improvements in revenue performance, that salary spending takes off again, perhaps because of a new pay commission, and that there is no reduction in salaries. In such a scenario, debt levels continue to increase, and the composition and quality of spending deteriorates. Committed spending (debt service, wages, pensions and subsidies) would increase from 89% of total revenues in 2003/04 (10.5% of GDP) to 106% of total revenues in 2007/08 (12.5% of GDP). Such an outcome is quite conceivable if hiring or pay restraint is relaxed, if subsidies are not reduced and if revenue performance does not improve significantly. How rapidly debt would accumulate will depend on how permissive the central government is. But under a "no reform" scenario, the choice will be between more borrowing and less non-salary productive spending; less borrowing will simply result in a crowding out of capital expenditure and O&M expenditure.

**This report is written to help share the lessons and success-stories to date, and to assist states and the central government in implementing the national agenda of state-level fiscal stabilization and empowerment.**

1.37 There is a broad consensus on the fiscal challenges facing India's states. Of course, they must reduce deficits to sustainable levels. But simply averting bankruptcy will not be enough. In addition to fiscal stabilization, fiscal empowerment also needs to be pursued. To become effective agents of development, states must also increase the quantity of spending in priority areas, and improve the quality of government expenditure.

1.38 This positive agenda for fiscal reform is in line with international experience with fiscal adjustment. As Box 1.4 summarizes, the empirical literature finds that more successful fiscal adjustments rest at least part on restructuring of recurrent expenditures. This work is based largely on OECD experience, although one study has found that this also holds for low-income countries (Gupta, Clements, Baldacci, Mulas-Granados, 2002). They find that fiscal consolidations achieved through cutting selected current expenditures tend to be more successful and trigger higher growth rates than adjustments based solely on revenue increases and cuts in more productive spending. According to this analysis, protecting capital expenditures during a fiscal adjustment leads to higher growth, as does an increase in the share of current spending on non-wage goods and services. Reductions in the

public sector wage bill are not harmful for growth for the sample as a whole. Reallocating government expenditures to more productive uses is also correlated with more persistent fiscal consolidation episodes.

**Box 1.4: International experience with fiscal adjustment**

Over the past decade a number of studies of fiscal adjustment have been undertaken. Following Alesina and Perotti (1995), fiscal adjustment strategies are sometimes broadly divided into two categories: 'Type 1', primarily relying on cuts in recurrent spending, and 'Type 2', relying primarily on tax increases with spending cuts mostly limited to public investment. In a study of 20 OECD countries for the period 1960-1994, 60 episodes of fiscal consolidation were identified. Of these episodes, only 16 were lasting, and among these successful cases 73% were based at least in part on recurrent spending cuts. Although most fiscal adjustment efforts rely on tax increases to lower the deficit and the debt burden, those successful in addressing fiscal imbalances rely more heavily on cuts in current expenditures than tax increases.

McDermott and Wescott (1996) find similar results for 74 episodes of fiscal adjustment in 20 countries during 1970-995. Whereas a little less than half of the 'Type 1' adjustment cases were successful, only 1 out of the 6 'Type 2' adjustment cases was successful. They also found that 'Type 1' adjustments are more likely to reduce the public debt ratio. Complementary to this, research by Alesina and Ardagna (1998) finds that the success of fiscal stabilization is not just determined by the size of the adjustment, but also by the composition. Adjustments that focus on cuts in transfers and wages are more likely to succeed in reducing the primary structural balance. Finally, Fiscal adjustments that rely primarily on cuts in transfers and the wage bill not only last longer, but can also be expansionary; on the other hand adjustments relying on tax increases and cuts in public investment tend to be contractionary and unsustainable (von Hagen, Hallett and Strauch, 2001).

1.39 Addressing these challenges requires much of the states: expenditure restructuring to generate fiscal savings on the expenditure side, far-reaching expenditure management reforms, and comprehensive revenue reforms and mobilization. This daunting agenda of state-level reforms, which is explored in Chapters 2 (on expenditure) and 3 (on revenue), cannot be carried out by the states alone. It also requires GoI actions to strengthen the framework for reforms and development. These issues relating to fiscal federalism (the "rules of the game") are explored in Chapter 4. Chapter 5 simulates some scenarios to analyze whether simultaneous pursuit of both fiscal stabilization and empowerment is possible.

**The precise sequencing and appropriate packaging of reforms will vary from state to state. But many lessons can be learnt from reforms already undertaken by various states.**

1.40 While political economy considerations lean towards emphasizing revenue enhancing reforms in the immediate term, given the resistance to expenditure restructuring saving measures, there is economic merit in following the exactly opposite sequence -- that is, to first improve the composition and quality of public spending before raising more resources from the public. But this can take time, and improving quality may also require additional resources (e.g. for more non-salary inputs, since salary costs are fixed). While it is difficult to draw generic lessons on how reforms should be sequenced and packaged, there is already a lot of experience at the state level on different reforms, what works and what doesn't. One aim of this report is to help share these lessons more broadly. In this spirit, the report draws on the interactions over many years now of Bank staff with various state governments, whether through collaboration over lending, analytical work, or simply information-sharing.

# CHAPTER 2

# EXPENDITURE REFORMS

## I OVERVIEW AND INTRODUCTION

2.1 **Overview.** Using 2000/01 as a reference year, state governments taken together spend 16% of India's GDP, 68% of which is funded by revenue, and the remaining 32% by borrowing. 90% of expenditure is on the current or revenue account, the remaining 10% on the capital account. The largest current expenditures are salaries (37% of current expenditure), interest payments (18%), and pensions (9%). Total expenditure grew at an average of 13% over the nineties. Expenditure/GDP fell over the first half of the nineties, but then increased from 1997/98 onwards. The fastest growing item of expenditure over the nineties was pensions (22%) followed by interest payments (18%).

2.2 Levels and composition of expenditure vary considerably between poorer and richer states. The poorer states run much smaller governments: expenditure is slightly higher in the five low-income states (21% vs. 20%) but much lower on a per capita basis (Rs 2,174 vs. Rs 4,142 for the other states). Poorer states also spend about 10% of expenditure on the capital account, but spend more of their current expenditures on salaries (41% of current expenditure) and interest payments (21%).

2.3 **Introduction.** Given the low levels and the worrying recent trends in both the quantity of expenditure in priority expenditure areas, and the quality of expenditure across the board, there is an urgent need for expenditure restructuring to free up fiscal resources and for reforms to improve the quality of spending. We consider these in turn in the sections which follow. Our focus in this chapter on areas where expenditure can be cut rather than where it should be increased is not because we think there are no areas of under-funding. Clearly, the analysis of the previous chapter (Box 1.1 and Section IV) suggests the opposite. However, which particular areas should be increased, and by how much, will likely vary from state to state, depending on initial conditions, and identified priorities. The areas where savings can be made have much more in common across states, and so are the focus of this report.

2.4 We examine three expenditure areas where fiscal savings can be found: the salary and pension bill, subsidies, public enterprises, and interest payments. The first of these is by far the largest and is dealt with at greatest length in Section II. Subsidies are the most complex and are discussed in Section III. Section IV deals more briefly with public enterprises and interest. Section V examines cross-cutting techniques by which the quality of government expenditure can be improved.

## II. SALARIES AND PENSIONS

### A policy of public-sector wage restraint is justified by India's large public sector pay premium; and is also warranted given current hiring policies.

2.5 Most public-sector employees in India are greatly overpaid relative to their private sector counterparts – a long-standing trend and one exacerbated by the Fifth Central Pay Commission. Survey data shows that the ratio of the average public to private sector wage is now 233%, up from 192% a decade earlier (Table 2.1). India's public-private wage differentials are in fact among the highest in the world. Studies for a large number of countries using similar methodologies find similarly large differentials to those observed in India only in two African countries (Ghana and Cote d'Ivoire) and in some regions of Brazil (Glinskaya and Lokshin, 2004). Of course, this hides the fact that wage compression implies under-payment for senior civil servants relative to market, but this is the exception rather than the rule. About 40% of state civil servants are teachers. In rural areas, where most of them live, they belong to the top decile of the income scale, and it is difficult to justify further real wage increases for them given the pressing needs to improve school infrastructure, and bring down pupil-teacher ratios in many states (Dreze, 1999).

**Table 2.1. Ratio of Average Wages in the Public and Private Sector, 1993/94 and 1999/2000**

| State | 1993/94 | 1999/2000 |
|---|---|---|
| Andhra Pradesh | 2.35 | 2.13 |
| Bihar | 1.41 | 2.14 |
| Gujarat | 1.91 | 2.05 |
| Haryana | 1.84 | 1.93 |
| Karnataka | 2.11 | 2.07 |
| Kerala | 1.78 | 2.06 |
| Madhya Pradesh | 2.08 | 2.19 |
| Maharashtra | 1.53 | 1.89 |
| Orissa | 1.88 | 2.30 |
| Punjab | 2.17 | 2.56 |
| Rajasthan | 1.72 | 2.70 |
| Tamil Nadu | 2.23 | 2.46 |
| Uttar Pradesh | 2.27 | 2.58 |
| West Bengal | 1.96 | 2.17 |
| *All India* | *1.92* | *2.33* |

*Notes:* Wage differentials are computed by comparing weekly wages for public and private sector wage employees. Calculations based on NSS surveys. *Source:* NSSO 50th and 55th Round Employment-Unemployment Schedule Data

2.6 The two trends observed in the 1990s of less public sector hiring and a greater public-private wage differential, have both reduced the quality of service delivery (by making hiring more expensive for governments) and made a public sector job more desirable but less attainable. Queuing for government jobs is of massive proportions, and has already resulted in social tensions and demonstrations.[9] While we argue for both reducing the public-private wage differential and restraining public sector hiring (on which, see below), a reduction in public sector wages offset by increased hiring would be superior to the current position on both social and service delivery grounds.

**Critical for maintaining a policy of wage restraint will be avoidance of establishment of a pay commission for as long as possible, since such a commission would in all likelihood lead again to a significant increase in real wages.**

2.7 Pressure for a real wage increase is mounting, but giving into this will sacrifice many of the hard-won gains of the last few years. If and when base salaries are adjusted, it will be important to put more emphasis on local market comparators in determining salary levels: this would limit the scope for real public-sector wage increases to areas in which it is needed. Since the last pay commission shows the influence of the central government on pay-related matters, the Government of India has a special obligation of leadership in this area.

**Some states have been much more innovative and responsible pay-masters than others.**

2.8 GoI's leadership role should not be interpreted to mean that states are passive implementers of a central pay policy. Far from it. Since the pay commission increases, several states have refused to pass on full cost-of-living allowances. For example, Orissa's cost of living allowance is at 51% of basic salary, well below the GOI allowance of 59%, resulting in a savings of about 5% of the salary bill. Some states have reduced other allowances, such as leave encashment. And, contrary to popular belief, salaries across states are far from uniform. Table 2.2 shows the starting, base salary for teachers in a number of states: salaries of teachers in some states are 25% less than in other states; these states save up to 10% on their total salary bill as a result. Some states have also saved large amounts by hiring new teachers on a contract-basis, and paying them much less than a newly-hired regular teacher gets: perhaps half or sometimes even one-fifth. The "para-teacher" phenomenon is most famous and extensive in Madhya Pradesh but has now spread to most states. Many para-teachers have exactly the same qualifications and responsibilities as regular teachers. Evaluations (summarized in Box 2.1) suggest that these fiscal savings do not result in any loss of quality: para-teachers seem to deliver a quality of service that is not necessarily high, but not any lower than that provided by regular teachers. Thus the para-teacher phenomenon appears to be a rational response by state governments to the excessive premium attached to public-sector

**Table 2.2. Starting Basic Salary of a Primary School Teacher**

| State | Basic Salary( Rs/month) | |
|---|---|---|
| | 1995 | 2003 |
| Andhra Pradesh | 1,010 | 3,750 |
| Karnataka | 1,040 | 3,300 |
| Orissa | 1,080 | 3,600 |
| Punjab | 1,200 | 4,550 |
| Tamil Nadu | 1,200 | 4,500 |
| Uttar Pradesh | 1,100 | 4,500 |

*Note:* These are less than half of average, all-in salaries; they exclude all allowances. *Source*: World Bank (1996); various state governments.

[9] A tracer study in Karnataka (World Bank, 2002) found an "overwhelming aspiration for a government job." Interviews with past and current high-school students revealed that the three things most sought from employment were: placement in the public sector, security of employment, and a 'good designation' or elevated social status (see pp. 16 and 17).

wages. Governments should recognize that para-teachers might naturally graduate to regular teachers, or the distinction between the two become blurred, but should also consider further extending the para-teacher principles to all new hires: lowering entry wages, and making employment contract-based, at least for an initial period of time.

**Box 2.1: Experience with Para-teacher Schemes in India**

An important intervention in education in the last decade has been the introduction of para-teachers: teachers recruited not by the state government but by the local community, typically at much less than the regular pay scale, on annual contracts, for formal as well as alternative schools.

There have been many different para-teacher experiments in India, in many different states. An important feature of these schemes (particularly when new schools are started in previously unserved habitations) is that a local committee (e.g., gram panchayat, village education committee) is given the authority for hiring the teachers. The most famous and largest scheme is the Education Guarantee Scheme (EGS) in Madhya Pradesh, through which para-teachers were made available to communities that did not qualify for a primary school and had no school within 1 km.

Leclerq (2003) and Gopalkrishnan and Sharma (1998) report that the EGS in MP has been especially successful in bringing schools within reach of the tribal population. On student outcomes, the Leclerq study finds that students taught by para-teachers perform similarly on literacy and numeracy tests as students trained by regular teachers, but also that both groups of students perform poorly, and that the quality of teaching is poor in both regular and non-regular schools (as well as private rural schools). Various aspects of Leclerq's study have been criticized by Sharma and Gopalkrishnan (2003), but they do not seem to disagree with his basic finding that the EGS has expanded access without sacrificing quality. Official statistics on pass rates for the board examinations also suggest that there is no difference in performance between EGS and government students (Clarke, 2003). But whether the two populations of students appearing for exams are comparable is not known.

Other studies provide direct evidence that alternative schools operated under para-teacher schemes are operating better, or at least, no worse, than formal primary schools. For example, an evaluation of the 'Shishu Shiksha Kendras' (SSK) scheme of West Bengal by the Pratichi Trust found that SSKs had lower teacher absenteeism (14 percent for para-teachers vs. 20 percent in formal primary schools), higher student attendance, greater parental participation, and a more conducive student-teacher relationship (Rana, Rafique, and Sengupta, 2002). Similarly, based on brief field visits to EGS schools in two districts, Clarke (2003) reports that the EGS program has resulted in clear improvements in classroom process and teacher motivation. Teacher absenteeism, based on this anecdotal account, seems to be much lower, By contrast, the WDR study of teacher absence in public primary schools finds that absence rates do not depend on the type of contract: para-teachers are no more or less likely to be absent from work than regular teachers (Muralidharan, 2004).

**Hiring restraint is justified, even though India's civil service is small by international standards.**

2.9 India's civil service employment is only around 1.2 percent of the population which is low by international standards. The OECD average is 7.7 percent, so that, even with heavy reliance on private-sector delivery mechanisms, one would expect India's ratio to increase as the country develops. The low level of civil service employment in India is consistent with large observed under-hiring in various areas. The pupil-teacher ratio in primary schools in some parts of UP, for example, is estimated at over 70:1 (Shrivastava, 2003). There are other, less publicized areas where India's civil services are grossly understaffed. It is reported that the Delhi Government has only 37 food inspectors to ensure the quality of food produced by over an estimated 450,000 food establishments – a ratio of 12,000 outlets per inspector (Center for Civil Society, 2003). The number of inspectors has apparently not increased since 1960.

2.10 It is one thing to say that over time India's government workforce will and should grow, and a different matter to say that the marginal rupee should today be spent on hiring. There are many cases in which salary spending appears to be too high relative to non-salary spending. As an example, the proportion of salaries in maintenance spending on irrigation in Orissa has increased from 61 percent in 1995/96 to 70 percent in 2001/02; the proportion of salaries in road maintenance for the same state and period has increased from 7 percent to 14 percent. Salary spending is also high in health: 60 percent of total expenditures incurred by the Department of

Health and Family Welfare in Karnataka went to salary payments in 2001/02. In education too, non-salary expenses have been squeezed out over time, even though various studies have found that learning achievements, though not necessarily attendance, appear to be much more responsive to increases in non-salary inputs than salaries (Kingdon, 1996; Pritchett and Filmer, 1999).[10] In most states, salaries are by far the single largest element of expenditure on primary education: they account for about 90 percent of the total in Karnataka, Andhra Pradesh, and West Bengal, for example. And salary spending is not always productive: a number of studies have found high levels of absence by front-line service providers such as teachers and doctors (Howes and Murgai, 2004).

2.11 Moreover, there are two ways the needed increases in employee numbers can be offset by reductions elsewhere. First, it is widely agreed that there are too many support and logistical personnel. These staff are all in Group D, which typically constitute up to one-fifth of government employees. Second, even among skilled staff, there are various areas of gross excess. This is difficult to quantify, but is certainly significant. For example, functional reviews undertaken recently by the Karnataka Administrative Reforms Commission (Government of Karnataka, 2001) found that 45 percent of filled positions in the Irrigation Department, 73 percent in the Public Works Department and 53 percent in the Mines and Geology Department were in excess of requirements. The reviews also found that field workers in the industry and sericulture departments had extremely low average workloads, with estimates ranging between 3-10 days per month. A study of UP's Irrigation Department found that 40 percent of the 82,900 positions in the department were surplus to requirements (FAO/World Bank, 2001). Again, however, one should not overestimate the potential of savings from downsizing in non-priority areas. In many states, about 60 percent of the total staff are in areas (teachers, medical staff, and police) which are likely to expand rather than contract in the future.

2.12 In summary, in the aggregate, India's civil service is small by international standards, and it is likely that public sector employment growth will resume in India once fiscal problems ease. However, one can certainly make a case that (a) for current levels of total expenditure, salary spending is too high and (b) required hiring in priority areas should be significantly offset by downsizing in non-priority areas. Thus continuation of a hiring restraint policy for the medium term seems to be well-justified.

**Targeted retrenchment programs have not been a success in India, but much can be achieved through attrition.**

2.13 Some states (e.g. Orissa, Karnataka), and GoI have offered their civil servants voluntary retirement packages, but have had no takers. Civil servants are reluctant to leave, and governments reluctant to push them to do so. Goa is the only state which has succeeded in actually retrenching civil servants. Some 2,000 civil servants have taken packages in Goa, about 5 percent of the civil service. However, this was more of an early-retirement programme: the majority of departees were aged around 55, and about 40-45 percent of them have been replaced by new, younger hires. Clearly, such a scheme will generate limited fiscal savings.

2.14 That states are only able to control civil service growth by attrition and a hiring ban rather than by active downsizing carries a cost. While some key areas have been exempted from hiring bans, this has been neither in all states nor in all key areas. Many of the poorest states have the biggest hiring needs. Even if one exempts teachers, medical staff, and police from a hiring ban, that leaves many other important areas increasingly understaffed. Many states have talked about redeploying surplus staff to areas of shortage, but we are not aware of this having actually been put into practice. The aversion to hiring has other negative consequences: a deskilling and aging of government staff; a strong reluctance to hire at the managerial level where capacity is typically completely inadequate; and a reluctance often to hire in tax departments, even if the cost-benefit analysis is strongly in favor of hiring. While these deficiencies should be studied and acted on, the policy of attrition and a selective hiring ban makes a lot of sense if retrenchment is not an option, and it will continue to

[10] Kingdon and Muzzamil (2000) find that in Uttar Pradesh "Between 1960 and 1981, the share of non-salary expenditure in total educational expenditure fell from about 28 percent to 10 percent in secondary education, from 15 percent to 6 percent in junior education, and from 12 percent to a mere 3 percent in primary education" (p.42).

be an important tool of fiscal adjustment. For example, projections for Karnataka show that it will continue to experience retirement of 3 percent and upwards annually, which means that 25 percent-33 percent of the civil service will leave in the next 10 years (World Bank, 2003d).[11] Several other states also appear to show attrition rates in excess of 3%, which, under a zero net hiring policy, allow significant scope for expansion in priority areas, such as health and education.

**A feasible reform program, based on wage and hiring restraint, can deliver significant fiscal savings: 2 percentage points of GDP over the coming decade.**

2.15 The above salary and pension reforms are admittedly partial. There is no active downsizing or rightsizing, and there is no effort to reduce wage compression (Das, 2001). Nevertheless, the reforms are proving quite effective in freeing up resources. Andhra Pradesh (AP) provides an example of this. Its core civil service is estimated to have declined by an annual average of 2.4 percent in the past three years.
As a percentage of GSDP, salaries are estimated to have fallen in AP from 5.5 percent in 2000/01 to 5.2 percent in 2001/02 and 5.0 percent in 2002/03, and are projected to continue to fall to 4.0 percent in 2006/07. Taking all states together since 1997, state employee strength shows an overall, marginal reduction of 0.7% (EWP, 2002). If the policy of net hiring can be sustained, and if salary increases could be restricted to the rate of inflation, then the combined state salary bill can be expected to fall from 4.3 percent of GDP in 2001-02 to 3.4 percent after 5 years, and to 2.3 percent after 10 years.[12]

2.16 The emphasis we give to salaries is not because we are anti-employee, but because of the importance of salaries to state government. The reforms we endorse here are mild ones – we are making a case neither for real wage cuts nor for forced retrenchment, both common responses in most countries to fiscal deterioration. They are the minimum required for India's state governments to recover their fiscal health, and improve expenditure productivity.

**Pensions are a rapidly-mounting liability, but states have shown that they can be contained by both immediate (parametric) reforms and longer-term (structural) reforms.**

2.17 Pensions are another major expenditure item (about 7.5% of total expenditure) and source of fiscal vulnerability. The annual average increase in pension spending was 30% between 1995/96 and 2000/01 making pensions the fastest growing expenditure item in state budgets. Two types of reforms are underway: structural reforms to enable shifting to a cheaper and less fiscally-risky defined-contribution scheme; and parametric reforms to contain the cost of the current pay-as-you-go system.

**Joining the GoI defined contribution scheme will deliver the states major fiscal gains in the future; these gains can be brought forward by shifting recently recruited employees to this scheme.**

2.18 GoI has announced the introduction of a defined contribution (DC) scheme for new civil servants, a scheme that will also be open to interested state governments, and the unorganized sector on a voluntary basis. Several state governments have indicated their willingness to shift to a DC scheme, and some have already announced that new employees will no longer be eligible for the old, defined benefit scheme (Maharashtra, TN, HP). The pension reforms recently introduced in Tamil Nadu are discussed in greater detail in Box 2.2. While it is important that the scheme be designed prudently to protect the employee from undue investment risk, the proposed new scheme has the potential to deliver major fiscal gains. Rough calculations suggest that the net present value of savings to government of each new employee who switches to the new scheme is more than 30% of the net present cost of putting the new employee under the existing defined benefit scheme. However, if restricted to new civil servants only, the shift to a defined contribution scheme will have no positive fiscal

[11] This is based on a demographic census of existing staff. No net hiring is assumed to 2005, after which growth of the civil service is assumed to equal population growth. Sen and Swain (2002) find a lower attrition rate of 2% for the central government. Tamil Nadu also shows an attrition role in excess of 3%.

[12] We assume 10 percent nominal growth in GDP, and 4 percent inflation.

impact for 30 years or more (assuming that new employees join at the age of 30 or less, and retire at the age of 60). Buy-outs of existing employees could increase and bring forward the fiscal impact of the scheme, but these would have to be voluntary for existing staff (and thus fiscally neutral if staff are rational) unless governments take advantage of the fact that no pension entitlement accrues without a minimum length of service, often at least 10 years, and force all those with less than that length of service to switch.

**Parametric pension reforms aim to bring about savings by tinkering with the existing pay-as-you-go pension system, and can deliver large fiscal savings when needed, namely now.**

2.19 Several states have brought in parametric pension reforms in the last year or so, the mostly highly-publicized being Tamil Nadu (see Box 2.2) whose employees went to strike over the issue. Attempted and possible reforms include the following (see also RBI, 2003):

- *Use of longer averaging periods for the calculation of benefits:* Some state governments use the last month's basic pay to determine pension levels. Others have followed GoI's lead in using the average of last 10 months of basic pay rather than the last basic pay drawn as the reference wage for pension determination. A shift from 10 months to a 36-month period as recommended by the Bhattacharya Committee (RBI, 2003), if not a lifetime earnings definition, could also be considered.
- *Use of a lower limit for the maximum amount of pension which can be taken as a lump-sum (commuted), at retirement.* India is one of a few countries with a practice of "commutation," which allows retiring civil servants to take a portion of their pension as a lump-sum at retirement. States save from any reduction in this limit, at least in cash-flow terms and often in net present value (for reasons given in the next point). The commutable percentage is as low as 20 percent in some states, and as high as 40 percent in others.
- *Use of a higher discount rate and a more realistic set of life-tables to calculate the value of the lump-sum (commuted) pension.* Some states still use a nominal rate of 4.75 percent discount rate for this calculation, below what is available in the market today, and also use outdated life-tables (generally 1971 Postal Life Insurance mortality tables) which are actuarially unfair in favor of the pensioner. Other states have shifted to a higher discount rate, and updated their life-tables.
- *Reduction in leave encashment limits* reduces the payout required from government at the time of retirement to employees who have saved up their leave. This ranges from 180 days in some states to 300 in others.

2.20 The most important parametric reform is to index pensions only to prices and not to real wages; what this implies in practical terms is that any pay commission, if constituted, should confine itself to real adjustments in the wages of civil servants currently employed. Simulations from Karnataka show that if only price, rather than wage, indexation is used in the future, and if commutation parameters are updated, then growth in the Karnataka pension bill can be limited to GDP growth for the next decade (World Bank, 2003d).

**Better data on pensions, and a model for forecasting liabilities and simulating reforms are also needed.**

2.21 Governments typically have poor data on pensioners. Data published by the Government of Karnataka (2003) shows a decline in the number of pensioners from 395,000 in 2000-01 to 249,000 in 2002-03, reflecting the information the government received from undertaking a census of pensioners. Weak data suggests poor control, and opportunity for abuse of the system (Sen and Swain, 2002). Improving data and controls will likely result in substantial savings.

2.22 Most states are also completely in the dark as to the future course of their pensions, since they have no data on the demographic profile of either pensioners or civil-servants. Several states, notably Karnataka, AP, and Tamil Nadu, have developed pension projection models, and GoI is now encouraging other states to follow suit. An integrated view is required, not just of the state civil service, but of other state organizations whose

employees have pension entitlements. In the case of Tamil Nadu, the latter category makes up one-third of total pensioners (Box 2.2).

**Box 2.2 Tamil Nadu Pension Reforms**

Tamil Nadu has been a pioneer in pension reforms in India. In April, 2003, it introduced a number of changes to the pay-as-you-go system which funds the pensions of current employees, and put all new hires under a defined contribution pension. The table below summarizes the major changes.

**Key Changes to Pension and Retirement Benefit Provisions**

| | Before Reform | After Reform |
|---|---|---|
| **Defined Benefit Provisions** | | |
| Coverage | All government servants | Only for government servants appointed prior to April 1, 2003; thereafter, no new entries permissible. |
| Qualifying service for full pension | 30 years | 33 years |
| Commutable pension | Up to 40% | Up to 33 1/3% |
| Reference wage for pension determination | Last basic pay drawn | Average of last 10 months of basic pay |
| **Defined Contribution Provisions** | | |
| Coverage | Not applicable to government servants appointed prior to April 1, 2003 | Applicable to government servants appointed on or after April 1, 2003 |
| Contributions | Not applicable | Within a range of 7.5% + 7.5% to 10% +10% by employee and employer, respectively |
| General Provident Fund (GPF) | 10% of basic wage for government servants appointed prior to April 1, 2003 | 0% for government servants appointed on or after April 1, 2003 |

Tamil Nadu also undertook a major data collection exercise into all types of pensioners. This showed the large number of employees outside of the regular civil service (almost 1/3 of the total) which would nevertheless be eligible for pensions – pensions the state government will have to pay.

**Groups with Claims to Civil Service-type Pensions**

| Groups | In Service Employees | Service Pensioners |
|---|---|---|
| Civil service (incl. govt. teachers, aided institutions) | 696,668 | 290,843 |
| Local bodies (urban and rural) | 72,384 | 27,470 |
| Electricity board | 86,542 | 32,636 |
| Transport board | 117,972 | 6,688 |
| Other statutory boards | 20,343 | 5,889 |

## III SUBSIDIES

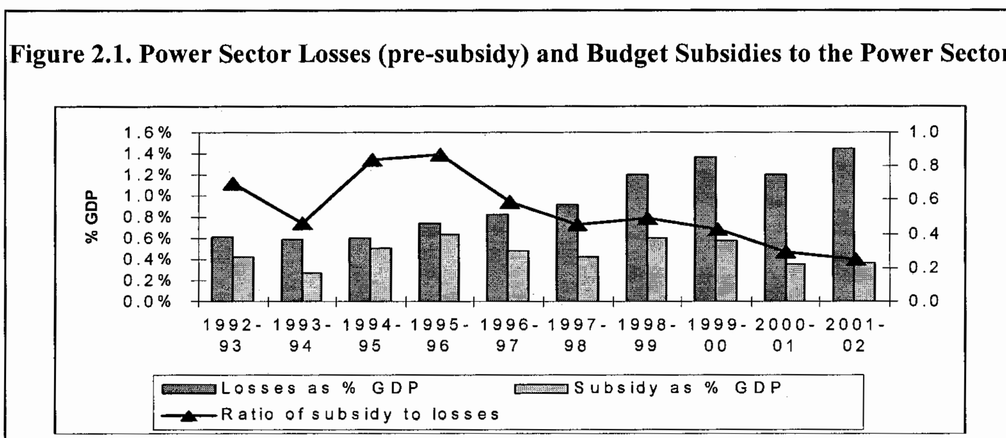
**Subsidies have proved difficult to cut, largely for reasons of political economy. The power subsidy is the largest state-government subsidy, and provides a good example of the difficulties involved in reforming subsidy regimes.**

2.23 Subsidies are typically the prime candidate for expenditure cuts, but reducing subsidies has been a surprisingly difficult task – surprisingly difficult against the hopes and expectations of many governments and analysts, but not against the backdrop of international experience. The largest state subsidy is for the power sector: this reached about 1.4% of GDP in 2001/02. Large implicit subsidies are provided for the irrigation and higher education sectors, while explicit subsidies are provided by many states for public transport, housing and food. Since the power sector subsidy is the largest, and most intractable of the subsidies, we focus on it here, as the analysis illustrates many of the broader points about reform of subsidy expenditure and management.

**The power subsidy is large and growing, but brings few benefits.**

2.24 The best measure for fiscal burden of the power sector is not the budget subsidy paid by governments to the state utilities, which is frequently artificially repressed, but the gap in the power sector between costs and revenues (before subsidy). As Figure 2.1 shows, the latter variable has grown much more quickly than the former. Whereas subsidies paid from the budget have more or less remained stagnant as a percentage of GDP, actual losses have increased from 0.6% of GDP in 1992/93 to an estimated 1.4% in 2001/02. The ratio of subsidy paid to losses made has fallen from 0.7 in 1992/93 to an estimated 0.25 in 2001/02. With a declining portion of losses funded by the budget, losses have been increasingly financed by borrowing, including accumulation of arrears.

**Figure 2.1. Power Sector Losses (pre-subsidy) and Budget Subsidies to the Power Sector**




2.25 There are various causes for the high and growing level of financial losses in the power sector, including inefficient operations (reflecting under-investment) leading to a high level of technical losses, and theft of power. Also important are high level of subsidies to two consumer groups who pay below-cost tariffs: households and farmers. The World Bank (2003c) estimates that on average households pay 60% of the cost of supply, and farmers 10%. These two subsidized groups are significant consumers of electricity. In Karnataka, for example, households are currently estimated to consume about 14% of total supply, and farmers about 28%. The Planning Commission estimates that the implicit subsidy to agricultural consumers was Rs 30,500 crore in 2001/02 (1.3% of GDP), while that to households was just over Rs 10,000 crore (0.4% of GDP); much of this is paid for by cross-subsidies from industry, which pays above-cost tariffs. The mix of problems varies from state to state, depending on the levels of the transmission and distribution (T&D) losses, and on the share of agriculture in total consumption.

2.26 The financial burden the power sector imposes on government brings with it few benefits. Indian industry pays world-record prices for low-quality electricity. Indian farmers get very cheap power, but at very poor quality. A recent survey of farmers (Public Affairs Centre, 2003) ranked satisfaction with money-lenders – often regarded as exploitative by analysts – far in excess of satisfaction with electricity services (or irrigation). Indeed, Indian agriculture is stuck in a low-price, low-quality electricity-supply equilibrium. The World Bank (2001) study of electricity supply to Haryana simulated the impact of tariff increases with and without improvements in the quality of electricity supply, and found that improvements in quality of supply could more than compensate farmers for a quadrupling of tariffs. The electricity subsidy is also highly regressive. A study of Karnataka by Howes and Murgai (2002) showed that only 9 percent of this subsidy benefited poor farmers. The rest went to farmers above the poverty line. Similarly, only 10 percent of the subsidy benefited scheduled caste or tribal families. The study found that, on average, large farmers who own irrigation pumpsets receive a Rs 29,000 subsidy per year, roughly 10 times the amount that each household would receive if the subsidy were distributed equally amongst all households in rural Karnataka. Similar results have been found for other Indian states.

**The rationing regime which governs the supply of power to agriculture is an enormous source of fiscal pressure and indiscipline.**

2.27 Agricultural supply being unmetered and often free (or close to it) has forced the introduction of a rationing regime for the supply of electricity to agriculture. Even if payments are required for electricity, if they are lump-sum, as they typically are, the marginal cost to the consumer of an additional unit of consumption is zero, and consumption has to be restricted by the producer to affordable limits, which often means just a few hours. This aspect of the electricity regime in India is not only clearly damaging for agriculture, and more generally rural development, but does great harm to the fiscal position of the states which are under constant pressure to supply more electricity to farmers, and which therefore typically do supply whatever is available, whether or not it is affordable or optimal. Whatever progress states might make either in improving their budgetary position or in reducing power sector losses outside of agriculture, or even in increasing agricultural tariffs, stands to be undone by the provision of additional supply to agriculture. Decisions on quantity of electricity to be supplied are never made by Finance but rather at the political level or by the utility itself: this despite the fact that Finance is the effective purchaser of power to farmers, and therefore has a legitimate, if not over-riding, interest in this issue. It is indeed ironic that finance departments around the country establish labyrinth prior-approval procedures, but are simply presented with a bill at the end of the month or year for power sector losses. It is not surprising, therefore, that one often sees a stand-off between Finance and the utility, and that, even if the utility is acting under political guidance, Finance frequently refuses to foot a subsidy bill which undermines the budget (and which, it is suspected, will only add to indiscipline and losses in the sector). This also explains why the power sector is so much more fiscally damaging to a state government than irrigation, whose variable costs (labor, repair contracts) are much more under Finance Department control.

**The biggest problem facing the power sector is the lack of commercial discipline which permeates the sector.**

2.28 Commercial discipline is lacking first in the utility-customer relations – non-paying customers are frequently not disconnected, and bills are often not paid – and second in the government-utility relationship – governments typically fail to compensate utilities for the losses incurred by them due to the supply of power at non-remunerative rates.

**There has been some recent progress –in some cases spectacular -- in reducing power losses, but not in agriculture.**

2.29 There has been some progress over the late nineties and into the new millennium in reducing the losses involved in the sale of electricity to households, and, more generally, the non-agricultural sector. A number of states have established independent regulators (21 at last count), imposed significant tariff increases, enforced collection of bills, cracked down on power theft, and ensured universal metering of domestic connections. Some states have shown spectacular results from such a strategy (Andhra Pradesh for example), and there are some signs at the aggregate level that the pattern of rising losses was reversed in 2002/03 (Rastogi, 2003). However, whether is a reversal that will be sustained remains to be seen. Reform of the power sector in agriculture has been a case-study of repeated failure, as Box 2.3 illustrates. Until this problem is solved, there can be no lasting solution to the problems of the power sector, since agriculture will continue to threaten to absorb whatever savings are made in the non-agricultural sector. Yet this history of repeated reform failure itself implies that there are no easy or guaranteed solutions: if there were, they would have surely been tried.

**Box 2.3. Attempts to increase the agricultural tariff: a history of repeated failure**

At the national level, a long sequence of resolutions has remained unimplemented:

- A conference in 1992 of state electricity ministers resolved to adopt a minimum tariff for agriculture of 50 paise, and this was when average cost of supply was estimated at close to 1 Rs. 50 paiseper unit is still regarded as a benchmark today, which very few states achieve, even though the average cost of supply (generation only) is now closer to Rs 2.

- The National Development Council in 1993 resolved that state governments would adopt a minimum all-India agricultural tariff, and that the subsidies to agriculture would be gradually phased out.
- In 1996, the Common Minimum Action Plan for Power stipulated that no sector shall pay less than 50 percent of the average cost of supply. The tariff for the agricultural sector would not be less than 50 paise per KwH, and would be brought to 50 percent within 3 years. These provisions were reflected in the central draft Electricity Regulatory Commission Act, but withdrawn due to the opposition of some state governments, in particular Tamil Nadu.
- The Chief Ministers' Meeting of 2001 resolved that "it is necessary to move away from the regime of providing free power.

At the individual state-level not much progress can be observed even in states otherwise regarded as reforming. This can be illustrated by looking at five states which in the past have had "free power" policies. All five have now moved away from free power, but, as we will see, only just:

- In Karnataka, though tariffs have been increased, collections are so low that power might as well be free.
- In Tamil Nadu, 75% of farmers get a refund for their power bill equal to or greater than their bill payment.
- Madhya Pradesh has significantly increased tariffs from their zero level of a few years ago, but a full write-off of arrears announced at the end of 2003 has again returned to the state to free power.
- AP has a low, non-zero tariff for farmers, but this has not been increased in the entire period of the state's reform program.
- Punjab introduced a non-zero tariff in 2002, and is now collecting it, and so is probably doing the best of these five states. But it shows no sign of willingness to further increase tariffs from the current cost-recovery level of 20%.

Other reforms normally recommended for the power sector in agriculture, such as metering, have had little more success. As Lal (2003) summarizes, "in state after state, power reform has lurched to a halt the moment it has run up against the agriculture sector, whether it be in the context of subsidies or installing meters to better monitor supply."

*Sources:* Godbole (2003), Gulati and Narayanan (2003), Guhan (1995), Lal (2003)

**To make further progress in power sector reforms, tackling the lack of commercial discipline in the power sector has to be the top priority; without this, no other remedy will work.**

2.30 To take an extreme case, there is little point increasing tariffs if they are not paid. From this perspective, privatization is an attractive option. Private sector suppliers are likely to be less tolerant of non-payment by customers, and more ready to disconnect. Yet, the two privatization experiences so far have shown that this privatization is no panacea. Orissa privatized its distribution sector in 2000, but the benefits from this have been both delayed and limited; Delhi privatized in 2002, and looks more promising, but more time is needed before a definitive assessment can be made. Neither Orissa nor Delhi have significant agricultural loads, so whether privatization of agricultural loads can succeed remains an untested possibility. Privatization carries with it its own risks (particularly arising from the possibility that private providers will under-supply to subsidized customers), but given how politicized the power sector is in rural areas, it is hard to see commercial discipline being introduced into the rural segment of the power sector without it. There are many different forms of privatization which could be attempted, ranging from contracting out of metering and billing at the local level, to introduction of bulk-supply arrangements to groups of farmers or cooperatives, to part or full-sale of existing public-sector utilities. There is no guaranteed recipe for success and more experiments are needed to see what works.

2.31 There are many other reforms required beside privatization, including the reduction of theft and losses, reduction in industrial tariffs, increases in household and agricultural tariffs, improvements in the quality of electricity supply, and the promotion of competition in generation, now enabled by the Electricity Act 2003. Metering of farmers is critical if agricultural tariffs are to be linked to consumption levels. Metering would also enable subsidies to be better targeted, by use of a tariff schedule which increases the per unit tariff with consumption levels. Farmers resist metering, but would perhaps start to demand meters if governments could credibly commit that only metered tariffs would be subsidized. Some states have had at least some success with meter installation, but only to find that the meters are not read (Karnataka), or that mass cheating results in the introduction of metering leading actually to a drop in revenue (Rajasthan). This underlines the futility of adopting reforms if the fundamental issue of increasing the level of commercial discipline in the sector is not resolved.

**The same prescriptions, and implementation difficulties, will apply to reforms of subsidies other than power.**

2.32 There are a number of parallels in the characteristics of different subsidies to those found in the power sector:

- Many subsidies have a basis in agriculture. Irrigation is the other obvious example. Some states also run output price support schemes, such as sugar price support in Uttar Pradesh, and cotton in Maharashtra. A scenario of growing input subsidies and increasing guaranteed output prices suggests that India is shifting to a regime of agricultural protectionism, which in turn implies that any effort to reduce subsidies is unlikely to be easy.
- Subsidies are typically highly inefficient. They might lower prices, but also quality. For example, irrigation services are poor; government housing is often of low quality. One survey (Public Affairs Centre, 2003) found farmer satisfaction with money-lenders higher than with irrigation.
- Many subsidies are regressive. For example, 32% of the canal irrigation subsidies accrue to large farmers who represent 7% of the households that benefit from canal irrigation and less than 1% of all agricultural households (World Bank, 2003d).
- Underneath most subsidies is a lack of commercial discipline. Irrigation is again a classic example, with unmetered consumption, low and lump-sum tariffs, and poor collection efficiency. Lack of commercial discipline also applies to government-utility relationship in many cases. For example, in the transport sector governments often do not pay the subsidy they owe to public bus companies for concessional passes for students; in return, those bus companies do not pay the transport tax they owe government.
- Not all subsidies are increasingly rapidly as the power sector subsidy is. The irrigation subsidy increased from 0.3 percent of GDP in 1980/81 to 0.4 percent in 1990/91 and by 1999/00 had fallen back to 0.3 percent,[13] likely because of the slowdown in irrigation investments. Several states have had success in cutting food subsidies. Box 2.4 describes the case of Tamil Nadu. There is no data on housing subsidies, but the increasing popularity of free rural housing schemes suggests they are growing rapidly, despite an almost complete lack of economic rationale.

2.33 Given the similarities, the same prescriptions also will apply to reforms of subsidies other than power, the most important of these being the need to promote commercial discipline by distancing the service-providers from government, through mechanisms such as corporatization and privatization. Yet the same implementation difficulties are again likely to be encountered. In irrigation, for example, the reform mantras are similar to those in the power sector, and actual implementation of these reforms has been equally lacking. Several states have increased tariffs, and a lot of emphasis has been put on the establishment of water-user associations which could act as bulk buyers of water and operators of the system within their area. But the results have in many cases been disappointing. AP, a reform leader in this as in so many other areas, increased water tariffs three-fold in 1996/97, and established 10,000 water-user associations across the state (Gulati and Narayanan, 2003). However, collection efficiency (the ratio of collections to demand) has fallen, and now languishes at around 30 percent. Moreover, the water-user associations were suspended for the most part of 2003 owing to a delay in elections for WUA office-holders, a strong indication that these associations, rather than commercializing the irrigation sector, have in fact themselves become politicized.

**Perhaps the most important lesson from the power sector for the issue of subsidy reduction is that subsidies are here to stay. This suggests more attention be given to subsidy management.**

[13] Calculated from Gulati and Narayanan (2003), Table 5.2, using the Vaidyanathan Committee method.

2.34 Just as hiring and real wage restraint is a more feasible strategy for controlling salaries than wage cuts or downsizing so too, in many cases, maintaining subsidies at their current levels will be a major success. There has been some success in reducing food subsidies (Box 2.4), partly through better targeting, and partly through GoI making more cheap grains available. But many subsidies will remain large claimants on government spending. State governments should focus more on improving subsidy management and targeting; this together with improving commercial discipline in subsidy-receiving sectors will have major efficiency gains which will themselves result in substantial subsidy savings.

**Box 2. 4 Food subsidy reforms in Tamil Nadu**

Tamil Nadu's food subsidy grew by 19.5%, on average, each year from 1990/91 to 2000/01; the subsidy reached Rs.1,540 crore in 2000/01, accounting for 8.5% of the state's revenue. In 2003, a number of reforms were introduced to reduce the rice subsidy. As a result, its cost is estimated to have fallen by half in nominal terms to Rs 800 crore in 2003/04. The reforms include:

- ***Withdrawal of state procurement.*** The GoTN withdrew from paddy procurement in favor of the Food Corporation of India. This ended an arrangement in which GoTN basically procured whatever was offered to it, resulting in over-stocking and wastage.
- ***Abolishing additional production incentive.*** The GoTN abolished the 8% markup over GoI's minimum support price for rice procurement from farmers.
- ***Better targeting.*** The government devised a self-selection process by which every family was given a choice to opt out of PDS rice in exchange for additional sugar/kerosene. This was followed by issue of rice coupons twice, in July 2002 and July 2003, which reduced the number of PDS rice-consuming families from 16 million to about 10.4 million.

## IV PUBLIC ENTERPRISE AND DEBT RESTRUCTURING

**Public enterprise (PE) reforms – closure and privatisation – will not provide large, immediate fiscal gains, but will prevent the future build up of utilities, and will prevent the need for budgetary support to keep loss-making public enterprises afloat.**

**Table 2.3: Enterprise restructuring by state**

| Name of state | Approx. no. of state level public enterprises (PEs) | PEs identified for disinvestment/ winding up/ restructuring | PEs in which process initiated | PEs Privatised | PEs closed down | PEs restructured |
|---|---|---|---|---|---|---|
| Andhra Pradesh | 128 | 87 | 79 | 13 | 12 | 6 |
| Bihar | 54 | 6 | 6 | 0 | 0 | 0 |
| Gujarat | 54 | 24 | 24 | 3 | 6 | 0 |
| Haryana | 45 | 8 | 6 | 1 | 4 | 0 |
| Karnataka | 85 | 39 | 20 | 2 | 11 | 0 |
| Kerala | 111 | 55 | 40 | 0 | 10 | 0 |
| Madhya Pradesh | 26 | 14 | 14 | 1 | 0 | 0 |
| Maharastra | 65 | 11 | 4 | 0 | 0 | 0 |
| Orissa | 72 | 33 | 10 | 9 | 11 | 0 |
| Punjab | 53 | 11 | 11 | 1 | 6 | 0 |
| Rajasthan | 28 | 10 | 6 | 1 | 1 | 0 |
| Tamil Nadu | 59 | 29 | 29 | 0 | 7 | 2 |
| Uttar Pradesh | 41 | 25 | 25 | 1 | 14 | 1 |
| West Bengal | 82 | 15 | 15 | 0 | 0 | 0 |
| **Total** | **903** | **367** | **289** | **32** | **82** | **9** |

***Source***: Ministry of Disinvestment website, 2004.

2.35 The budgetary burden of public enterprises (PEs) is very difficult to estimate, but surely significant. The fiscal burden can be computed by comparing the actual return on government enterprises – frequently negative –

with a "market reference". Calculations carried out by the Government of India for 1997/98 showed the implied subsidy to state level PEs to exceed Rs 1,000 crore for the 14 major states. However, these costs are largely sunk, and it is unrealistic to think that PE reforms will result in firms producing profits for governments. Rather the aim should be to prevent further unproductive investments from occurring and future losses accumulating. Moreover, there is slow, but steady leakage of funds from governments to PEs. These are basically transfers and concessions made to keep sick PEs alive; in extreme cases, governments make transfers to enable PEs to make salary payments. In Karnataka, for example, it has been computed that, even excluding foregone returns, Rs 600 crore was lost to 5 of the largest enterprises over a ten year period. Beyond the fiscal imperative, PE restructuring is also warranted from the perspective of removing governments from activities where there is no basis in public policy for their involvement. If this rationale is accepted, profit-making enterprises should also be put on the block.

**Most state governments have launched some sort of restructuring program for their public enterprises; the leaders include AP and Orissa.**

2.36 According to recent GoI data, 14 states have identified 367 state-level PEs (about 1/3 of the total) for privatization/closure (Table 2.3). Of these, the process has been initiated in 289 state-level PEs. AP, Karnataka, Kerala and West Bengal account for nearly half of all PEs, and all are actively pursuing reforms in this area. There have been more cases of closure than privatisation: partly it is less political, partly states have few viable privatisation candidates. Box 2.5 discusses the successful experience with public enterprise reform in AP.

**Box 2.5: Public enterprise reform in Andhra Pradesh**

Andhra Pradesh began to reform the state PE sector in 1999 after the state government concluded that public resources should not be used for activities where the private sector can perform more competitively and no compelling social or environmental reasons warrant a public presence. A quasi-independent privatization secretariat and implementation committee were set up, under the direction of the state, and a cabinet committee set up to vet PEs selected for liquidation, restructuring, or privatization. The procedures for evaluating PE assets, preparing tendering documents for competitive bids, and evaluating and awarding bids, was set up in the implementation secretariat. In parallel, the state also established procedures for providing retirement payments to PE employees who would lose their jobs, as well as elective job training and placement assistance to help laid off workers find new employment.

Between 1999 and April 2004, AP successfully liquidated, privatized or restructured 39 PEs, ranging from operating sugar factories and fertilizer factories, to agro industry and handicraft corporations. Already US $30 million in gross proceeds has been realized from the sale of assets and another $40 million from divestment Over the next two years an additional 45 corporations, cooperatives, and enterprises with minority government ownership are scheduled for processing.

Several factors have contributed to these achievements, including political support from the top, the creation of an Implementation Secretariat with a commitment to the program, and technical assistance to build institutional capacity and provide advice. Part of its success comes from putting in place the VRS and social safety net program to compensate employees for the loss of jobs and assist them in finding alternative employment. As of April 2004, over 22,000 employees have taken VRS.

**Experience teaches the importance to successful PE reforms of political commitment and institutional capacity.**

2.37 Some of the lessons learnt from the state-level PE restructuring experience include the following:

- Political commitment to the process is critical, since every PE will have a reason to not be to included.
- Institutional arrangements do not substitute for political commitment, but are also important. Establishing a dedicated unit with the mandate and capacity to implement the state's restructuring policy helps. It is no co-incidence that the two leaders in PE reform – Orissa and AP – have both benefited from extensive consultancy support in this area.

2.38 The failure of VRS in the core civil service stands in contrast to the widespread use of VRS for public enterprise employees: the difference being perhaps that enterprises, unlike government, can be closed or sold, and thus enterprise employees have far less job security than core civil servants. States have displayed widely varying degrees of generosity in their severance payments (Table 2.3), though there is no evidence that states with lower severance payments have found it more difficult to attract VRS candidates.

**Table 2.4: Total redundancy compensation by State**

| | Andhra Pradesh | Uttar Pradesh | Madhya Pradesh | Orissa | Karnataka | Central Government |
|---|---|---|---|---|---|---|
| Total Compensation | 366,175 | 418,500 | 359,226 | 195,346 | 433,899 | 694,190 |
| Average monthly salary | 7,486 | 7,616 | 6,038 | 4,329 | 5,771 | 10,968 |
| VRS as months of salary | 19 | 24 | 29 | 10 | 36 | 31 |
| *Total compensation as months of salary* | *48* | *54* | *59* | *45* | *75* | *63* |

*Source*: World Bank (2003f)

**Interest savings will largely follow from reduced borrowing, but states can also take advantage of a low interest rate regime by aggressive debt-restructuring.**

2.39 Some of the negotiated loans the states have taken allow for pre-payment; and put options on off-budget borrowing can be exercised. GoI has opened a window to allow for swapping high cost GoI and small saving debt. GoI could also help by allowing states to fund debt-restructuring by additional market borrowing – but on the basis that the states approach the market on their own, and on the basis of a credit rating – or access to adjustment lending available from external agencies. Chapter 4 provides a further discussion of debt restructuring, while Chapter 5 examines the impact of different fiscal adjustment paths on the interest burden.

## V REFORMS TO IMPROVE THE QUALITY OF SPENDING

**The quality of spending must and can be improved**

2.40 The strength of the case for increasing spending levels in health, education and infrastructure depends on the extent to which quality can be improved. Quality is undermined by various problems, including: skewed composition of spending towards salaries, a regressive distribution of benefits; low civil-service productivity, as evidenced, for example, by very high absence levels of service providers; high levels of corruption; an ineffective spread of funds over too many projects; and duplication of services provided by the private sector. What can be done to improve the quality of spending? Although the problems are legion, Indian states have also made some remarkable achievements in this area. We highlight some common themes and examples of ways in which expenditure efficiency can be improved across sectors. These are essentially ways in which both citizens and policy makers can provide service-providers with stronger incentives to deliver effective services.[14]

2.41 Perhaps the most important message of this section is that the quality of state government expenditure can be improved. While there is much cynicism on this subject, much of it is no doubt well deserved, India's states have many remarkable achievements. These need to be rolled out across the country. Some of the recent success stories on expenditure quality reforms are culled out in a special annex to this chapter, which consists of a series of 7 case-studies. At the same time, it would be naïve to embrace every governance initiative as a success story. Many initiatives fail: e-governance projects are particularly prone to failure worldwide, and India is no exception to this rule. The first case in the Annex to Chapter 2 provides some examples of this. One can

[14] See the 2004 World Development Report on service delivery for a theoretical framework. This topic is also being explored in more detail in a volume under preparation which highlights and seeks to explain recent improvements in service delivery in India.

find plenty of other examples where reforms have been introduced, but have failed to yet make much of a dent on ground reality. Passage of right-to-information legislation in some states would probably also fall into this category (Case 2). But this does not mean that such initiatives should not be attempted: strategies which fail in one scenario can succeed in another. In a scenario where there are no clear solutions, a widely-based, multiple-pronged strategy is a prudent one. In this spirit, we present some of the key reforms open to government to improve the quality of spending: agency-specific reforms to increase efficiency; cross-cutting institutional changes; and public expenditure management reforms.

**Agency-specific reforms including an increased role for the private sector can improve service delivery**

2.42 Most government products and services are delivered by government agencies, most of whose performance levels leave a lot to be desired. Governments face two choices: either to get these agencies to work better under state-government ownership, or to transfer responsibility for the service – either by sale, liberalization, or decentralization – to the private sector or local government. If public control is retained, public agencies need to be pressured to reengineer their processes to improve efficiency and reduce discretion, including through the introduction of e-governance, to gear up to meet improved service standards embodied in agency-specific citizen charters. If the private sector or local governments are involved, contracts, regulatory systems, and local-level fiscal and accountability frameworks have to be given careful attention (World Bank, 1999, 2003e). Experience indicates that both approaches can be successful: Case 3 gives examples of each from the health sector. Several states have shown that public-sector performance can be improved, though the positive experience, or at least the evidence for it, is mainly limited to urban areas so far: see Case 4 on Bangalore for an example. Concerning private sector involvement, there is a range of success stories, from privatization of solid waste management in some cities to outsourcing of roads maintenance under performance contracts. Even if governments are not ready to privatize entire services, individual service components can be outsourced. Several states now outsource the maintenance and cleaning of public hospitals, for example (Case 4). At the same time success is not guaranteed, whichever reform route is taken. There are many citizens' charters which are produced, but not disseminated. And there are cases of privatization which have been less than successful, for example in the power sector, as discussed earlier. Much depends on the enabling environment, to which we now turn.

**The broader enabling environment is key to improving service delivery and the quality of spending**

2.43 Whether services are delivered by the private sector, local government, or state government, success or failure will very much depend on the broader environment within which such services are provided. Especially where the private sector is already a predominant supplier (as in the case of the health sector), focusing on the enabling environment and providing effective oversight and information can be as or more important than the government's own funding. Some of the key reforms in this regard include:

- *Promoting cost recovery and commercial discipline.* Unless there are compelling efficiency and equity arguments to the contrary, and of course sometimes there are, governments should try to make services self-financing, and should increase charges for better services. As already discussed, however small the actual charges levied, the government should refuse to provide services to those who do not pay. Promoting commercial discipline is also key in government-provider relations: outputs need to be clearly specified, and full payments made in return.

- *Encouraging citizen demand for better services*: Encouraging civil society to actively monitor government performance and promises at both the micro and macro level holds tremendous promise. The rapid improvement in Bangalore's service delivery owes a lot to this approach (see Case 4). At the micro level, the rapid improvements in education in Himachal Pradesh are held to be in large part due to high parental demand for good education (PROBE 1999). Campaigns at the local level to hold government officials more accountable and to make information about beneficiaries public have also been successful. Conversely, lack of demand for better health services is often linked to lack of awareness of health status and issues, e.g. that

contaminated water and indoor smoke are harmful to health. While clearly states with more active civil societies will benefit most from such pressure, governments can also take steps to give civil society "voice", for example by regularly placing information about public services in the public domain, as was done in Bangalore. The entire thrust towards decentralization can also be interpreted in this light.

- *Increasing transparency*: Some states have adopted legislation to make procurement processes more transparent (Karnataka, TN) and to provide a legislative basis for the public's right to information (Delhi, Rajasthan, Tamil Nadu, Karnataka, Maharashtra and Goa). It would be naïve to think either that simple passage of legislation would eliminate corruption from procurement or open up all government secrets to the public. However, there is anecdotal evidence that procurement legislation has helped promote competition and deliver savings to government. A recent survey of right to information implementation in India (Case 2) indicates it has also played a limited though useful role in at least some states. But passing legislation is only one part of a strategy for transparency. Governments need to make much more information available on a regular basis, following agreed rules; and need to overhaul institutional structures to reduce the scope for discretion and corruption. Tamil Nadu's drug procurement reforms are a good example of what can be done in this regard (Case 5).

- *Cracking-down on civil service transfers and leaving reform champions in place* Mass transfers breed corruption through a market for postings, while managerial transfers undermine the potential impact of reform champions. Table 2.5 gives an example of the magnitude of the latter problem, by showing the number of project directors for a World Bank funded project over a three-year period: average tenure across 5 states ranges from 3-8 months. Several states have shown that both the volume and the discretionary nature of mass transfers can be reduced through the introduction of strict rule-based systems, especially if they are computerized (AP, Karnataka, TN). Reducing managerial transfers seems much more difficult, but there is no reason why the same approach of introducing minimum tenures and a rules-based system could not be introduced provided the requisite political commitment to improving service delivery is in place.

**Table 2.5 Average Tenure of Managing Directors of Rural Women's Empowerment and Development Project (1998-2001)**

| State | Number of MDs | Average tenure (in months) |
|---|---|---|
| Bihar | 3 | 8 |
| Gujarat | 7 | 3.1 |
| Karnataka | 4 | 6 |
| MP | 4 | 6 |
| UP | 5 | 4.8 |

*Source:* Rao Seshadri (2003)

- *Establishment of a strong and independent anti-corruption commission.* Most states have anti-corruption agencies, but very few of them are strong, independent and effective. Karnataka has shown what an independent and dynamic anti-corruption agency can achieve (Case 6), not so much by prosecuting corruption charges – a formidable challenge given India's creaking judicial system – but by launching high-publicity raids, and thereby putting pressure on government and its agencies to reform.

**Improving the expenditure management framework within which the state governments operate will be critical to improve the effectiveness of government spending. Important experiments to improve financial accountability are now underway.**

2.44 The Bank has recently undertaken a series of *State Financial Accountability Assessments*, from which a number of lessons have emerged on public expenditure reforms:

- *Budget realistically, and implement the budget as passed.* A good budgetary set-up is one in which it is difficult to get some project into the budget, but then implementation, post-budget- approval, is automatic. In most Indian states, the opposite is the case. States are endemically over-stretched, and their reach far exceeds their grasp. Any number of initiatives are introduced, and then under-funded. This shows up in a number of ways. As Table 2.6 shows, budget revenue estimates are systematically overly-optimistic: for the

four-years ending 2001/02, budget revenue estimates exceeded actuals by an average of 9%. The systematic nature of this bias suggests that the problem is a political one, and that revenue forecasts are inflated to allow artificially high expenditure levels to be projected. And then during the year, new projects are added through policy pronouncements and supplementary budgets, which often add another 5-10% to total spending. The result is that not only do deficits exceed targets, but cash and administrative rationing have to be used to prevent too many budgeted projects from actually proceeding. Projects thus lie incomplete, huge arrears of unpaid bills pile up, and enormous amounts of administrative time is consumed in persuading Finance to release funds. The most important PEM reform which state governments could undertake would be to base the budget on realistic revenue forecasts, to restrict new policy initiatives to the budget period, and then to relax post-budget central controls on spending.[15] This is harder than it sounds. It requires very tough decisions to be made on what governments can and cannot afford to do, and strong political leadership over and ownership of the budget.

**Table 2.6: Deviation of actuals from budget estimates, 1998-99 to 2001/02**

| | 1998/99 | 1999/00 | 2000/01 | 2001/02 | Average |
|---|---|---|---|---|---|
| **Total Revenue (I+II)** | (15.11) | (6.25) | (2.93) | (11.76) | (9.01) |
| **I. Tax Revenue** | (14.54) | (7.15) | (4.56) | (13.05) | (9.01) |
| **State's Own Non Tax Revenue** | (14.64) | 2.04 | (0.30) | (3.21) | (9.01) |
| **Share in Central Taxes** | (18.47) | (3.97) | (0.14) | (24.23) | (9.01) |
| **II. Non - Tax Revenues** | (16.61) | (4.08) | 1.05 | (8.69) | (9.01) |

- *Enhance departmental accountability and flexibility in the budgetary process.* In India's states, budgets are typically put together by scheme, rather than by department, and there is little discussion of what the objectives or desired outcomes are. Departments could be given more flexibility to spend money as they best see fit to achieve agreed targets within an agreed envelope of resources. This reform itself needs to be seen within the larger context of focusing departments on targets and results (Table 2.7).

**Table 2.7: Institutions for Effective Departmental Governance**

| Objective | Operational implementation |
|---|---|
| Clarity of goals | (a) Mission and Vision statements, (b) Citizen's Charter, (c) Medium range modernization plan. |
| Measuring goal achievement or performance | Performance Indicators. |
| Enabling performance | Operational autonomy for departments; budgetary flexibility. |
| Communicating performance | (a) Annual Reports to government and (b) Performance Reports for individuals, functional units and field offices based on performance indicators. |
| Rewarding and motivating performance | Department budgets linked to performance with positive and negative individual and unit performance incentives. |

- *Tighten budgetary controls over open-ended obligations and capital projects.* While many of the controls typically exercised by Finance Departments can be relaxed, there are some areas where controls are too weak. Most subsidy obligations are on an open-ended basis, and need to be re-defined on the basis of "purchaser-provider" agreements under which Finance commits to a certain subsidy level in return for an agreed delivery of services. Similarly, control over capital projects (over both their entry into their budget, and their implementation) is weak, with far too many capital projects receiving miniscule amounts of funding, and thus never being completed.

[15] The comment is sometimes made that ambitious tax projections need to be set as "stretch targets". If this is necessary, the stretch targets could be internal rather than budget, or, overly-conservative budget estimates can be used for central government revenues.

- *Tighten accounting and audit arrangements:* India's accounting and audit arrangements are fine on paper, but neglected in practice: state governments have little information on their accounts in the course of the year; audit observations are not responded to; and many local governments do not even produce accounts, let alone audits. The challenge is to re-activate the system to reduce the gap between theory and practice.

2.45 A number of states have started to move on this agenda: for example Karnataka has computerized accounting (the Treasury system), and monitoring responses to audit observations. AP has been a leader in simplifying the fund release process post-budget-approval. Orissa has undertaken a zero-based pruning of its capital investment projects. Goa has developed an integrated cash-management system. These examples are highlighted in Case 7 of the Annex to this Chapter. There needs to be much more cross-state learning, with the support of key central agencies – not only GoI, but RBI and C&AG – to replicate and further develop these promising beginnings.

**India's states are currently stuck in a low-quality, low-quantity expenditure equilibrium. Any expenditure empowerment strategy has to attack this problem from both sides. Thus, side by side with improvements in quality, need to come increases in expenditures in priority areas.**

2.46 In many cases, improving quality will imply more expenditure. For example, with salaries fixed, spending more on non-salary inputs will require an increase in aggregate expenditure. Teachers may be more likely to be motivated in a well-equipped classroom; doctors perhaps more likely to attend to their work if they have drugs to dispense. And human development expenditures are likely to become more progressive as they increase in size (Lanjouw and Ravallion, 1999). The mid-day school meal scheme, which has recently been instituted in a large number of states, provides a good example of how good quality additional expenditures can really make a difference in the social sectors (Box 2.6). Expenditure in priority areas can also, in theory, be compensated by cuts elsewhere, e.g. on subsidies, though we are yet to see such packaging being effectively made by state governments.

**Box 2.6 Mid-day meals: an example of productive, additional expenditure**

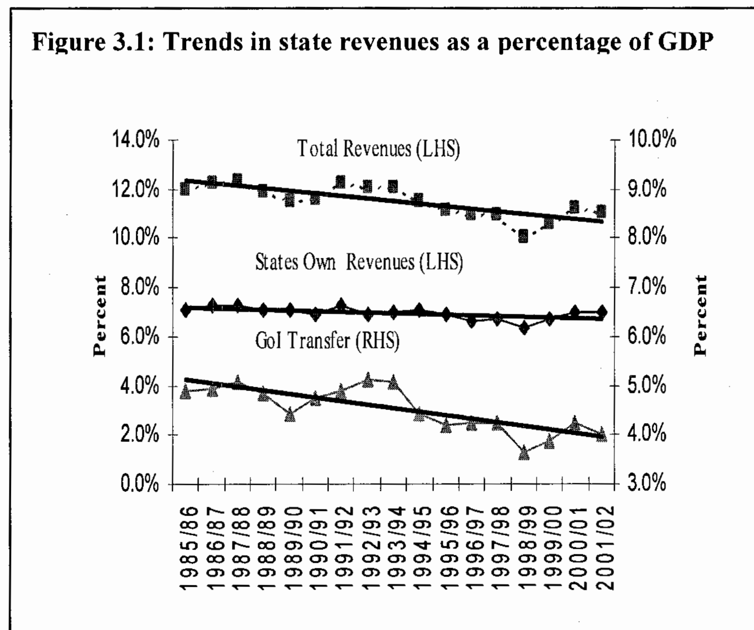
In mid-1995, the Government of India launched a centrally sponsored scheme, the National Programme of Nutritional support to Primary Education, under which cooked mid-days meals are to be served to children in all government and government-aided primary school: the central government provides the grains for free, and the state government provides cooking and logistical facilities. Orders from the Supreme Court in 2001 on a "right to food" litigation led to the widespread introduction of this scheme across most of India. An evaluation of the scheme in three states (Rajasthan, Chattisgarh, and Karnataka) shows that the scheme has helped improve school enrolment as well as attendance, in addition to eliminating classroom hunger and breaking caste and class barriers. In particular, the study finds that enrollment increased on average by 15% in the three states covered in the year in which the mid-day mean was introduced, and notes that "qualitative data point firmly in the direction of a significant improvement in daily attendance. The study points to some shortcomings that need to be urgently addressed – inadequate infrastructure in some areas, insufficient monitoring of quality standards, need for more varied and nutritious menus etc. However, the experience so far also shows that public expenditure on the mid-day meals program has the potential to contribute significantly to both educational and social outcomes. It should come as no surprise that the states which have done least to implement the Supreme Court order are among the poorest: in particular, Bihar, UP and Orissa.

*Source:* Dreze and Goyal, 2003

# CHAPTER 3
# REVENUE POLICY AND ADMINISTRATION

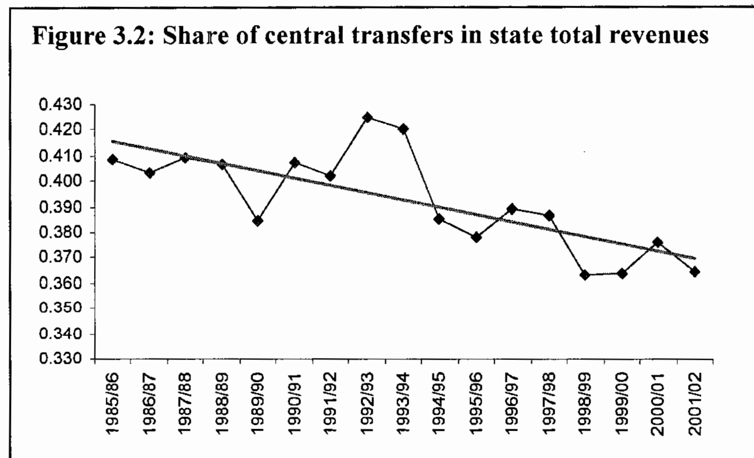
## I. Introduction

Figure 3.1: Trends in state revenues as a percentage of GDP




3.1 As outlined in Chapter 1, one of the causes of the fiscal crisis was the declining states' revenue to GDP ratio over the second half of the nineties. States' revenues fell from around 12 percent of GDP in the late eighties and early nineties to just over 10 percent by 1998/99 (Figure 3.1). States in India derive revenues from own sources and central transfers; central transfers consist of shared taxes and grants. States collect about 65 percent of their revenue themselves; the remaining 35 percent is transferred to them by the central government. As Figure 3.1 shows, abstracting from cyclical factors – especially the down-turn in the late nineties – state governments have done well to keep their own-revenue to GDP ratio roughly constant, but this has not been enough to offset a decline in central transfers to the states, which fell from about 5% of GDP in the mid-eighties to 4% at the end of the nineties. Figure 3.2 confirms the decline in the share of central transfers in total revenues – although these remain extremely significant, especially for the poorer states (see also Chapter 1). Central transfers are discussed further in Chapter 4; this chapter focuses on states' own revenues.

Figure 3.2: Share of central transfers in state total revenues




**Strong growth in state revenues is essential to ensure fiscal imbalances are sustainable and developmental spending is sufficient to achieve the desired developmental outcomes.**

3.2 While state government revenue has performed better than central government (see Figure 4.4), an increase in the own-revenue/GDP ratio of the states will be critical to reduce deficits, and fund much needed spending increases in priority areas.

3.3 India combines a low tax take with very high rates. Stamp duties on property transactions are among the highest in the world (sometimes above 10%, compared to the 1-2% in many countries), as are combined center and state indirect taxes (often 30% compared to half that in many Asian countries). High rates and a low tax take imply a narrow base, reflective in particular of the inability of India's states to tax agriculture and services. Thus the great bulk of taxes are raised from industry which only constitutes 25% of the economy. One of the key challenges facing India's states is thus to broaden the tax base.

3.4 Another challenge is to simplify India's tax system, and reduce the corruption in the system. India's indirect tax system administered independently by the centre and states is probably among the most complex in the world, while India's tax offices are some of the most corrupt in the country. A survey of industries in

Karnataka found that 31% of respondents paid bribes to the Commercial Tax Department, a higher number than for any of the other 13 agencies mentioned (Public Affairs Centre, 2003). Reforms to simplify and reduce corruption are thus critical. This chapter considers in section II policy and administrative reforms for the more important, individual revenue sources; and in section III some cross-cutting administrative reforms. Section IV concludes.

## II. State own-revenue structure and reforms

3.5 The powers of Indian states to specify and levy taxes, excises, duties, fees or royalties are specified in the State List in the Seventh Schedule of the Indian Constitution. Residuary powers to tax items not specified in the State List, including importantly services, lie with the Center. Under these provisions, the states can collect revenue on land and buildings; agricultural land and income; mineral rights; alcohol and narcotic substances but not tobacco; entry of goods into a local area for consumption or sale; electricity consumption or sale; sale of "goods" except newspapers but including works contracts and goods sold through hire purchase; motor vehicles, boats, transport of goods or passengers by road or inland waterways, and road or inland waterway tolls; professions; luxuries, entertainment and gambling; stamp duties and registration fees on documents and court fees collected through judicial stamp duties. Compared to other major federations, India lies somewhere in the middle in terms of the share of total domestic indirect taxes and income taxes that are collected by states (Box 3.1).

**Box 3.1: Tax structures in major federations**

Tax structures in major federations vary widely in terms of reliance on domestic indirect taxes and income taxes, with India being somewhere in the middle. Among taxes, motor vehicles taxes and, to a lesser extent, stamp duties appear to be widely assigned and collected by provinces. Fiscal imbalances, with central transfers therefore being an important source of provincial government finance, are common. The percentage of domestic indirect taxes and income taxes collected by states in the total tax take is in the table below.

**Table: Comparative tax structures of sub-national governments in various federations**

| Country | USA | Canada | Brazil | India | Australia | Argentina |
|---|---|---|---|---|---|---|
| **Period** | **1980-98** | **1978-97** | **1977-97** | **1975-97** | **1975-98** | **1975-98** |
| Domestic Indirect Taxes | 82 | 61 | 53 | 49 | 27 | 18 |
| Income Taxes | 12 | 36 | 2 | 0 | 0 | 25 |

*Source*: Rajaraman (2003)

Major sub-national government revenue sources in the various countries are as follows: *Argentina*: taxes on turnover, property, motor vehicles, gambling and social security as also stamp duties. *Colombia:* taxes on liquor and tobacco. *Indonesia*: motor vehicles taxes and fees. *Pakistan*: stamp duties, motor vehicles tax; entertainment tax. In *China*, less than 10% of revenues come from taxes, mainly sales taxes, and these are collected chiefly by sub-national governments except for the VAT. In terms of fiscal imbalance, transfers to provinces are the major source of revenue in Argentina, Colombia, Indonesia, Morocco, Pakistan, South Africa, and Tunisia (see Bird and Vaillancourt, 1998).

**The major tax sources are sales tax, stamp duties and registration fees, state excises on alcohol, and motor vehicles, goods, and passenger taxes. Non-tax revenues have declined in importance since the mid-eighties.**

3.6 There are several federal constraints which impact the tax system in Indian states. The first is the constitutional restriction of the states' power to tax sales of goods only, not services. Consequently, though some services bear tax through specific levies mentioned in the previous paragraph, this severely restricts the power of states to levy a broad-based tax on goods and services, including a value-added tax (VAT). Other federal constraints which restrict states' power to specify tax rates or levy taxes include: (i) the Central Sales Tax Act, which provides for the centrally set rates on inter-state sales and goods declared to be of national importance ("declared goods"); (ii) central power to collect "additional excise duties" in lieu of sales tax on sugar, textiles and tobacco (referred to as AED goods); (iii) the constitutional ceiling on the professions tax under Article 276, and (iv) centrally set rates of mineral royalties on major minerals. A final important factor is that, although agriculture has been reserved for the states, they have not exercised this right, and the agricultural sector's direct tax burden is close to zero.[16]

**Table 3.1: Structure of State's Own Tax Revenue: 1985-86 to 2001-02**

| | All taxes | State Sales Tax & Central Sales Tax | Stamp Duties & Registration Fees | State Excise Duties | Motor Vehicle Tax |
|---|---|---|---|---|---|
| 1985-86 to 1992-93 | 100 (1.01) | 58.2 (1.02) | 6.8 (1.25) | 14.8 (1.11) | 9.1 (0.88) |
| 1993-94 to 1999-2000 | 100 (1.07) | 60.2 (1.11) | 8.6 (1.06) | 14.1 (1.02) | 8.2 (0.94) |
| 2000-01 | | 62.2 | 8.2 | 13.6 | 7.4 |
| 2001-02(RE) | | 60.0 | 8.7 | 13.5 | 8.6 |

*Notes:* Data pertain to all states. Buoyancies are reported in parentheses.

3.7 In practice, this has resulted in most states having four major tax sources (sales tax, state excises on alcohol, stamp duties and registration fees, and motor vehicles, goods and passenger taxes), and then several smaller levies and non-tax revenues. The relative importance of each of the four major taxes has remained stable although there has been a slight fall in motor vehicles tax, and relative gain in the sales tax and stamp duties (Table 3.1). Non-tax revenues have declined considerably since the mid-eighties and tax receipts now make up 80% of total own revenues (Figure 3.3).[17] The remaining 20% of own-non-tax-receipts consist of a diverse bag of revenue sources including mineral royalties, sales of produce from forests, various user charges, lottery proceeds, interest and dividends.

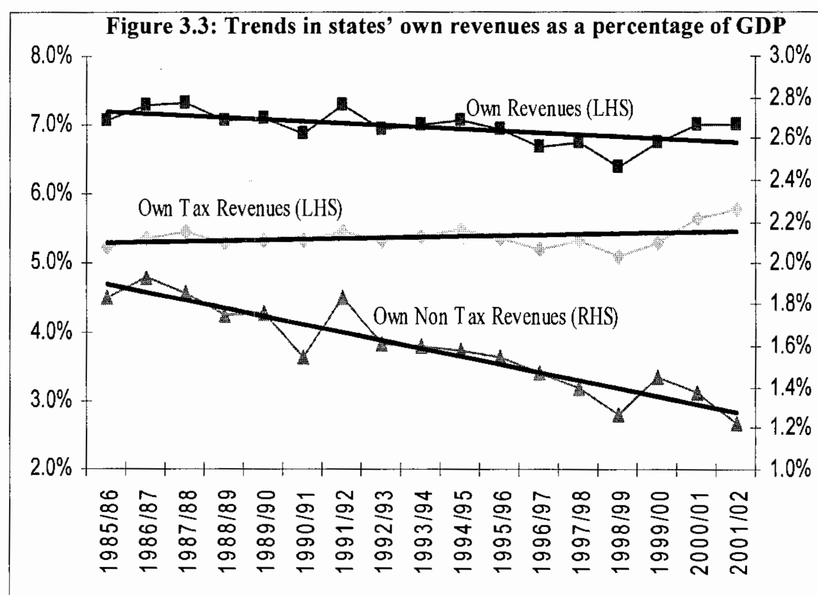


**Figure 3.3: Trends in states' own revenues as a percentage of GDP**

[16] Various suggestions to tax agriculture exist with Rajaraman and Bhende (1998) and recent proposals by the (Kelkar) Direct Tax Task Force (Min. of Finance,2002), being the most recent.

[17] Throughout this report, we deduct expenditure on lotteries from non-tax receipts (and from expenditure) so that we are left with only net lottery receipts. There are many other adjustments which should be made but for which data is not available (e.g. interest receipts are a mix of actual and imputed receipts).

3.8 Are state taxes progressive? Aggarwal (1995) concludes that the state sales tax is progressive, though less so than central indirect taxes. Given the bases of motor vehicles tax and stamp duties, these taxes are also likely to be progressive. It is unclear whether excise duties on liquor are progressive, but there are good public policy reasons for high taxes on alcohol.

**There are significant variations in own-revenue performance among states.**

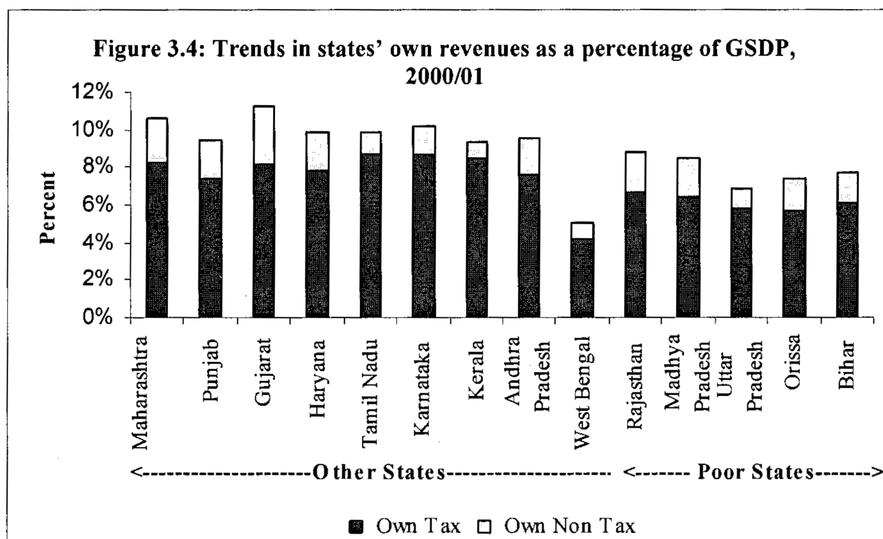
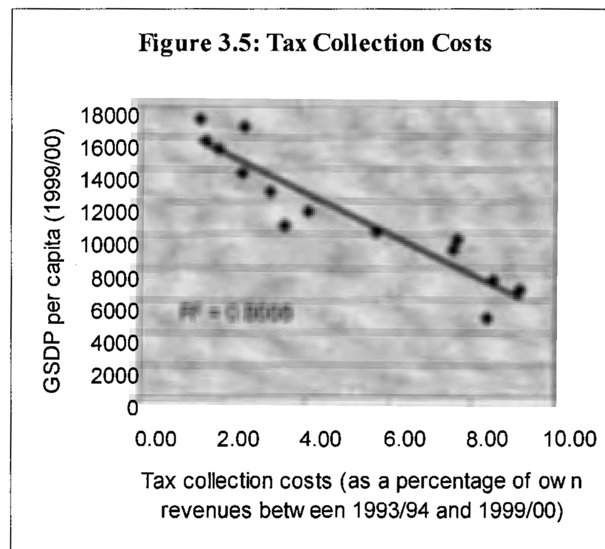



**Figure 3.4: Trends in states' own revenues as a percentage of GSDP, 2000/01**

3.9 As Figure 3.4 shows, the highest own-revenue/GSDP ratio (Gujarat) is more than twice as high as that of the lowest (Bihar). These ratios tend to be on the low side in the poorer states, 8-9% for Rajasthan and MP, 7% for UP and Orissa, and 5% for Bihar. The other middle- and high-income states all have ratios in excess of 9% except for West Bengal, which has a surprisingly low ratio, just above that of Bihar. These differences between states cannot be explained by rates of taxes, or bases. A key cause of low taxable capacity is the higher share of the agricultural sector in GSDP in the poorer states. Part of the lower tax/GSDP ratio may also be explicable in terms of low tax effort resulting from poorer tax administration and from the negative incentive effects of being in receipt of a large volume of central grants (a subject we return to in Chapter 4; see Box 4.2 Section III).

3.10 Revenue net of collection costs[18] is what is actually available to finance government provision of goods and services. Yet collection costs data are largely neglected. Collection costs are on average just over 4 percent of tax revenues. This is high by international standards, the norm being 2 to 3 percent. Besides inefficiency, this possibly reflects costs associated with non-revenue functions. Collection costs vary systematically and negatively with per capita GSDP (Figure 3.5), due possibly to economies of scale associated with the potential tax base being less dispersed across taxable entities in the richer states.[19]

**Figure 3.5: Tax Collection Costs**




[18] Date on collection costs are from the sub-head "Collection of taxes and duties" under the budget head "Expenditure on fiscal services". Clear data errors were identified for Gujarat (1985-86), Karnataka and Rajasthan (1987-88) and Maharashtra (1992-93 onwards). The Gujarat observation, being at the beginning of the sample period, was dropped. For Karnataka and Rajasthan the average compound growth rate between the preceding and following year was used to estimate 1987-88 collection costs. For Maharashtra, where certain transfers to reserve funds have been booked since 1992-93, data net of such transfers were kindly provided by the Finance Department, Government of Maharashtra. No information on such transfers, if any, is available for other states.

[19] Other possible determinants of cost inefficiency, as measured by collection costs as a percentage of tax, include the land area of the state, the share of central transfers in total revenues, and urbanization as measured by the percentage of population in urban areas and total population.

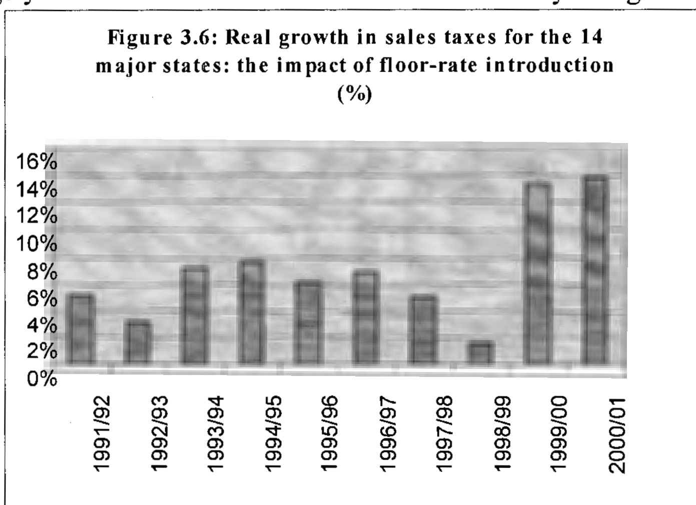
**The sales tax is the most important state-level tax. Encouraging progress in sales-tax reform – which led to a large boost in revenue – has been stalled by an impasse over VAT introduction.**

3.11 The sales tax contributes some 60% of total own-tax revenue; its importance derives from its relatively broad based coverage of industrial goods, even though services are excluded. Sales tax comprises of the General Sales Tax (GST), levied on intra-state sales, and the Central Sales Tax (CST), applicable to inter-state sales, which is legislated by the center but collected by the states. Many states levy additional taxes on selective services (electricity, transportation, entertainment) and additional tax surcharges.

3.12 The GoI-led joint decision of state governments to introduce floor rates and discontinue industrial tax incentives from January 1, 2000 gave an enormous boost to sales tax growth in the next two years (Figure 3.6). It also suggests that the reason for low growth in sales tax revenue over the nineties was a "race to the bottom" as state governments competed with each other to attract industry by offering low rates, and tax incentives. This reform was meant to be a precursor for the coordinated introduction of a state-level VAT to replace the sales tax, something which had first been mooted in the early nineties. However, the coordinated one-time shift of all states to a VAT regime has come undone, with repeated postponements of the target date, the latest one in early 2003 being indefinite.

3.13 The case for a comprehensive sales tax reform remains compelling. India's extant indirect tax regime is one of the most complicated in the world. It is non-transparent and distorting, has large efficiency costs and retards India's growth performance. The existing tax structure consist of multiple indirect and cascading levies; most states continue to impose taxes on inputs and capital goods. With a mixture of specific and ad valorem rates, multiple rates of tax, and cascading, the effective rates of tax on different productive sectors and consumer goods are nearly impossible to assess. Tax rates remain high by international standards and the base is narrow, not only confined to manufacturing goods, but largely at the wholesale level due to the tax mainly being levied at the first point of sale. In spite of recent reforms, most states continue to have a great many sales tax rates. Data in 22 states for 2000-01 in Purohit (2002) shows that the number of rates varied between 6 and 15, with 14 states having 10 or more rates. The maximum rate varied between 15 percent and 33 percent.

**Figure 3.6: Real growth in sales taxes for the 14 major states: the impact of floor-rate introduction (%)**




3.14 The delay in the implementation of the VAT, despite several states having completed their preparations, is a key failure of subnational revenue reform in India. VAT will eliminate input taxes, and will allow for the value-added in India's increasingly organized retail sector to be taxed. It is equally attractive as a vehicle for other reforms of the sales tax regime: such as the introduction of a functional administration system to break the dealer-trader nexus, computerization, and rate simplification. In principle there is no reason why these related reforms cannot be introduced on their own, and without VAT, Box 3.2 gives some recent proposals for administrative reform made in relation to Tamil Nadu, but which are applicable to most states. In practice, however, states have linked them to the introduction of VAT: not without reason, since it makes little sense, for example, to computerize the existing system if the system is about to be overhauled.

**Box 3.2: Tax Administration Recommendations for Tamil Nadu's Commercial Tax Department**

A recent analysis of the Commercial Tax Department noted that reforming the way the department did business was TN's "most urgent priority for improving revenue collection and reducing tax-related obstacles for business development in Tamil Nadu". Recommended steps included:

- ***Move to a functional structure:*** the single most important reform initiative the Tamil Nadu government can take to reform the tax administration, one that would have to be carried out at the headquarters and territorial levels to separate the key tax administration functions of registration, audit, collection, and taxpayer services.
- ***Create a special structure for large taxpayers:*** A small number of large traders contribute the bulk of sales tax collection in Tamil Nadu: currently, the largest 400 taxpayers—representing 0.37% of assessments—account for 75% of total sales tax collections To address the compliance risks and the special service needs of this group of taxpayers, the government should set up a special large taxpayer unit responsible for the administration of the largest 200-500 traders in the state, and staffed with senior and experienced tax officials. Such a unit would also considerably facilitate the introduction of a VAT. The unit should be organized along functional lines, and indeed should be a pilot for the re-organization of the department along functional lines.
- ***Strengthen the human resources of the Commercial Tax Department:*** A professional and specialized tax administration requires an appropriate level of highly qualified staff. This requires increasing the percentage of senior staff at officer level in the administration.
- ***Strengthen the enforcement function:*** A total of 4,646 inspections of shops were conducted in fiscal year 2001/02. These inspections resulted in the assessment of additional taxes and penalties amounting to Rs.211.86 crore, which accounts for only 3% of total sales tax collections. Enforcement productivity is thus extremely low. To enable the department to counteract tax evasion more effectively requires strengthening risk analysis for case selection; moving from a routine desk inspection to a targeted field inspection system; introducing an enforcement management system with clear plans and regular review of performance of enforcement units; and training of professional staff.
- ***Establish a vigilance unit:*** The Commercial Tax Department has an audit wing responsible for internal audit of its operations. The audit wing focuses primarily on reviewing the correctness of the assessment work, but does not assume responsibility for ensuring integrity and counteracting corruption in the tax administration. To investigate taxpayer allegations against tax officials and detect corrupt practices and officials in the department, a special vigilance unit should be established.

*Source:* World Bank (2004e)

**The impasse over VAT introduction might be broken by allowing states to move individually towards VAT, without compensation, but on the basis of floor rather than uniform rates.**

3.15 The center has to take the lead if the decade-long journey of the states' VAT is to resume. Progress to VAT was stalled by political controversy (protests by dealers) as well as complications over the issue of compensation to be provided by GoI to states which would lose from VAT due to the introduction of uniform rates. Tax rates vary greatly across India's states. Whereas a main rate of 12.5% was proposed for all states, southern and western states calculated the revenue neutral rate of VAT to be 15-16%. Hence the call for compensation. But once compensation is introduced, issues of moral hazard and game-playing are raised,[20] and GoI becomes in a sense both responsible for VAT performance, and able to exercise veto power over its introduction. To break the current impasse, over both issues of compensation and trader resistance, a more modest strategy may be warranted. That is, the long-term goal of harmonization should be replaced by a more modest short-term one of ensuring uniform floor rates are adhered to. States should be allowed to graduate individually into VAT, without compensation, with the choice of rates left to the individual states (so that they can choose a revenue-neutral rate, and thus not require compensation). Several states would likely go ahead, and others would then probably follow. Haryana is the one state which has not been deterred by GoI's postponement of VAT (Box 3.3). It in fact introduced a VAT on its own, effective April 1, 2003. It has since experienced reasonable revenue growth, and has no plans to roll the VAT back. Those states which did not want to go for VAT could pursue other reforms (computerization, functional organization, etc) within the sales tax framework, rather than continuing with a waiting game. Delinking the goals of harmonization and VAT introduction would

[20] One can note that once GoI announced 100% compensation, states started putting an increasing number of items on the lower 4% rate in the expectation that revenue loss from this would be covered by GoI.

allow the former to be pursued over a longer period without holding the latter hostage: it can be noted that the European Union has successfully introduced VAT and floor rates, but is still pursuing the goal of harmonization across member states (Box 3.4).

**Box 3.3: Haryana's VAT- going it alone.**

Variants of VAT on manufactured goods using the subtraction method has been tried out in individual states on resellers of taxable commodities e.g. AP and Maharashtra in 1995. While it continues to exist in AP for 19 commodities, Maharashtra gave up the experiment in 1999 after loss of sales tax buoyancy and rise in retail prices and returned to the old system of first point taxation along with turnover tax and surcharge. It is in this context that the decision of Haryana to go in for a VAT from April 1, 2003, against the decision of GoI to postpone VAT introduction, merits attention.

Haryana was better placed than most states to introduce VAT because it had introduced input tax deduction from output tax on manufactured goods in 1998. In 2003, Haryana replaced the General Sales Tax Act (HGST) by the Haryana Value Added Tax Act, interestingly without seeking Presidential assent on the grounds that the sales tax is on the State's List of the Constitution (unlike other states, which sought and then failed to receive Presidential assent once GoI decided to postpone VAT). All existing dealers were issued 11 digit taxpayer identification numbers and full input tax credit offered on the opening stock of goods

There are three main VAT rates of 4%, 10% and 12% (as under HGST, but not in line with the design agreed by all states of two rates of 4% and 12.5%) besides 1% on bullion and jewellery and 20% on liquor, petrol and aviation turbine fuel. The number of tax-exempted goods is high at 83 items. Input tax credit is allowed immediately on purchase of goods and no correspondence is required between goods purchased and goods sold for input tax credit. Input tax credit on capital goods has been restricted to their use in manufacture of taxable goods for sale. The treatment of inter-state trade is as per the agreed VAT design: input tax on goods exported out of India are zero rated with full input tax credit. Tax on inputs used to produce goods sold through inter-state trade is refundable to the extent the input tax exceeds output tax (CST). No setoff is available on input tax in the case of branch transfer or consignment sale of goods out of the state or on purchase tax.

Other administrative reforms introduced by Haryana at the same time as VAT include a self-assessment system, whereby the filing of VAT returns is itself taken as deemed assessment. Detailed criteria have been evolved for selection for assessment, and time limits fixed for completion of assessment. Freedom to design sales invoices provided certain mandatory information is included has been introduced, inspection of business premises by officials without express permission has been debarred, and an audit wing created. The policy of no barriers at the state border has been continued.

With the introduction of VAT, the number of tax payers has increased from 6417 to 8504. State sales tax revenue grew 20% in 2003/04 as opposed to 17% in 2002/03. Overall sales tax revenue (including Central Sales tax) grew 14% in 2003/04 as against 13% in 2002/03. With some complaints emerging about non-refunding of input tax credit, the net growth could be a little lower. While it is too early for a definitive verdict on Haryana's VAT, that VAT introduction has not resulted in tax losses and seems to have improved compliance is apparent.

**Box 3.4: International Experience with Value-added Taxes in a Federation- lessons for India**

Most federations, if they have a VAT have a centrally controlled VAT, though sometimes administered by the states (Argentina, Australia, Germany, Mexico). America has a state-based retail tax not a VAT. There are three federations which run state-level VATs similar to what India is trying to introduce by replacing the state sales taxes by state VATs: Brazil, Canada and the European Union. All of them have lessons for India.

- **Brazil's** system is that of an *uncoordinated dual VAT* (centre and state). The central government has a VAT on industrial goods (IPI). The state governments run a VAT on goods and services (ICMS). The ICMS is Brazil's largest tax, and collects 7.9% of GDP. The IPI collects 1.5% of GDP. Reviews of the Brazilian tax system commonly refer to problems relating to inefficiencies associated with the existence of a state-level VAT. Major problems diagnosed in Brazil are: (i) complexity of each of the 27 states having its own VAT with 27 different laws, and more than 40 rates, and different rules for assessing tax credits; (ii) evasion – associated with the complexity; and (iii) fiscal wars, with states offering companies reductions in the interstate ICMS rate (even though this is illegal). The system of interstate trade is itself complex: with different rates allowed in different states (though set centrally) for inter-state sales, and both exporting and importing states collecting the interstate tax revenue.
- **Canada** tells a much happier tale: in the province of Quebec a *coordinated dual VAT* is in operation. The Quebec state government and the central government run a dual VAT system (other states have other tax arrangements: some participate in a unified VAT with the central government, some run their own sales tax). The rates and tax base are set independently by the respective governments but collected by a single administration (the Quebec Department of Revenue). Exports from Quebec, whether to another province or another country, are zero-rated. Imports are taxable but the tax is assessed on the interprovincial imports only when it is a sale by a registered trader to an unregistered trader or consumer in the province. The high degree of collaboration and information exchange between the state and the federal government (e.g. a joint approach to audit) regarded as critical to the success of Quebec's VAT.
- The **European Union**, if regarded, for the sake of comparability, as a federation, runs a *state-level VAT*. The EU required as far back as 1967 that each member have a VAT. Broad guidelines have been established, and there is a floor rate of 15%. Despite various efforts at harmonization actual rates vary from 15% to 25%. Sales between states are zero-rated: this arrangement was originally introduced as a transitional arrangement in 1993, but agreement on alternative proposals for tackling inter-state trade has not been forthcoming.

***What are the lessons for India?***

- In a positive vein, as Richard Bird writes, Canada has "demonstrated that with good tax administration it is perfectly feasible to operate a VAT at the subnational level on a destination basis, at least for large regional governments." Canada also suggests it is feasible to have different indirect tax systems operating in a country, i.e. not all states need introduce VAT at the same time.
- At the same time, introduction of state-level VATs will not solve all, or even most indirect tax problems India faces. Its system will closely resemble that of Brazil, and will face the same problems that Brazil does today. To avoid them, India needs to work over time towards the goals of harmonization and information sharing across governments.
- The European Union experience shows introducing floor rates is much more feasible than harmonizing rates across member-states, and suggests that VAT introduction should not be held hostage to harmonization.
- All the case-studies throw up the issue of how inter-state trade should be taxed. None of the arrangements in place are regarded as fully satisfactory. Brazil's system is open to manipulation, and benefits the better-off states. The Quebec and EU zero-rating systems have the great advantage of preserving a common market, but they break the VAT chain, and give incentives to evade by declaring intra-state sales as inter-state. Various suggestions have been put forward for how to solve this problem, including systems of refunds across states, and through central government taxation and rebating of inter-state trade, but none have yet been implemented The consensus in India is to adopt the Quebec and EU systems of zero-rating inter-state sales, which would be achieved by reducing the Central Sales Tax – which is set centrally – to zero. Since this would give strong incentives to evade along the lines mentioned earlier, the earlier point about improving information sharing across governments becomes even more important.

*Sources*: Guardia and Sonder (2004); Bird (2000); Purohit (2003); Burgess, Howes and Stern (1995).

**Phasing out of the distorting and inequitable CST is critical, and will likely require compensation.**

3.16 The Central Sales Tax (CST) is particularly distortionary and there is widespread agreement that it should be eliminated. The CST applies to interstate sales; it is collected and retained by the exporting state. Because the CST is levied on the basis of the origin of goods, it has enabled the relatively advanced states to export the burden of their own taxes to the less developed states, which tend to be net consumers. The result is a considerable concentration of CST revenues among a few states. Origin-based taxation of interstate sales also leads to tax evasion via branch transfers and consignment sales, and is a serious impediment to the achievement of economic efficiency and a common market. Recent reform of the Central Sales Tax to permit states to tax local sales of declared goods at multiple points has reduced constraints from separate regimes for declared and other goods. Nevertheless, further steps need to be taken to phase out the CST. There is no reason for the phase out of CST to be linked to VAT, but it will require compensation to the losers. It will also demand increased surveillance over interstate trade since shifting to zero-rating of inter-state exports will increase the incentive to evade the state sales taxes by claiming goods are being exported (Box 3.3).

**India's long-term, indirect tax goal should be a national VAT**

3.17 International experience has a number of lessons to teach India in its pursuit of a dual centre-state VAT (the GoI indirect tax is also a VAT, CENVAT). These are summarized in Box 3.4, and some have already been highlighted. Brazil's experience is particularly salutory. It suggests that, even with state VATs, India' indirect tax system will still be very complex, and that a dual VAT system should only be viewed as a staging post towards a more integrated, national VAT, with revenue starting between the centre and states.

**Transfer to states of the right to tax services is a very positive initiative.**

3.18 This constitutional amendment will give states access to the fastest growing sector of the economy, and reduce India's high level of vertical imbalance. It is not yet clear how this will be implemented: there are two competing proposals (Box 3.5) Over time, it does not seem desirable that states should be allowed to integrate the taxation of services into their sales tax/VATs.

**Box 3.5: State taxation of services: expert group versus advisory group**

The recommendations of the Planning Commission's Advisory Group for Tax Policy and Administration for the Tenth Plan under Parthasarathi Shome in 2001 and the Finance Ministry's Expert Group on Taxation of Services (Govinda Rao Committee), 2000-2001 differ in a significant way. The former has recommended that the power to tax specified services be given to states with the Centre retaining the power to tax other services. The Govinda Rao Committee recommended comprehensive VATs covering both goods and services at both Central and state levels implying concurrent taxation of services, as is currently the case with goods. Since input rebates for Central levies are unlikely to be granted by states and vice versa, the scheme proposed by the Shome Committee will result in continued taxation of inputs and cascading of tax. Concurrent taxation by Centre and states, as proposed by the Govinda Rao Committee, will avoid this as each level of government will provide rebates for its own input taxes.

**There is a rich agenda for reforms in other taxes, requiring wide-ranging actions by the center and the states.**

3.19 Currently, the **professions tax** – the base of which is essentially income or presumed income in the case of the self-employed - is not levied in five major states at all. Where it is levied, enforcement is weak. A key problem with the professions tax is that the constitutionally-imposed ceiling is very low (Rs 1500 per person), and needs to be raised. This requires action at the centre to amend the constitution and quadruple the floor rate.

Increasing this rate will give states more incentive to utilize this tax, especially in the unorganized sector.[21] We estimate that potential collection from the professions tax is possibly 10 times the current level of Rs 2, 200 crore (that is 0.9% of GDP rather than 0.1% as currently) with ceiling revision and improved collection. Especially given the undertaxation of services, this tax, which will cover services as well as industry, seems well justified. One possibility that may simplify administration is outsourcing tax collection from professionals to professional associations, with risk based sample follow up checks by the concerned tax department.

3.20 **State excise duties** are levied on the production of alcohol and other narcotic substances and via license fees for liquor wholesale and retailing permits. They are the second most important source of revenue for most state governments, and contribute on average 14% of state own-tax revenue. Duties are mostly specific. Despite alleged rampant evasion and smuggling, excise revenue from alcohol sales is a relatively buoyant source of own revenue (with an all-state buoyancy in excess of 1), though the buoyancy has shown a small secular decline over time. Confiscation of liquor on which duty has not been paid and fines also provides a steady revenue stream.

3.21 The liquor market in India is fragmented into "Indian made foreign liquor" (IMFL) and "country liquor" segments; the former can be traded across state borders whereas the latter cannot. Country liquor vending licenses are auctioned in many states, where country liquor is not banned, leading to revenue buoyancy in this segment. IMFL has proved to be somewhat less buoyant. To safeguard IMFL revenue and enforcement, some states have monopolies in wholesale IMFL trade (e.g. Andhra Pradesh, Karnataka) and retail trade (Delhi, Tamil Nadu). Retail monopolies are costly in terms of efficiency, but wholesale monopolies can be effective. There is also some evidence that ad valorem duties may have greater revenue potential, as they are inflation proof, but only if complemented by effective excise enforcement. Maharashtra implemented an ad valorem excise duty with a specific floor in 1997. Though this led to an immediate jump in excise revenue, this did not improve revenue buoyancy, almost surely due to weak enforcement.

3.22 Even though most excise departments have inspectors posted at distilleries and breweries, procedures are not very effective and leakages are a major problem, with corruption alleged to be a major reason. Most excise departments have yet to adopt modern distillery monitoring technology and have outdated information systems. Large excise duty cum sales tax rate differences (and prohibition, in some states, of either country liquor or all liquor) lead to cross-state smuggling, an activity which can only be curbed if rates are harmonized. Since some states benefit from cross-border smuggling induced by rate differentials, this may be hard to achieve.

3.23 There is much scope to improve the performance of state excise duties. Karnataka's creation of a new wholesale IMFL monopoly, and a crack-down against illegal "seconds" has boosted excise revenue in 2003/04 by an estimated Rs 300 crore (more than 10%). Even before inter-state information sharing becomes a reality, gains can be made by curbing leakage via control of inputs (molasses, raw alcohol), induction of modern distillery monitoring technology, random checks by staff, and targeted generation and management use of information such as fluctuations in input-output ratios in distilleries and, above all, staff incentives. Other measures include expanding the number and kind of retail outlets, though such measures should be taken only if they are felt to be in consonance with health concerns of individual states.

3.24 **Stamp duties and registration fees** are the equal third most important tax for state governments, contributing about 9% of revenue. These taxes are governed by central acts, with variations incorporated in state-level acts; as for rate setting, there are central, state and concurrent powers for different classes of documents. Stamp duties and registration fees, for which property transfers are the major base, have had the best

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[21] It has been suggested that central reluctance to raise the ceiling is because the professions tax is as a deduction from income subject to the income tax. However, from the point of view of states, the implied loss in shared central revenue is outweighed by direct collection from the professions tax. For example, for Uttar Pradesh given its 19.8 percent share of central taxes recommended by the Eleventh Finance Commission, and the 29 percent share of states in total central tax collection, Rs 100 from the professions tax results, even at the maximum marginal income tax rate of 30 percent, in a loss of shared revenue of Rs. 5.94, resulting in a net gain of Rs 94.06. The net increase in the taxpayer's extra tax burden is Rs. 70.

recent revenue performance among major state taxes, largely due to the secular rise in property construction and sales and also property values in the wake of rapid urbanization.

3.25 Fees on the transfer of immovable property are very high by international standards, sometimes by an order of magnitude. High rates of duty have induced avoidance as well as undervaluation of property. Some states have carried out a number of important reforms along with a reduction in the rate of stamp duties. The rate of stamp duty on property sales has been brought down in a number of states including Rajasthan, Karnataka and Uttar Pradesh, leading to additional increase in the declared quantity and value of property sales.[22] To reduce the undervaluation of land, some states (Andhra Pradesh, Karnataka, Maharashtra, Uttar Pradesh) have completed or are in the process of strengthening their official valuation machinery and, by publishing guidance (minimum) value lists, and have made valuation transparent reducing the scope for corruption. Streamlining of document registration procedures through automation (in Maharashtra and Karnataka via outsourcing) and strict monitoring of duration norms have also led to improved citizen's services. A fourth, progressive, reform in Karnataka in 2003 was to abolish the archaic use of stamp paper which itself is likely to have reduced the scope for forgery and loss of revenue. These important reforms can also help other states to increase their stamp duty revenues. Halving by the Centre of all stamp duty rates that are centrally set has been proposed in 2004, though this will impact at best 5 percent of the tax base.

3.26 Further scope for reforms to boost revenue exists. The most important is the closing of loopholes whereby properties are transferred through substitute transactions which attract a lower duty rate (such as "power of attorney sales") by raising duties close to rates on property sales. Second, improved land valuation can be accompanied by improved enforcement to curb unregistered property transfers and undervaluation of buildings as discussed previously. Third, most stamp departments require reforms of incentives, given the considerable scope for corruption that still exists based on the high average property price and the prevalence of middlemen like real estate agents and even local revenue officials (Caseley, 2004). Reform of stamp duties and registration fees and its administration should ideally be designed as part of an overall policy to improve the security of land titles and contract enforcement.[23]

3.27 **Transport tax** Like the stamp duties and registration fees, the transport tax constitutes about 9% of state-level own-tax revenue. There exists both a central and a state Motor Vehicles Act governing motor vehicle regulation and taxation. The revenue implications of the central act are minor, with the Act setting uniform fees for transport department services like issuance of licenses and permits. The major revenue raising power lie with the state acts. Given the explosion in the motor vehicles population on Indian roads during at least the past decade, the low buoyancy of taxes on transport[24] comes as a surprise. It is possible that part of the low growth is due to the gradual relative decline in the importance of buses as a means of transport in recent years as more private cars or two-wheelers are seen on Indian roads. The latter are less heavily taxed. Moreover, tax rates on buses and trucks are specific – even though they are subject to frequent revision.

3.28 Another source of low buoyancy is state monopolies of public passenger transport (STUs) with most transport departments fighting a losing battle to control violations of route monopolies by private transport operators, especially mini-buses and "maxi-cabs".[25] Consequently, to increase revenue from motor vehicle taxes as well as improve economic efficiency, state governments will need to "de-nationalize" most routes currently reserved for STUs. This should also result in lower administration costs and reduced corruption.

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[22] Stamp duty in Rajasthan was lowered from 12 percent to 7 percent in 1996-97. World Bank (2000) documents a 36 percent increase in stamp revenues between 1996-97 and 1998-99. The rate was subsequently raised to 10 percent.

[23] A discussion of the major flaws in current institutions in this respect is beyond the scope of this chapter. See, for example, Wadhwa (2002), and Das-Gupta (2003a) and references cited there.

[24] Though the all-state buoyancy for 1993-94 and 2000-01 was 0.83, buoyancies were above 1 in 8 of the 14 major states (AP, Bihar, Gujarat, Kerala, MP, Orissa, Punjab and UP), being above 1.5 in Orissa. Thus states other than the 14 major states have had low buoyancy along with the other six major states.

[25] World Bank (1998) estimates the tax gap in Uttar Pradesh in 1996-97 at around 24 percent of potential.

3.29 Rate reform can lead to major revenue gains and is also desirable on efficiency and equity grounds: the motor vehicles tax as well as the tax on goods under the goods and passengers tax (the passenger tax is discussed below) can be viewed as an "excise duty" on motor vehicles and should ideally be levied on the benefits principle as a user charge. Benefits include road usage, and tolerance of environmental damage and vehicular congestion by citizens. Viewed from this perspective, motor vehicles tax rates are skewed and disproportionately favor two wheelers, jeeps, taxis and multi-axle and heavy commercial vehicles at the expense of mass transport vehicles, and to a much smaller extent, cars and light commercial vehicles (see Table 3.2). Therefore, economic efficiency and equity suggest raising of taxes on other vehicle classes relative to buses. Such a rate rationalization could also be revenue enhancing, if it is done by raising tax rates, given the faster growth rate of all other classes of vehicles, compared to buses, and the likely absence of extreme sensitivity to small price changes for vehicles other than trucks.

**Table 3.2: Revenue from Sales Tax and Transport Taxes Per Vehicle versus Road Costs, 2000-01**

**(Indices with 2-wheeler = 1)**

| Category | 2-wheelers | Cars | Jeep/Taxi | Bus | LCV | HCV | MAV |
|---|---|---|---|---|---|---|---|
| Revenue | 1.0 | 9.4 | 10.1 | 322.3 | 12.2 | 32.6 | 59.0 |
| Road capital and maintenance cost | 1.0 | 3.4 | 8.8 | 6.4 | 6.3 | 26.6 | 41.0 |
| Road maintenance cost | 1.0 | 3.5 | 9.0 | 7.1 | 6.7 | 38.4 | 57.2 |

*Notes:* (i) For two wheelers, the road maintenance to revenue ratio is estimated at 0.55 and the capital and maintenance cost ratio at 2.34. (ii) MAV: Multi-axle vehicles. HCV: heavy commercial vehicles. LCV: light commercial vehicles. *Source:* Calculations based on data in World Bank (2003).

3.30 The passenger tax is a tax on transport services and so should ideally be merged with the state VAT when it is extended to services. Given the ease of evasion of this tax, a per-seat-per-quarter specific rate, coupled with rebates for presumptive bus operating costs may be easier to administer.

3.31 **Other taxes** Among the many other state taxes in existence, most are of minor revenue importance. They should be merged with the VAT on goods (a part of luxury tax, entry taxes, special levies on motor spirits, cesses and surcharges). Others should be merged with the state VAT if services are included in the VAT base (electricity duty, entertainment tax, betting tax). The electricity tax is important in a context of law tariffs, and can be used to reduce subsidies to particular categories of consumers, but should not further increase the tariff burden on industry. Property tax on houses accrues to local government, and is increasingly the focus for reform, especially in urban areas (reference).

**Non-tax revenues have stagnated, and need more policy attention from state governments.**

3.32 As shown in Figure 3.3, there has been a significant deterioration in the performance of own non-tax revenues, from just below 2% of GDP in the mid-eighties to just above 1% of GDP today. It is imperative that state governments focus on improving the revenue performance of major non-tax revenue sources.[26] Unlike tax revenues, where many problems are common across taxes and their administrations, different non-tax revenues sources have very distinct problems although institutional strengthening is of importance across the board.

3.33 Revenue from **mineral royalties** already constitutes a major source of non-tax revenue for many states, and there is potential for further increases. Recent hikes in the international price of steel as well as greater demand for building materials due to increased road and building construction activity have caused mineral royalties in some states (e.g. Karnataka, Uttar Pradesh) to become the fifth most important source of own revenue. Measures that may further increase the importance of this source of revenue include rule-based setting of royalty rates by the Centre, and also states, including revision at least once in three years with reference to market prices; streamlining of the clearance process for grant of mineral prospecting licenses with the help of automation; strengthening of administration, particularly where minor minerals are of importance; and introduction of self-assessment and risk-based scrutiny of royalty returns to reduce litigation.

[26] Information on the cause of Punjab's non-tax revenue increase is not available.

3.34 Revenue from the sale of **forest produce** is often next in importance to mineral royalties. A problem with many forest departments is their limited attention to sale of forest produce since they perceive their role primarily in terms of conservation and protection of forests and wild-life.[27] One way out is the formation of forest corporations to enable focused exploitation of forest resources on commercial lines, while leaving conservation and regulatory functions, including regulation of corporations to the government as is already the case in some states.[28] This will be facilitated with time-bound completion of mandatory "work plans" for forest exploitation in some states (e.g. Assam) in the absence of which forest revenues have been badly hit. A second major reform with great revenue potential is strengthening the infrastructure for eco-tourism, with the participation of the private sector.

3.35 The performance of **user charges** has been poor. A key reason for this is inadequate, and in many cases, deteriorating recovery of costs, associated with a more general problem in the provision of government services, discussed in Chapter 2, namely a lack of commercial discipline, manifested in an unwillingness to withdraw services from non-paying customers.[29] Restoring commercial discipline and improving cost recovery can be very difficult in the public sector, especially when beneficiaries are politically powerful. Where external benefits or merit good characteristics are unimportant, rather than attempting recovery of user charges, the government should ideally withdraw. Where the government stays involved, some basic principles for improved cost recovery and commercial discipline need to be applied. These are summarized in Box 3.6 below. Not all user charge increases are controversial, and governments need to carefully scrutinize all services offered and charges levied to see where it is feasible to implement increases.

**Box 3.6: Five principles for improved cost recovery**

*Principle 1:* Price discrimination and usually product differentiation with a self-selection mechanism can lead to improved cost recovery while continuing to provide cross-subsidized and free services for target groups, in applicable sectors (e.g. health, higher education, hostels for weaker sections, inspection bungalows).

*Principle 2:* Introduction of collection and enforcement incentives for field staff, both rewards and sanctions, can lead to greater collection effort and cost recovery in applicable sectors (e.g. forests, mines, irrigation, hostels for weaker sections).

*Principle 3*: Identification of under or unutilized government assets, including land and buildings, and improved utilization, with private sector participation in suitable cases, can reduce the direct cost of government services and also give rise to new sources of non-tax revenue.

*Principle 4:* Computation of notional cost-based prices and explicit compensation via book transfers for the difference between notional prices and user charges can bring about greater transparency and realism in costing of government services by removing hidden cross-subsidies, in applicable sectors (e.g. inspection bungalows, housing, health, education, forests, irrigation).

*Principle 5:* Physical and financial performance indicators should reflect quality and quantity of outputs within the control of responsible departments and social outcomes relative to targets as accurately as possible and be subject to external auditing.

*Source:* Das-Gupta (2004)

3.36 **Interest performance** The importance and performance of interest receipts in state non-tax revenues is difficult to determine as the heading includes notional contra entries, a major item being irrigation contra entries, and pass through receipts. For "genuine" loans, published documents do no give details of loans, interest rates, arrears, write-offs and other information necessary for performance evaluation. Similarly, aggregate dividend data are not readily available and must be compiled from surveys of public sector undertakings. Nevertheless, no

[27] For example, though forest revenues were important in Assam up to the 1990s, their importance decreased sharply after a Supreme Court judgement requiring tree felling according to scientific work plans, since the forest department had not completed 90 percent of the work plans even by 2000. See D. K. Srivastava et. al. (1999b).

[28] According to the Indian Forest Conservation Act, these corporations must be wholly owned by the government to ensure that no overexploitation occurs. Several states are handing over collection of minor forest produce to community groups.

[29] For recent studies of government subsidies, which are the complement of cost recovery, see Rao (2003) and D.K. Srivastava and Tapas K. Sen (1997). These studies document the low rates of cost recovery even for goods which have no externality benefits or merit good features.

state shows impressive growth in these sources of revenue. Alleged reasons are that loans to public undertakings and cooperatives are often really grants, not intended to be recovered. The poor performance of PSUs is of course well-documented.

## III. Reforms to Tax Institutions

**Tax administration reforms are probably more important than tax policy reforms but have received relatively less attention to date.**

3.37 Tax reforms in India require not just policy changes, but also institutional reforms to improve policy-making, weed-out corruption, and increase incentives for compliance and collections. We have already presented some tax-specific administration reforms. We now turn to more cross-cutting reforms, without which a sustained increase in the tax/GDP ratio will be difficult to attain. The institutional structure of major revenue raising departments is currently weak. They suffer from many of the problems most other government departments suffer from, briefly outlined in Chapter 2. Many do not have mission or vision statements; transparent performance monitoring is often absent as is systematic citizen's feedback on services provided and individual accountability; departments often have limited budgetary flexibility; management information systems are rudimentary; and anti-corruption institutions are often ineffective. Overall performance reporting of administrations via annual reports that stress effectiveness in achieving goals and (cost) efficiency are as yet absent. This leads to lack of transparency in the performance of tax administrations, hampers legislative oversight and limits departmental accountability. Within tax administrations, absence of performance indicators and poor record structures for functional units and individual staff makes accountability for performance difficult.

3.38 Chapter 2, Section V listed some general principles for improving government effectiveness. These apply equally to the functioning of tax departments. Some specific recommendations are summarized below.

3.39 **Strengthening accountability.** Departmental accountability can be promoted through better articulation of departmental goals and more budgetary flexibility, and individual accountability through the provision of incentives to staff. In some states, encouraging progress has been made in achieving clarity of goals via mission and vision statements, and especially citizen's charters. However, not all mission statements reflect concern for effectiveness and efficiency of activities. Revenue collection performance and performance in delivering non-revenue services are also not well-addressed. Less progress has been made in translating these statements into measurable indicators, except in rare cases (see Box 3.7). Without such indicators, targets for tax departments will continue to be ad hoc and primarily in terms of revenue. Sustainable improvement in the revenue effort of tax departments requires performance assessment not only in relation to revenue targets, but also in the manner in which these are achieved. Important dimensions include: improving identification and registration of taxpayers and sanctioning of non-compliance with requirements; effective targeting of tax inquiries at evasion prone cases to limit underassessment of taxes due to corruption; non-arbitrary assessments which will withstand legal challenge thus limiting appeals; improved tax collection efficiency rather than growing arrears; and citizen friendly procedures to limit non-compliance caused by excessive bureaucratic complexity.

3.40 **Non-tax revenue retention.** Some states, notably AP, have tried to provide non-tax-revenue-raising departments with the capacity to retain at least some of the revenues they raise, thus providing a direct incentive for departments to investment more in revenue collection. This is a common practice in other countries, as it helps departments internalize the state-wide goal of revenue mobilization. In many states, field units, such as hospitals and water-user groups are also allowed to retain their user charges. This has the added advantage that such units are thus able to show improved service charges in return for improved collections.

**Box 3. 7 Performance measurement in the Commercial Tax Department, Andhra Pradesh**

In 2001, the Commercial Tax Department in Andhra Pradesh introduced a system of departmental performance indicators which included (a) departmental indicators of corresponding to each component of its mission, including revenue raising and citizen's services and (b) numerical performance indicators for individual staff posts. Noteworthy features of these indicators were the inclusion of achievements relative to targets and potential and only a five percentage weight given to the discretionary "general impression of superior". However, individual indicators were still to incorporate quantitative indicators of service delivery to citizens, since client feedback had yet to be institutionalized. These staff evaluations were linked to salary increments and promotions. The impact of these indicators has been reported to be positive, particularly on work disposal and arrears collection in "unpopular" activities such as the professions tax or appeals.

*Source*: A 2001 presentation on "Performance Indicators" by the Commercial Taxes Department, Andhra Pradesh. A general discussion of fiscal performance indicators in Andhra Pradesh is in Finance Department, Government of Andhra Pradesh (2002).

3.41 A frontal attack on **corruption** is required. As discussed in Chapter 2, anti-corruption institutions need to be strengthened. Functional organization of departments instead of current systems where a single officer is responsible for groups of taxpayers, are a key reform to reduce corruption, besides increasing administration efficiency and effectiveness. This has only begun to be introduced in some state tax departments. Clearly laid down arms-length procedures which minimize unsupervised contact with taxpayers and computerized personnel record which permit individual accountability for actions to be determined are also important reforms. Removal of discretion in recruitment and transfers is also critical.

3.42 **Promoting user-friendliness and citizen feedback**. The importance of e-governance and improved citizen's services is increasingly being recognized by governments at all levels in India, and significant steps have been taken in tax administrations in some states to improve citizen's services. These steps include: (a) commitments made by the government to service quality and timeliness via Citizen's Charters; (b) improved public information through pamphlets, information kiosks, public information desks, and websites; (c) easier access and compliance such as via e-governance kiosks, on-line forms, electronic payment, application and return filing; (d) improvements in the location, layout and facilities of offices dealing with citizens. In a few instances (the Transport Department in Karnataka and the Stamps and Registration Department in AP), institutionalized taxpayer feedback on service quality, timeliness and corruption: as noted in Chapter 2, encouraging consumer voice can be a powerful way to improve government service standards. In some cases, this has been achieved by involving the private sector and even outsourcing.[30] Additional measures required are the inclusion of data on compliance with the Citizen's Charter and citizen's feedback in management information systems, performance indicators and reports, and providing incentives (positive and negative) for improved service delivery to citizens.

3.43 **Reforms to the structure of revenue departments.** In many states, the administration of revenues is fragmented among 10 or more administrative departments, which mostly also perform non-revenue functions. This leads to problems of coordination, lack of uniformity in administration and fragmented taxpayer records. A more promising structure is one with four departments: a main tax department which would cover most taxes, and separate departments which would combine revenue and regulatory functions for transport, land, and mines. A permanent, secretary level, revenue committee would ensure coordination. This structure is close to that in states which have commercial tax departments. Since, in the case of stamp duties and registration fees, bifurcation of registration and duty collection would possibly have efficiency benefits, registration of deeds could be made the responsibility of the land revenue department and stamp duty collection could be brought under the tax department. Box 3.6 provides a summary of tax administration recommendations for improving Tamil Nadu's commercial tax department.

3.44 **Modernizing field enforcement and check posts.** While mobile squads and particularly border check posts constitute an impediment to internal trade and a common market, their removal at the current stage of

[30] In a number of Stamps and Registration Departments such as Andhra Pradesh, Maharashtra and Karnataka.

development, given large scale evasion will lead to reduced state capacity to collect revenue.[31] However, current check posts at state borders are generally poorly equipped and corruption-prone: a recent estimate puts the cost of "facilitation payments" at about 10% of transport costs" (Harral, Jenkins, Terry, Sharp, 2003). Besides, separate check posts are typically maintained by different departments, including sales tax, state excise, motor vehicles, mines and minerals and forests adding greatly to waiting times at state borders. By integrating border check posts and mobile squads across different departments, and eliminating most internal check posts, these costs can be reduced.[32] Furthermore, by adoption of modern technology and institutional reforms, their effectiveness and cost efficiency can simultaneously be increased, while reducing avenues for corruption.[33]

3.45 **Use of common facilities** Certain institutions can be on a common footing to facilitate coordination across all departments. Importantly, this includes common taxpayer identification numbers. Coordinated field services, via mobile squads and check posts, can also be made the responsibility of a single department to reduce duplication and citizen's compliance costs. Other common activities for taxes and mineral royalties include delinquent collection, except for unpaid land revenue, and maintenance of overall taxpayer master files and current accounts.

3.46 **Inter-jurisdiction revenue coordination** While several institutional mechanisms are in existence for coordination of revenue policy and administration between centre and states and also between states, most are ineffective, often because their role is merely advisory. In some important cases, the need for coordination is yet to be recognized. For example, it is impossible to get information on rates and bases across states for most taxes, preventing lessons from being learned from cross-state analysis and hampering the work of Finance Commissions.[34] The encouraging recent experience of the Empowered Committee of State Finance Ministers, through which states have achieved significant coordination in streamlining their tax regimes for taxing goods and in designing the proposed state VAT, shows that effective inter-state coordination is possible and can yield major benefits. Conversely, lack of coordination results in (a) inter-state tax competition reducing revenue potential of states; (b) inter-state trade diversion and resource misallocation due to differing tax rates and tax provisions; (c) tax avoidance by exploiting the timing of taxes in different jurisdictions; and (d) impaired ability to identify tax reforms to promote revenue buoyancy and economic growth. Much more serious is lack of coordination in revenue administration. This lack of coordination has its greatest impact on revenue by limiting information available to different tax administrations to combat evasion. A major negative impact on economic efficiency and revenue collection efficiency also arises from duplication in revenue administration such as via identical taxpayer reporting requirements imposed by different tax departments and by multiple check posts at state borders. While comprehensive estimates of the economic and revenue cost of this lack of coordination are not available, piecemeal estimates suggest that these costs may equal several percent of India's GDP. Some proposals to strengthen revenue coordination, as well as some examples of how other countries handle this issue, are contained in the Annex to this chapter, which appears at the end of this volume.

3.47 **Development of tax policy and forecasting capacity**. There is no single channel for proposing revenue reforms and, in most states, no laid down technical analysis procedure for evaluating the impact of such proposals. Consequently, it is often the case that no view on a proposal is expressed and no analysis offered by revenue departments. Capacity for this needs to be developed both in tax departments and in Finance

[31] Das-Gupta (2003) presents evidence that the removal of border check posts in the European Union in 1997 possibly led to negative revenue effects despite its developed economic status. This is supported by conclusions in Ebrill, et. al. (2001). See also Cudmore and Whalley (2002). For India, Das-Gupta (2003) argues that Maharashtra, which along with Haryana has no sales tax border check posts, has a poorly performing sales tax.

[32] Integrated check posts are being established in Andhra Pradesh and Karnataka and possibly Maharashtra. Das-Gupta (2003) reviews desirable ingredients of integration and modernisation packages.

[33] The importance of institutional reform to accompany induction of modern technology is illustrated by the experience of Gujarat. Computerisation of Gujarat's border check posts in 1999 led to a threefold growth of check post revenues in 2 years. However, staff resistance and lack of maintenance led to check post equipment becoming unusable thereafter. See Pandey (2002)

[34] For example, fiscal equalization by Finance Commissions requires estimates of tax exportation which, in turn, requires data on sales tax rates and bases. A second example, a long standing recommendation by fiscal experts to lower stamp duty rates has been resisted by states since evidence that lower rates would result in greater revenue buoyancy is lacking wthout improved cross-state data.

Departments so that an informed view can be taken. No state has a tax forecasting model: tax forecasting capacity needs to be urgently developed not least to help withstand the temptation to artificially inflate revenue budget estimates (Chapter 2.V)

3.48 **Rationalization of tax laws**. Tax rates, including ad valorem rates, can be revised by annual state budgets. However, tax rules, procedures and forms do not require either cabinet approval or legislative sanction. Furthermore, mid-year changes to the tax base, rates and especially exemptions can be made by executive ordinance, subject to ratification by the legislature within 6 months. A consequence of mid-year changes and executive discretion is the existence of a large number of government orders and notifications, not forming part of relevant acts or rules. This proliferation of orders and notifications can also give rise to gaps in administrative control. A legal clean-up is overdue for tax law in many states.

3.49 **Involving the private sector**. Tax farming is being tried for collection of the entertainment tax from cable television operators in Maharashtra. It has also been used for octroi (a local tax on the passage of goods), though with mixed results. State tax departments are also increasingly turning to public-private partnerships, especially for computerization, e.g. in Karnataka and Maharashtra for property registration. While clearly not a general solution to tax collection, involving the private sector can help, provided regulatory issues are satisfactorily dealt with.

3.50 **Tax amnesties** Several states have in recent times announced one or more tax amnesties particularly for sales taxes and stamp duties (including AP, Karnataka, Maharashtra and TN). Amnesties tend to reduce taxpayer compliance in the long term and even short term revenue gains may be illusory since only those taxpayers who are likely to lose tax disputes or who have a high probability of being caught will rationally participate: Amnesties are generally best avoided. There is also no justification for a permanent tax amnesty via a settlement commission. These institutions greatly weaken the ability of administrations to enforce taxes and have negative effects on willingness of taxpayers to comply with taxes. Since they are typically limited to large taxpayers, they are also inequitable.

3.51 **Dispute resolution institutions** are slow and services not logically priced. In most states, there is a vast backlog of tax appeals, mainly for sales taxes, and additional disputes pending in courts. Many appeals are filed purely to delay tax payment and take advantage of the slow disposal of appeals cases. This is facilitated by low filing costs of tax appeals and the absence of any direct cost to appellants of seeking adjournment of hearings. Furthermore, appeals are typically viewed narrowly and do not result in comprehensive reassessment. Other appeals, particularly higher appeals filed by tax Departments, have a high chance of being decided in the taxpayers favor or, at best, low revenue return for the time and expense incurred by tax departments. To increase revenue effectiveness and reduce taxpayer compliance costs, dispute resolution institutions need urgent reform.

## IV Conclusion

3.52 Further tax reforms are necessary to help restore fiscal sustainability and to raise revenues for public investment and other developmental spending. As a guiding principle, the revenue productivity of Indian states can be increased by broadening the tax base coupled with reforms to ensure few low rates and limited exemptions. This will also help to improve compliance. Major specific recommendations are summarized in Table 5.1 in the concluding chapter. The key reform is to replace the sales tax and other minor commercial levies by a destination-based consumption-type VAT on goods. The move to an integrated VAT on goods (and, if possible, services) is likely to have appreciable growth benefits, provided tax administration is also streamlined and tax payer compliance is held in check. The distorting and inequitable central sales tax should also be phased out. Significant further revenues can also be raised through reforms to the professions tax.

3.53 State tax reforms require wide-ranging actions by both the states and the center. The center has to take a lead if the decade-long journey of the states VAT is to resume; we have suggested a way out of the current

impasse by allowing states to graduate ahead individually into VAT, without compensation, with a choice of rates restricted only by a cross-state agreement on floor rates. Professions tax, where there is potential for states to raise an additional 0.8% of GDP, can also only move forward if the center takes the lead in amending the constitution to increase the floor rate.

3.54 Sustained improvement in the revenue performance of states cannot be achieved without thoroughgoing institutional reforms in tax administration and inter-state coordination facilitated by the induction of modern technology. The Centre could take the lead in institutionalizing inter-state coordination, not only in tax matters but, perhaps more important, tax administration and information sharing. Institutions for coordination and information sharing between central and state tax departments also needs urgent attention (see the Annex to this chapter for details). Most importantly, strengthening weak tax administration institutions and related e-governance reforms will enable effective use of enforcement information, increased managerial control, better incentives for tax department staff, and improve taxpayer services. Of all pending reforms, improved enforcement technology and procedures coupled with staff incentives, management flexibility and effective anticorruption institutions have the greatest potential to lead to a significant and sustained increase in state revenue.

# CHAPTER 4
# FISCAL FEDERALISM AND THE INCENTIVE FRAMEWORK FOR STATE-LEVEL REFORM

## I. INTRODUCTION

**By international standards, India's states have a lot of autonomy.**

4.1 To understand why states are in fiscal difficulty, and how to strengthen their development-effectiveness and motivation to reform, one needs to look at the incentives they face. These incentives are in turn determined by India's federal fiscal architecture, the subject of this chapter. Box 4.1 provides a summary of India's fiscal federal arrangements from an international perspective. We have already noted that their heavy expenditure responsibilities are matched only by China among other developing countries. On the borrowing side too, relatively few limits are placed on the states compared to several other developing country federations. Nevertheless, GoI still plays a dominant role in the Indian federation. Relative to their expenditure responsibilities, India's states are unusually dependent on central-government transfers. In 2000/01, central transfers contributed 37% of total state revenue. Central transfers are particularly important for the poorer states, who get 51% of their revenue from the central government. Second, GoI plays a leadership role with respect to many national policies: for example, the Central Pay Commission in theory sets salaries only for GoI civil servants, but in practice influences salaries paid in the public sector throughout the country. Third, GoI not only lends to the states but, under the Constitution, sets the borrowing framework within which states operate.

**India's complex system of fiscal federalism is important to understand in any analysis of state reforms.**

4.2 India has developed elaborate and complex institutional structures in the area of fiscal federalism. The two most important federal institutions are the constitutionally mandated Finance Commission, which convenes every five years to determine the sharing of revenues between the center and the states, and the Planning Commission, which, though not a constitutional body, is responsible for developing the national 5-year plan and approving state-level plans, and which provides funding for the same. Whereas the Finance Commission recommends allocation of tax shares and grants, the Planning Commission oversees allocation of both grants and loans.

4.3 In many ways, India's fiscal federal system has served the country well, and has brought stability over an extended period of time. Yet, with growing fiscal stress, and divergence in performance, the system has become the subject of increasing controversy. Following the award of the Eleventh Finance Commission for 2000-05, some have argued that center-state transfers are not adequately progressive to address the widening imbalances between states, while others have complained that the high-income states are being punished rather than being rewarded for performance. For all the disagreement, there is also a clear and shared recognition of need for change. Traditionally stated policy objectives of center-state fiscal arrangements, namely inter-regional equity and efficiency in the use of public resources, have been joined by a new set of objectives -- fiscal responsibility, sustainability and public financial accountability – which have gained prominence in recent years.[35]

4.4 In part because we advocate the need for a sharp distinction to be made between grants and loans, we approach this chapter by considering separately the state-level borrowing regime (Section II) and system for the distribution of central transfers to the states (in Section III). Section IV concludes. We begin by noting that the study of fiscal federalism both internationally and in India is vast; our main aim in this chapter is to summarize and synthesize the work done by Indian and other scholars in this area.

[35] In the words of Dr. C. Rangarajan, Chairman of the recently constituted Twelfth Finance Commission, mandated to recommend the regime of resource-sharing between the center and state governments during 2005-2010, "Equity considerations must be incorporated within a framework of fiscal prudence".

**Box 4.1: International perspective on India's fiscal federalism**

**Expenditure responsibilities** India is very decentralized in terms of expenditure responsibilities. The share of state to total expenditure is about 57%; this is the same as Canada, and below China, but above most other countries. The average for OECD countries is 35% and for Latin America 15%.

**Revenue transfers and vertical gap.** The share of state in total revenues in India is about 39%. This is about average, but low given the extensive expenditure responsibilities of India's states. The ratio of expenditure to revenue for India's states is 1.45, which is below Australia and Denmark in the table, but above everyone else. This reflects a high degree of dependence on central transfers as well as borrowing.

| | Sub-national as a percentage of total ... | | (1)/(2) |
|---|---|---|---|
| | Expenditure | Revenue | |
| | (1) | (2) | |
| China | 81.5 | 59.7 | 1.37 |
| Canada | 58.8 | 53 | 1.11 |
| India | 56.7 | 39.1 | 1.45 |
| Denmark | 53.9 | 31.7 | 1.70 |
| Australia | 49 | 31.7 | 1.55 |
| Argentina | 45.6 | 39.1 | 1.17 |
| U.S.A. | 44.4 | 42.1 | 1.05 |
| Germany | 38.8 | 33.8 | 1.15 |

**Equalization.** Most federations have some sort of commitment to equalization built into their federation. Some, such as Canada and Germany, have the goal of horizontal equalization explicitly built into its constitution. India's constitution, in many respects detailed, is quite vague on the principles which should guide central transfers, leaving the onus of interpretation on the Finance Commission. Similarly, in terms of outcomes, central transfers are progressive in practically all federations, but very equalizing only in some (Canada, Germany, Mexico, Australia), and partially equalizing in others (Brazil). As we discuss in detail in the text, India fits in the latter category, no doubt in part because the constitutional and institutional commitment to equalization is India is much less explicit.

**Borrowing** rules India's rules for sub-national borrowing, especially as they are put into practice, are relatively liberal. An IMF study of 53 countries found that all but 6 had some restrictions on sub-national borrowing; in 16 sub-national governments were barred altogether from borrowing; in 19 overseas borrowing was banned. (see Ter-Minassian and Craig, 1997; Anand, Bagchi and Sen, 2003) Overseas borrowing by states is banned in India, but, unlike in many other countries, there are no aggregate limits on domestic borrowing: by contrast, in Italy, for example, regions can borrow only for capital projects and subject to a limit that debt service not exceed 25% of a particular definition of revenue; Brazil's states, under the country's Fiscal Responsibility Act, face a debt limit equivalent to two times the states' net current revenue to be achieved within a 15-year period, with annual reductions equal to $1/15^{th}$ of the original excess over the limit. Two restrictive features of India's borrowing arrangements, which have not always been present in some others, and have caused trouble when they have not (e.g. in Argentina, Brazil), are that states are not able to borrow from central or provincial banks ("print money") and that there is a limited, though not absent, history of debt write-offs. India is unusual in acting as a creditor to state governments. Pakistan, whose federal government used to extend loans to finance investments of state governments, has discontinued this practice

**Debt levels:** Reflecting the relatively liberal borrowing regime, India's states seem to be the most highly leveraged in the world. In 2000, for all of India's states combined, the ratio of debt to revenues stood at 203%. Canada was next with 189%, Brazil with 170%. In Argentina the ratio was 69%, and the US 44%.

## II BORROWING REGIME

### States face six sources of borrowing, all of which have been increasing since the late nineties

4.5 The 1950 Constitution of the Union and States of India sets the basic rules of India's sub-national borrowing regime. Section 293 forbids state governments from borrowing abroad and requires them, as long as they owe even one rupee to the Union Government, to obtain central approval for domestic borrowing. The following sources of domestic borrowing are open to the states:

(i) *GoI (central plan) loans*. These accompany the central grants to help finance state plans. See para 4.9 for a more detailed discussion.

(ii) *Market borrowing*. State bonds are issued to banks and financial institutions through a process managed by the Reserve Bank of India. Nearly all bonds from states are sold at the same time and the same price. RBI also manages debt-servicing, and allocates for this purpose funds transferred from the central government, all of which pass through the RBI. Thus such funds are supported by an implicit escrow

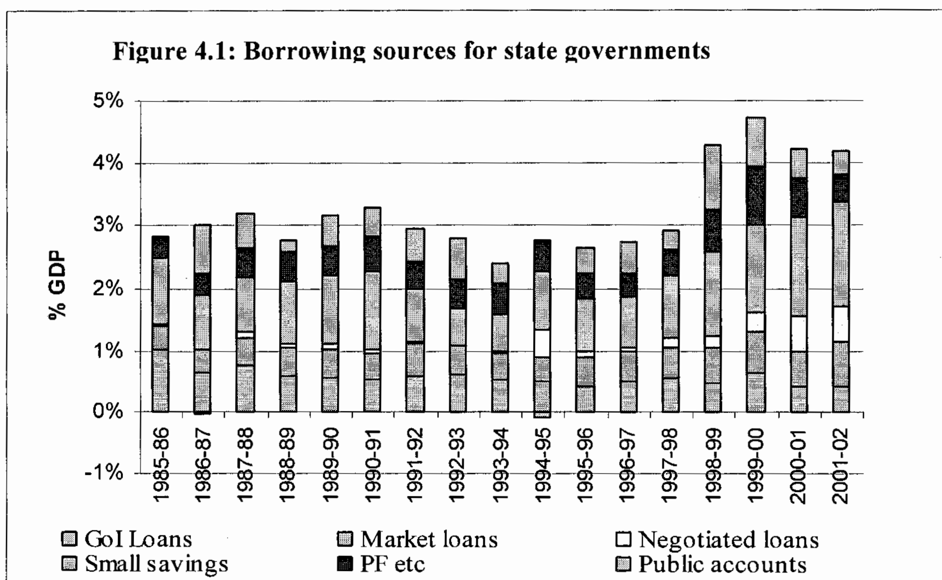
arrangement though not by a central guarantee. The amount of borrowing per state is determined by GoI (Finance Ministry) at the start of the year, largely based on precedent, though ad hoc adjustments are frequently made in the course of the year to allow for "additional market borrowing".

(iii) *Negotiated loans*. These are from public insurance companies and other GoI-owned financial institutions. Their quantum is determined at the time of Plan finalization, and also subject to being supplemented during the course of the year, with room for central discretion and hence for political lobbying.

(iv) *Small savings:* net public deposits in central post office savings schemes with administered interest rates that have been maintained above market rates. All such deposits are available to the states in which they accrue – partially for general deficit financing purpose (80%-60% during 2002-05) and partially to swap with old and more expensive small savings debt

(v) *Provident and insurance funds.* These are involuntary savings of the state government employees at administered interest rates – the net inflow being the difference between deposits of monthly premium by each account holder, on the one hand, and the sum of net loans extended and final payment on maturity (at the time of retirement), on the other hand.

*(vi)* *Other Public Accounts.* By definition, Public Accounts include all transactions in respect of which the state government acts like a banker. Besides the involuntary savings (provident fund accounts) of state employees and those in state-aided institutions, Public Account borrowing is a practice best understood as one in which expenditures are booked under a public account, but not incurred. The increase in the balance of the public account is then defined as deficit-financing for the booked expenditure. Expenditure booked in this way are by definition not incurred in the year in which they are booked, and experience shows that in fact they are often not incurred in subsequent years. Other Public Account stocks are excluded from debt stock calculations, and Other Public Account "borrowing" is often fictitious.[36]




4.6 As Figure 4.1 shows (and as was also discussed in Chapter 1), borrowing from all sources was constant at around 3% of GDP, but has been above 4% since 1998/99. The most important source of borrowing is now small savings, about 40% of the total. Market borrowings are the second most important at about 15%. Negotiated loans have grown very rapidly and now make up almost 15% of total borrowing, up from just 1 or 2% at the start of the nineties. GoI loans are a declining share: they were above 20% of the total, but are now down to 10%. The provident fund has also declined to about 10% of total borrowing. Borrowing from other public accounts fluctuate wildly, reflecting accounting adjustments rather than real debt accumulation.

4.7 There are also two other borrowing mechanisms, which exist outside the formal framework. First, to circumvent central controls on market borrowing, some states raise funds through special purpose vehicles: the debt is off the budget, but debt-servicing is through the budget. Such practices became very popular in the course of the nineties; various orders have been issued by GoI and RBI, which would, if implemented, bring off-

[36] See Ravishankar and Mathur (2003) for further discussion. Note that this item is defined residually, and thus also includes changes in the cash balance.

budget borrowing to an end, or under stricter control. Second, states run up arrears. The most striking case of this was in the power sector, where budget constraints were truly soft as states could "buy" power from central utilities (para 1.29), sell it at a loss, and not have to pay for it. One of the most significant developments of the post-crisis period is the reform to the paying mechanism for central utilities, which has, at least to a large extent, closed off this loophole.

**The strengths of the sub-national borrowing regime are its ban on offshore borrowing, and the limited history of bailouts. But there are many weaknesses: too much borrowing, and neither effective central regulation nor market based discipline**

4.8 **Strengths and weaknesses.** The strengths of the sub-national borrowing framework in India include: its bar on borrowing abroad, which is strictly implemented and which augurs well for macroeconomic stability; the inability of states to print money; and the strong controlling role given to the central government under the constitution, although the implementation of these controls is far from complete. Another important strength has been the limited history of bailouts. Although there have been some debt write-offs offered periodically by various Finance Commissions, these amount to 7% of GDP over a 30-year period, and less than 2% of GDP in the last 20 years (i.e. not annually, but spread over the number of years mentioned) Thus, so far, states have normally had to repay debt that they have incurred. At the same time, the borrowing framework suffers from a number of weaknesses:

- *Too much state-level borrowing, especially for the poorer states.* This is the most fundamental problem. India's states were already heavily leveraged before the crisis: they have the highest debt/revenue ratios of any sub-national entities world-wide (Box 4.1). Since then, the state-level debt burden has skyrocketed. The poorer states are particularly indebted with significantly higher deficit and debt ratios than the other states (see Chapter 1). This problem is unlikely to go away soon. Small savings is a key source of debt that is growing explosively. In the last two years, GoI has wisely controlled the growth of small savings by earmarking a significant and increasing portion of new small savings to retire old, high-cost small savings loans. However, this can clearly only be a temporary solution.

- *Limited central control of state borrowing.* Federations around the world show a great deal of variety in their sub-national borrowing regimes; as discussed in Box 4.1, India is stricter than some, and more relaxed than others. What one can say is that the actual controls over sub-national borrowing are far below what the constitution allows for. Of the six borrowing sources outlined above, only three – loans from GoI itself, market borrowing and, to some extent negotiated loans – are under the direct control of GoI. The other sources are not capped by GoI though they make up over one-half of total borrowing.

- *The interest rates states face are independent of their creditworthiness.* By and large, states all pay the same interest rates for their debt, and have the same access to capital markets. States typically approach the market together, and it is well known that the RBI pushes creditors to buy a mix of state bonds, in particular leaning on them to purchase bonds from states perceived as being less credit-worthy: thus the better-managed states cross-subsidize the worse-managed. Such practices enormously weaken the incentives for prudent fiscal behavior. In 1999, the RBI did allow states to sell bonds on their own, up to 35% of their total allocation. But this remains only an option, not a requirement, only a few states take advantage of it, and there has been no subsequent liberalization of the market-borrowing facility.

- *Soft budget constraint* Budget constraints are said to be soft if there is a perception of a bail-out in the future. While bail-outs have been limited in India, they have not been entirely absent. Some small states, such as Himachal Pradesh, are repeatedly bailed out, and states in stress are sometimes given additional loans by the central government. This sort of behaviour clearly weakens the incentives for fiscal prudence (McCarten, 2003; Anand, Bagchi and Sen, 2003).

- *Complex system, with elements of discretion and arbitrariness.* The borrowing regime is complex with multiple borrowing channels, each with its own rules. There are clear elements of discretion and arbitrariness, especially relating to open-market borrowings. The allocation of market borrowings between states follows no pattern except history. The additional market borrowings window gives rise to significant lobbying, and reinforces the perception that borrowing is a source of revenue to be maximized rather than managed. India is also one of the few federations in which the central government acts as a creditor to the states. This again gives rise to lobbying opportunities. Several econometric studies have shown undesirable outcomes from this arrangement (see Box 4.4), including that politically powerful states get more access to central loans, and end up with higher deficits.

- *Planning process out of step with pro-reform fiscal framework.* The emphasis on enlarging the aggregate size of 'State Plans' and the system of financing through a package of central transfers, central loans and additional borrowing has fed into a spiral of debt accumulation by the states, unrelated to the debt bearing capacity of each state. (The planning process and the problems it causes for the states, and possible solutions are discussed in Box 4.8 at the end of this chapter, since it cuts across both loans and grants.)

4.9 In summary, the states are disciplined neither by the credit markets nor by the central government: consequently, neither the hierarchical nor the market-based controls advocated by the literature on sub-national borrowing are well developed. Reforms need to be considered both to govern future borrowing and to handle the large, existing stock of debt. We consider these in turn.

**The most important reform to the borrowing regime would be to introduce flexibility within a global cap.**

4.10 In general it is clear that the sub-national borrowing regime needs to be rationalized and simplified. At one extreme, one could advocate forcing all states to go to the market for borrowing, and relying on the markets to discipline the states, and punish imprudent policies with worse credit ratings and higher interest rates (Lane, 1993). Such a system of market-based fiscal discipline works well in developed countries such as the US, Canada and Australia, which face few, if any, central controls, even over foreign borrowing. However given the experience in some other developing countries, especially Latin America, and the lack of a role for credit-markets in the current federal fiscal system in India, it would be risky to rely solely on this approach. Thus the consensus in the literature is for "market-based discipline supplemented by rules-based controls."[37] There is a good argument for, at least for the time being, developing a "global cap", which would place an upper bound on state borrowing. Within that cap, however, states should be provided with the maximum flexibility for arranging their own borrowing, and be exposed as much as possible to market discipline. Adoption of such an approach would have a disciplining impact on both the states and the center. It would close avenues for political bargaining by the states for additional loans, and closes the avenue for the center to use the approving of additional loans to states as political favors. We outline below some of the steps, which could be taken to move the borrowing regime in this direction.

- The first step would be to define the global cap, which would be the maximum amount of borrowing a state government could undertake in any given year. Many countries have such caps: see Box 4.2 for examples. The cap should be based on observables, and not subject to negotiation: it could be based on a percentage of GSDP or revenue from a couple of years earlier. Given that states are now adopting fiscal responsibility acts, the central government can simply adopt, and enforce, the borrowing targets already legislated by the states. It could be based on debt-servicing or debt-stock or debt-flow ratios. While in theory different states could sustain different degrees of debt, dependent on their growth rate, in practice, it would probably be more feasible to have the same ratio across all states. This ratio would need to be below current levels of borrowing for most states, which would force one to define a time-period within which borrowing would need to be brought under the cap, and a transitional path. It would also need to be decided what borrowing sources would be brought under the cap. On the one hand, the

[37] Anand, Bagchi and Sen (2003, p. 95)

definition should be comprehensive; on the other it should be practical, and able to be enforced. Whether the cap should include borrowing from the public accounts, off-budget borrowing, and other guarantees should be given particular attention.

- Once the cap has been decided on, enforcement mechanisms are needed, ex ante and ex post. Ex ante, all resource allocation discussions between the centre and state (e.g. Plan discussions) would have to be consistent with borrowing being at or below the cap. Consideration would have to be given as to whether the cap would be enforced by law (e.g. Brazil's 2001 Fiscal Responsibility Law) or simply by administrative order. It could be based on debt servicing or debt stock or debt stock flows. Ex post, one would need mechanisms to ensure that actual borrowing is consistent with the cap. Special consideration will need to be given to captive, open-ended borrowing sources, such as small-savings and provident funds. If such sources are retained in their current form, the degree of access to them should be contingent on total borrowing not exceeding the cap; any borrowing over the cap in one year would have to be offset in the next year. It will also be important to establish a credible system of timely reporting of states' debt and guarantees to enable the center to set and administer hard, state-specific borrowing ceilings.

- Borrowing arrangements within the cap should be simplified to the extent possible. Just as GoI is, so the states should be largely, if not completely, dependent on market borrowing, and face interest rates determined by their own credit rating. The main fear in this regard is the likelihood that some states would be unable to access the markets at all due to poor fiscal performance. However, with RBI providing liquidity (escrow) support, this situation might not arise, and poorer and poorer-managed states might be able to access markets, but at a higher interest rates. If necessary, GoI could also offer a guarantee facility, at a price, to backstop poorer states.

- Captive sources of loans should be done away with. Financial institutions and small-savings should have to buy government bonds, not offer loans directly to state governments. This would reduce lending pressure on state governments, and also lower their interest costs. If GoI wants to offer subsidized interest rates to small savers, it should cover the costs of this, and not burden the states. Off-budget borrowing should either be banned, or included within the cap.

- Lending from GoI to the states should also be done away with. This would not only be consistent with international practice, but also with the principle of reducing complexity and discretion and increasing the role of the markets. A special problem is posed in this regard by the role the central government plays as an intermediary between official external financiers and the states. This is discussed in para 4.36.

- Relying only on constraints on borrowers means that lenders such as public sector financial institutions may still push loans and find politicians with a short-term perspective willing to borrow, despite the rules. Hence tighter regulation of the financial sector is also needed in the form of a disincentive for financial institutions to make high-risk loans to non-creditworthy sub-national public clients. In the event that market based fiscal discipline, with interest rates on sub-national debt that reflect risk premia, is not feasible for India over the next five to ten years, then it may be worth considering a suggestion (Eaton, 2003) that the risk-weighting required for lending to states (currently uniform) be linked to an experience rating that reflects the probability of loans and guarantees becoming non-performing.

**Box 4.2 Borrowing restrictions on sub-national governments: principles and practice**

Ter-Minassian and Craig (1997) undertake a survey of the control of sub-national borrowing around the world. They draw four main conclusions:

- Sole reliance on market discipline for government borrowing is unlikely to be appropriate in many circumstances. However, market discipline can be a useful complement to other forms of borrowing control.
- The case for centralized administrative controls on borrowing (involving, for example, a centralization of borrowing or approval of individual loan operations) is not strong; in particular, it undermines transparency.
- Rules-based approaches to debt control would appear preferable, in terms of transparency and certainty, to administrative controls.
- These considerations would argue for setting global limits on the debt of individual sub national jurisdictions on the basis of criteria that mimic market discipline, such as the current and projected levels of the debt service in relation to revenues. It is important that projections used for these ceilings be realistic, preferably conservative. It is equally important that a comprehensive debt definition be used (including extra budgetary operations, guarantees, and recent financial innovations, such as long-term leases).

Petersen and Valadez (2004) in a more recent review states that "Regulatory schemes for sub national borrowing need to have prudential limits that are clearly stated, well-monitored and enforceable. Good information systems are key components of success." (p. xxxv). They note the need for clear definitions to avoid conflict and give the following examples of common debt limits and rules:

- The amount of indebtedness issued, usually expressed as a ratio of revenue
- Annual debt service as a ratio of uncommitted annual revenues
- No rolling-over of short-term indebtedness
- Long-term borrowing restricted to capital investments
- No external borrowing

Not all borrowing controls work. Burki, Perry and Dilinger (200x) note the mixed experience in Latin America. They argue for "neither a purely regulatory nor a purely laissesz-faire approach", but also note that "the name of the game is effective hard-budget constraints on subnationals, and these can be done or undone in several ways."

**Some country examples:**

- **Poland**: annual debt service no more than 15% of current revenue; debt no more than 60% of revenues.
- **Romania**: in addition to limits, a requirement that each subnational debt instrument contain a statement that there is no express or implied central government guarantee.
- **Brazil:** As part of the Fiscal Responsibility Act, a debt limit equivalent to two times the states Net Current

4.11 The reform agenda sketched out above is ambitious. It could of course be picked up piecemeal. In principle, a global cap could be introduced without any simplification in the borrowing rules. However, the advantage of tightening up overall access to loans while introducing flexibility within the cap is that it offers benefits to both the center and the states.

4.12 It is also important to realize that a global cap may not be the final solution. International experience suggests that, whatever the cap, states will always try to get around them. For example, in Australia state governments started to make extensive use of capital leasing to get around borrowing restrictions. Over time, it should be possible to rely more and more on discipline by markets (and voters) and do away with a centrally imposed global cap. However, we are a long way from that happy scenario now.

**Allowing states to borrow commercially to restructure debt is consistent with a shift to a "global cap with flexibility" model. But debt relief raises a number of questions**

4.13 **Treatment of existing debt-stock: options for debt-restructuring and relief.** The debt restructuring initiated by GoI over the last few years (para 1.30) is a welcome development for the states. The practice of ear-marking a significant ratio of small-savings to retire high-cost debt has helped keep overall borrowing levels down in the last two years, and provided a temporary solution to the explosive growth of small savings loans. Such earmarking should continue until a permanent solution is found to the problem of small savings utilization. Allowing states to access market funds to finance debt-restructuring is also consistent with giving states more flexibility to manage their debt within a fixed ceiling, and could be used to get states used to more commercial

borrowing operations. For example, states could be allowed to go in for additional market borrowing to finance debt restructuring provided that they obtain a credit-rating, and that they agree to their bonds being auctioned separately, rather than mixed up with other states. Debt-restructuring could also be a good use of adjustment lending resources available from external funding agencies.

4.14 For some Indian states, the combination of voluntary debt-restructuring and fiscal reform will be insufficient to restore fiscal solvency. The more highly indebted states shown in Figure 4.2, most of whom are the poorer states, are unlikely to eliminate their deficit on the current account, even with the strongest possible efforts to improve their own revenues and control their non-interest expenditures, because of the heavy burden of debt and annual interest burden that they have inherited (see Chapter 5.V. for further elaboration of this point). Just as the international community has floated the "HIPC" (Highly Indebted Poor Countries") initiative (summarized in Box 4.3), the suggestion has been made that GoI should float a "HIPS" (Highly Indebted Poor States") initiative, under which good fiscal performance would be rewarded by debt write-downs.[38] There is certainly merit in this suggestion: a well-designed HIPS scheme would incorporate the same suggestions made for the current Fiscal Reforms Facility (discussed later in Box 4.7) with perhaps a greater emphasis on a track-record of several year's good performance. At the same time, one has to note three caveats.

- First, the theoretical basis and practical backdrop to the HIPC initiative is the Krugman (1988) idea of "debt overhang". This noted that, in a scenario in which sovereign states were defaulting on their debt, agreeing on a workout could be in the interests of both the creditor and the debtor. But this observation does not apply to the Indian context, at least not in any immediate way, since default on state-level debt by the Indian states is rare. In such a context, the provision of debt-relief and additional assistance are equivalent. As noted, India already has the Fiscal Reforms Facility (Box 4.7), which provides additional assistance to reforming states. If necessary, more resources can be made available under the FRF to highly-indebted states, subject of course to meeting the performance benchmarks.

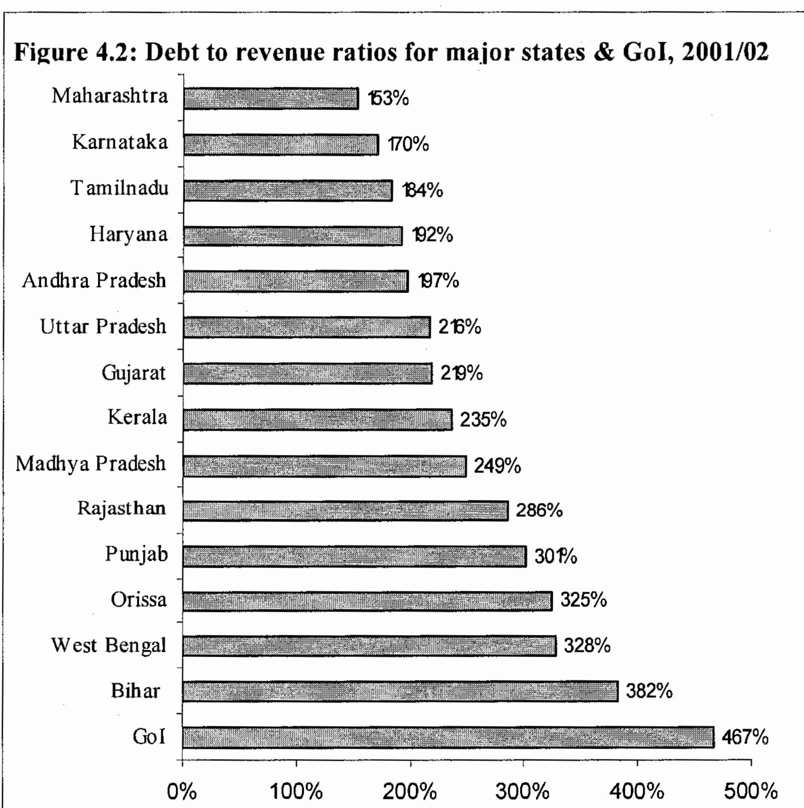


**Figure 4.2: Debt to revenue ratios for major states & GoI, 2001/02**

- Second, since the set of highly-indebted and poor states largely overlap, any shift towards horizontal equalization (discussed in the next section) will at once ease the relative debt-burden of the poorer states.
- Third, the states' largest creditor, and the only one which could offer relief, is the central government. Its indebtedness, as measured, say, by debt/tax ratio, is above 400%, which is higher than even the most indebted state (Figure 4.2). The rationale for a more-indebted creditor to extend debt relief to less-indebted debtors is unclear.

4.15 Thus while the problem of

[38] The 12th Finance Commission has been asked, for the first time, to assess the debt position of the states, and suggest corrective measures consistent with debt sustainability, and giving "weightage to performance in the fields of human development and investment climate."

excessive debt-levels certainly needs to be taken care of, it is unclear if this should be done by provision of debt relief or by addressing other problems – adequate rewards for good fiscal performance, and adequate horizontal equalization. Even a well-designed scheme runs the risk of inadvertently undermining the current expectation among Indian states that debt incurred will need to be repaid. The Latin American experience with frequent debt bailouts suggests that this is a path to be trod only with great caution.

**Box 4.3: HIPC- what is it, and has it worked?**

HIPC began in 1996 with the goal of removing the debt overhang as a constraint to economic growth and poverty reduction. It was enhanced in 1999 to bring about deeper, broader and faster debt relief, and also to support a more ambitious set of objectives: to provide a "permanent" exit from debt rescheduling, promote growth, and release resources for higher social spending.

The key HIPC target was to reduce the ratio of NPV debt/exports: initially to 200-250%, then to 150% under E-HIPC. Any country with a ratio above this level, and which met the performance criteria, was eligible for HIPC assistance. Initially, a country was required to put in 6 years of "good performance" to qualify for HIPC: a 3-year track record of macro stability and policy reform was required to reach the "decision point", i.e. become a HIPC candidate, and then another 3-year period to reach the "completion point" at which time debt relief became available. However, the enhanced HIPC halved the track-record time requirement by making debt-relief available at the time of the decision point

From 1996 to 1999, only seven countries became eligible for debt relief. But 20 countries became eligible (reached decision point) by the end of 2000; another 6 qualified by August 2002. By August 2002, the number of countries eligible for HIPC relief reached 42, while 26 were actually receiving relief. The cost of the initiative is expected to be $27 billion in 2001 net present value terms.

It is difficult to evaluate HIPC at this stage, given the shortness of time that has passed. Evaluations of debt relief more broadly are divided. Some (Sachs 2002, Hanlon 2000) argue that debtors have been given just sufficient relief to enable them to pay their primary creditors, but not enough to allow their economies to grow, let alone to reduce poverty. Other studies concluded that the greatest relief has gone to countries with bad policies (Easterly 2002) or without good governance (Neumayer 2002), and that it has not yet been used for poverty reduction (Allen & Weinhold 2000), or that debt relief had little effect on the actual flow of debt payments because those debt service obligations which were forgiven were largely ones which debtors would not have met anyway (Policy and Operations Evaluation Department, 2003).

The independent Operations Evaluation Department of the World Bank published a review of HIPC in 2003. It found that it the anticipated debt relief is delivered, the initiative will succeed in substantially reducing most HIPCs' external debt stocks and their debt service to below the levels of other poor countries. But to achieve the broader objectives, the initiative would have to transfer additional real resources, which in turn would require an increase in the global aid budget, whereas in fact there was a sharp decline in global net resources about the time HIPC started. The OED review also found that the "track record" requirement for HIPC relief was progressively reduced in the enhanced HIPC, and that there were questions over whether some HIPC countries had the policies in place to generate sustained poverty reduction.

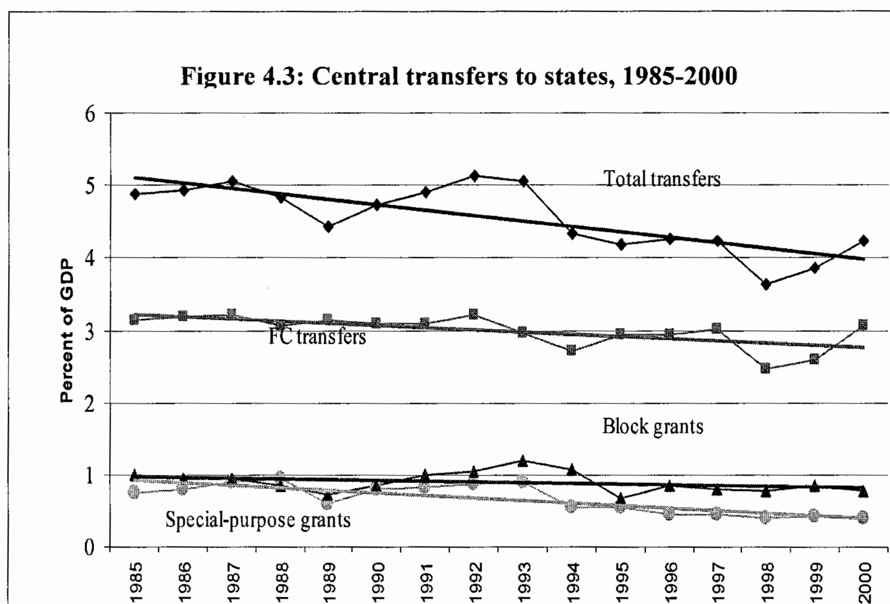
## III REVENUE TRANSFERS (GRANTS)

### India is characterized by a large degree of vertical imbalance.

4.16 **Vertical imbalance**. The tax and functional responsibility assignments between the center and the states of the Indian Union, as stipulated in the 1950 Constitution, imply a significant vertical gap -- that is, an imbalance between the revenue-raising ability of a level of government and its expenditure responsibility. The center is resource rich relative to its expenditure responsibilities, while the states are revenue poor relative to their rich mandate of expenditure responsibilities. This vertical imbalance, as measured by the share of central transfers in total state revenues, is about 40%, high by international standards (Box 4.1).

**A long-term decline in central transfers to the states is one of the contributory factors behind the deterioration in state finances.**

4.17 **Transfer volumes and channels.** There are three principal ways in which the vertical gap is filled by transfers from centre to states: Finance Commission (FC) transfers, block grant transfers which are part of the plan allocation to states, and specific-purpose grants for schemes run by GoI. Figure 4.3 shows the trends in total transfers and by categories. As was discussed in Chapter 1, overall grants from the centre have been declining from about 5% in the early nineties to about 4% of GDP today.[39] A decline in all three sources of transfers is responsible for this, though the sharpest decline in the falls in special-purpose grants. Some brief details on the three types of transfer channels follow:




(i) *FC transfers* are largely untied, formula-based transfers, consisting of tax sharing and unconditional grants,[40] which are distributed among the states by the Finance Commission, a constitutional body, for a 5-year period.[41] As Figure 4.3 shows, FC transfers account for major and growing share of the total revenue transfers during the 1990s (two-thirds by 2000/01). They suffered a sharp cyclical decline in 1998/99 and 1999/00, but have subsequently recovered. The awards of the Finance Commissions have generally been based on a formula-driven tax revenue sharing component,[42] and a small (10%) grant component that is determined on the basis of projected gaps between revenues and expenditures of states.

(ii) *'Block' grant transfers* called 'Central Assistance to State Plans', are the grant component of a mixed grant-loan transfer overseen by the Planning Commission: the loan/grant mix is 70/30 for the major or 'general category' states and 10/90 for the special category (small and border) states. The transfers consist of a "normal" portion, whose aggregate size is at the discretion of the central Ministry of Finance and 70% of which is distributed among the 15 major States according to a Planning Commission formula[43] with 30% earmarked for the special category states; and an "additional" portion, which is the onward transmission of generally earmarked external resources through the center to the states. Block grant transfers make up about 20% of total transfers, and just less than 1% of GDP.

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[39] The most recent actual data for central transfers received by state governments is for 2001/02 which shows a further decline to 4.0% of GDP (from 4.2% in 2000/01) due to a decline in tax devolutions, associated with stagnant tax collections by GoI that year. This data is not broken down into block grants and special-purpose grants, and so is not included in Figure 4.1. 2002/03 actuals are only available for tax devolutions: they are at 2.3% of GDP

[40] Small parts of the FC awards do have conditions. For example, the Eleventh Finance Commission award (2000-05) included one portion of grants conditional on fiscal correction by the states, under a centrally administered Fiscal Reform Facility: see Box 4.7.

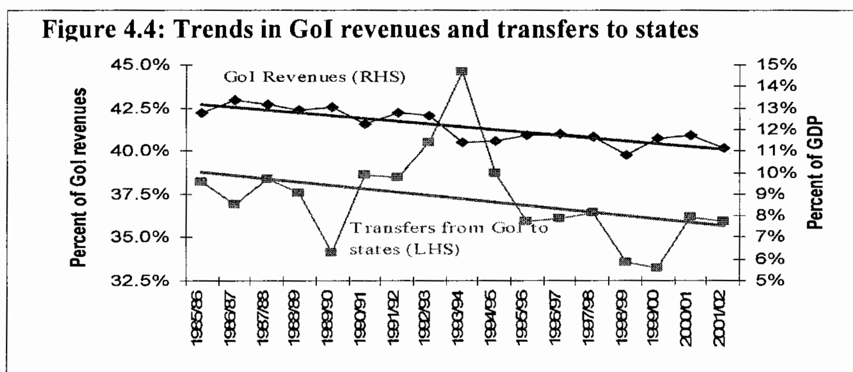
[41] It is not mandatory upon the Government of India to accept the recommendations of the FC, but it invariably does with respect to the tax sharing formula.

[42] The formula varies from commission to commission: the Eleventh FC formula used weights of population (10%), income differential with the richest state (62.5), area (7.5%), index of infrastructure (7.5%), tax effort (5%), fiscal discipline (7.5%)

[43] The revised Gadgil formula (1991) gives 60% weight to population, 25% to an inverse measure of per-capita income, 2.5% to tax effort, 2.5% to fiscal management, 2.5% to national objectives and 7.5% to special problems.

(iii) *Specific-purpose or conditional grants* finance centrally designed programs through cost-sharing arrangements with the states. Some of these also involve loans, but most are given as grants. They finance about 130 schemes, about half of them for rural development; other significant schemes are in the areas of health, nutrition, and education. Special-purpose grants have fallen sharply as a share of total grant transfers during the 1990s: from close to 20% in the early nineties to less than 10% now. It is important to note, however, that what is reported here as specific-purpose grants are only those received on-budget by the states. Many centrally-financed cost-sharing programs do not appear in the books of the state governments; rather, both the central and state governments provide funds in agreed ratios to third-party implementers, typically district-level societies. In 2000/01, 62% of central grants were disbursed under such an arrangement. It may well be that the fall in specific-purpose grants reflects a greater shift to this type of disbursement arrangement. As noted in Chapter 1.V, in the last few years, a new type of conditional grant has come into existence, namely one which links fund disbursement not to particular sectoral expenditures but to the achievement of various reform milestones. These remain quantitatively small, but are a significant development in the Indian fiscal federal landscape.

**Figure 4.4: Trends in GoI revenues and transfers to states**

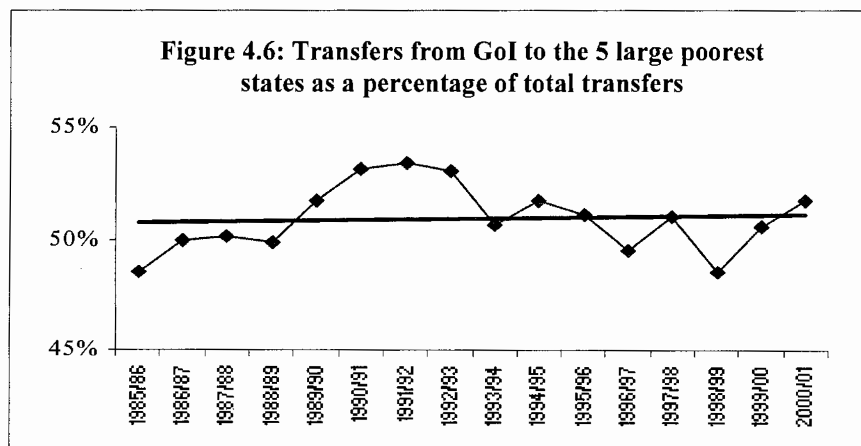



4.18 Both those central transfers linked to the tax take of the central government (tax devolutions) and those specified in absolute values have fallen. More recent data is available for tax devolutions up to 2002/03 (Figure 4.4), and this confirms the fall seen in Figure 4.3. In the 13 years before 1997/98, the ratio of tax devolutions to GDP fell below 2.5% only once; from 1997/98 to 2002/03, it has never exceeded it. Central transfers have fallen both because GoI revenue has fallen as a percentage of GDP (this explains two-thirds of the fall); and because there has been a decline in transfers to the states as a percentage of central revenue, reflecting the central government's own fiscal stress.

### The formal transfer system is modestly progressive

4.19 Of the different transfer types, the FC transfers are the more progressive (negatively correlated with the income level of states), other GoI transfers less so (see Table 4.1). The combined effect is a distribution of central transfers that is negatively correlated with, but much less varied than, state income: while the per-capita income of the richest state is more than 4.5 times the poorest (among the 14 major states), the per-capita transfer to the poorest state is a little less than double that to the richest. Also, while the richest states clearly get less than the poorest, the middle-income states often get more. For example, Table 4.1 shows that for the period 1995-2000, Tamil Nadu, Kerala, and AP all received more central transfers per-capita than UP, the second poorest state.

**Figure 4.6: Transfers from GoI to the 5 large poorest states as a percentage of total transfers**



| Table 4.1 Per capita transfers among India's states (average for 1995-2000) | | | | |
|---|---|---|---|---|
| | | Per capita transfers | | |
| | GSDP p.c. | FC transfer s | Other transfers | Total |
| **Poor States** | | | | |
| Bihar | 4846 | 614 | 120 | 734 |
| Uttar Pradesh | 7149 | 436 | 125 | 561 |
| Orissa | 6602 | 557 | 197 | 754 |
| Madhya Pradesh | 9037 | 549 | 210 | 759 |
| Rajasthan | 9716 | 432 | 190 | 622 |
| ***Average Poor States*** | **7211** | **500** | **153** | **653** |
| **Other States** | | | | |
| Andhra Pradesh | 10598 | 479 | 163 | 642 |
| Karnataka | 12614 | 391 | 158 | 549 |
| Kerala | 11360 | 460 | 131 | 591 |
| West Bengal | 10226 | 379 | 125 | 503 |
| Tamil Nadu | 13756 | 417 | 148 | 564 |
| Gujarat | 15768 | 356 | 122 | 478 |
| Haryana | 15304 | 263 | 167 | 430 |
| Punjab | 16659 | 289 | 124 | 413 |
| Maharashtra | 17107 | 273 | 115 | 388 |
| ***Average Other States*** | **13471** | **374** | **137** | **511** |
| **Average 14 States** | | **430** | **144** | **574** |
| **Correlation with GSDP p.c.** | | **-0.91** | **-0.32** | **-0.87** |

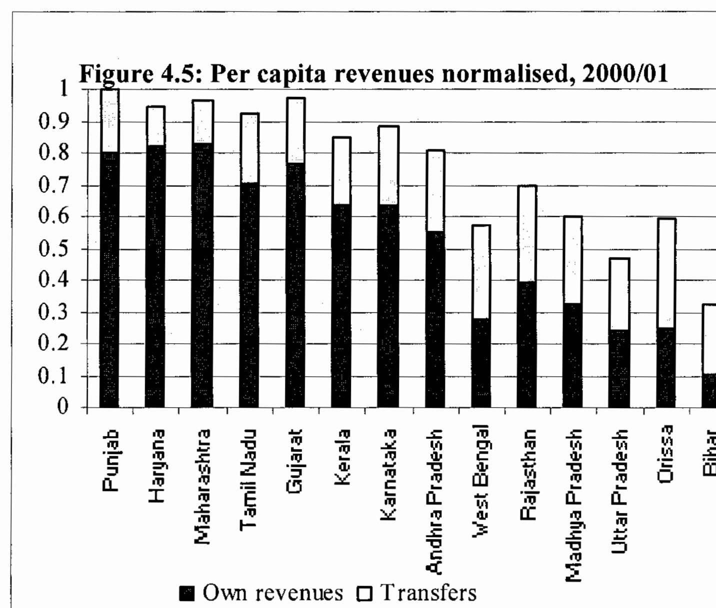
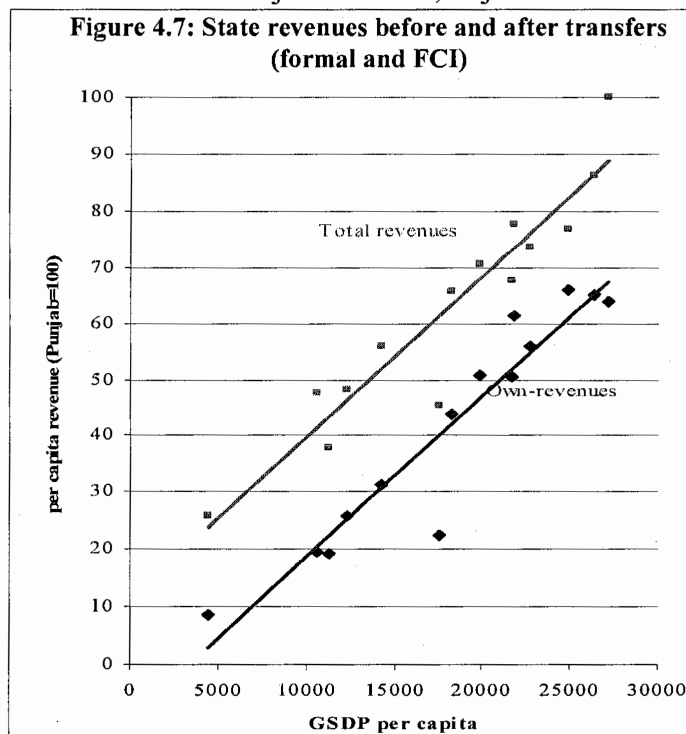


**Figure 4.5: Per capita revenues normalised, 2000/01**

4.20 Although progressive, central transfers, separately or combined, do not come close to achieving anything like horizontal equalization. Table 4.1 shows total per capita revenue for the 14 major states, normalized to the state with the highest revenue per capita, Punjab. It shows that among most of the middle- and high-income major states there is not much difference in per capita revenue. However, the per capita revenue of the poorer states is much smaller. With low own revenues and transfers, Bihar and UP end up with less than half of the per capita revenue capacity of Punjab. MP and Orissa do slightly better, but nevertheless end up with no more than 60% of Punjab's revenue; Rajasthan has 70%. Similar results are obtained if one looks at per capita revenue capacity rather than actual revenue, i.e., abstracting from differences in tax effort (Bagchi and Chakraborty, 2003). The modest progressivity of the transfer system can be seen from Figure 4.6 which shows that the 5 poorest large states with 40% of India's population and about 50% of its poor get 50% of central transfers. The figures also illustrate the stability of the distribution of transfers among states, with some year-to-year volatility, but no significant underlying trend.

**Figure 4.7: State revenues before and after transfers (formal and FCI)**




**There are also large and regressive informal transfers. Once these are considered, India's transfers are roughly distributed on a per capita basis.**

4.21 **Informal transfers.** Beyond these formal transfers, there are hidden or implicit revenue transfers among states, with substantial fiscal consequences. Chapter 3 has already discussed inter-state tax exportation through the Central Sales Tax: this is a regressive tax since it is imposed by

the manufacturing (rich) states on the consuming (poor) states. Another hidden transfer arises from the procurement of farm produce. This concerns the practice of the Food Corporation of India to procure at above market prices from particular states. Seventy-three percent of the rice and 84 percent of the wheat purchased by the Food Corporation of India (FCI) is from the relatively well-off states of Haryana, Punjab, and AP, even though these states produce only 26 percent of India's rice and 35 percent of its wheat. Farmers in these states enjoy assured sales at prices, which are much higher than where the FCI is not active.[44] An attempt has been made to quantify the benefits of this enjoyed by the various states (World Bank, 2004e). The results are startling: Punjab and Haryana together account for 67% of the subsidy, and receive more in FCI subsidies than they do through the formal subsidy system: for example, Punjab gets Rs 814 per capita through the FCI subsidy, but only Rs 636 per capita through the formal system.

4.22 The informal transfers vitiate the modest progressivity of the formal transfer system. On average, India's transfer system for all its complexity, approximates a system in which transfers are made to states on a per capita basis. That is to say, there is no correlation between transfers and income per capita. This can be seen from Figure 4.7 wherein the trend line plotting total per capita total revenues (i.e. after transfers, including FCI transfers) is parallel to the trend line plotting per capita own revenues (i.e. before all transfers). Thus, on average, all states gain the same amount per capita from the transfer system.[45]

**India's system of central transfers has several core strengths but also weaknesses.**

4.23 India's transfer system has the virtue of stability. It is quite remarkable that the core Finance Commission recommendations which concern the sharing of some 3% of GDP are accepted automatically by the political system: this fact provides basic stability to federal finances as well as a degree of fiscal security to states. The constitutional change, effected in 2000, in the basis of FC transfers from individual central taxes to all taxes is also a welcome development. Another positive development over the nineties is the elimination of the practice of subsidized lending to states, which used to provide large transfers to generally better-off states (Rao, 1997). However, the Indian system of transfers also suffers from a number of related weaknesses, which have been pointed out by a large number of analysts (for recent reviews, see Rao and Singh, 2003; Bagchi and Chakabrobarty, 2003; Srivastava, 2003). Box 4.4 summarizes the extensive empirical research done into India's federal fiscal architecture.

- *High degree of vertical imbalance.* Some amount of vertical imbalance is inevitable since it often makes sense to collect taxes nationally, but spend them in a decentralized way. However, large transfers from higher to lower levels of government weaken accountability to the taxpayers, as they weaken the connection between marginal expenditure and taxation decisions by each level of government. Econometric evidence (summarized in Box 4.4) suggests that this is not just a theoretical problem, but a practical one in India, which reduces tax effort and possibly leads to higher deficits.

- *Declining volume of grants.* At the same time, the solution to India's vertical imbalance is not to reduce central transfers without increasing the taxing powers of the states, which is what has been observed in India over the nineties. While some of the decline in special-purpose grants may be only due to a change in fund-flow mechanisms (see para 4.9), in fact all sources of transfers show a decline. This trend has exposed the states to increased fiscal stress and constrained the growth of expenditure in productive areas.

- *Only partial elimination of horizontal imbalance.* While central government transfers are progressive, they fall far short of achieving horizontal equalization. We have seen that once FCI transfers are taken, all states receive roughly equal per capita transfers, regardless of income. It should be noted here that,

[44] Saxena (2003) reports that "In January 2002 the author found that farmers in east UP were getting only Rs 330 to 350 per quintal for paddy whereas Punjab farmers were getting 540 for the same crop."
[45] Revenue from tax exports are included in own-revenue numbers. However, these figures do not show the sources of such taxes. Rao and Singh (2003) estimate that Uttar Pradesh losses 0.8% of its revenue in taxes paid to other states.

unlike some federal constitutions, the Indian constitution does not mandate equalization, and that there are other federations which also show only partial equalization (Box 4.1).[46] Given the vast disparities within India, it is unlikely that a per capita distribution of transfers is optimal. Indeed, however there are strong efficiency and equity reasons for a more progressive distribution of resources, though any shift to provide more resources to the poorer states would admittedly have to grapple with issues of incentives and varying performance, given that the poorer states are also in general the poorer performing.

- *Weak incentives for reform and good performance.* The practice of Finance Commission to award additional grants to states with large projected revenue deficits (para 4.9) sends out a wrong signal in this regard, even though the amounts involved are small, and a large part of the projections are normative, rather than based on state-provided actual data. There are few explicit rewards for reform or good performance, though, as mentioned, the last few years has seen a growth in reform-based funds. There is also econometric evidence that block transfers are determined in part by factors other than need and merit, in particular political affiliation (Box 4.1).

- *Linking of loans and grants.* The practice of transferring resources as a mixed loan-grant package has the problem that it mixes together funding sources, which should be treated in very different ways. While grants can be provided on the basis of need and priority, borrowing has to be provided on the basis of affordability. Mixing them together blurs this fundamental distinction, which in turn contributes to the mentality that leads states to borrow on the basis, not of affordability, but availability.

- *Proliferation of centrally sponsored schemes.* Specific purpose grants to finance specific programs are justified to the extent there are externalities and high priority national goals. However, in India there are now almost 200 such schemes.[47] Transfers impose restrictions on the use of funds, thereby possibly undermining efficient allocation choices.

- *Complexity and discretion*: There is no one agency in charge of transfers from GoI to the states. The Finance Commission, Planning Commission, and Finance Department are all key players, but each has responsibility for particular areas, and neither can control the behaviour of the others, and thus plan for reform of the transfer system in an integrated way.[48]

- *Hidden transfers* India's hidden federal fiscal transfers are not only, by definition, non-transparent, but large and regressive.

[46] The Brazil comparison is particularly interesting. World Bank (2002a) shows that the standard deviation of income per capita of the states 50% of the mean and the same figure for state revenues is 36%, i.e. a reduction of 28%. The same figures for the 14 major states of India are 35% and 28%, a reduction of 20%.

[47] According to the Expenditure Budget of the Government of India, 2004-05, there are 178 specific purpose grant programs administered by over 30 line ministries/departments.

[48] As it was recently put in an *Economic and Political Weekly* editorial (Feb. 21, 2004): "Recourse to the multiplicity of channels has precluded the evolution of a rational system of intergovernmental transfers that could redress the twin imbalances – vertical and horizontal – that all federations face."

**Box 4. 4 : Econometric Studies of the Determinants and Impact of India's Fiscal Federal Transfers.**

**Determinants of grants and loans.** There is an extensive literature which tries to link the grants received by a state to its political affiliation with the central government. Results vary from author to author but generally find some degree of political influence on at least some categories of grants, especially the more discretionary ones (see Rao and Singh, 2003 for a survey of the various studies). Khemani (2002)looks at the political determinants of loans (deficits) to states. She finds that a state which is politically affiliated with the central government gets a deficit which is 10% higher, with the additional deficit of politically affiliated states is financed almost entirely by additional loans from the central government. Results from other countries also often find political determinants underlying transfers, especially discretionary ones.

**Impact of transfers on deficits** It is generally believed that "transfer-dependent governments face weak incentives to be fiscally reliable." (Rodden, Eskeland, and Litvak, 2003, p. 14). However, the evidence is mixed for India. Purfield (2004) indeed finds that the higher a state's dependence on central transfers, and the higher its reliance on central government for loans (relative to other funding sources), the higher its deficit. However, Khemani (2003) finds no evidence for the view that the design of intergovernment transfers lead state governments to run higher deficits. In fact, she finds a small, negative effect of transfer-dependence on state deficits.

**Impact of transfers on tax effort.** There is a large literature on the impact of transfers on tax effort in India, surveyed in Naganathan and Sivagnanam (1999) (see also Jha et al (1999)and Coondoo (1999). The general finding is that higher grants by central government reduces tax effort. Research carried out for this report (by Arindham Dasgupta ) also finds that dependence on central transfers reduces tax collection efficiency. Findings from other countries are similar. For example, a recent study (Baretti, Huber and Lichtblau, 2002) found that the very strong commitment to equalize state revenues in Germany produced high "marginal tax rates" on states' tax efforts, and therefore tended to discourage state tax effort. Use of a normative system (e.g. basing transfers on estimated tax capacity rather than actual tax collections) will minimize such distortions, but not necessarily remove them (even without any tax on tax effort, higher transfers may produce an income effect which reduces tax effort). At the same time, 90% of variation in p.c. own revenue among India's states can be explained by GSDP per capita, suggesting that the main determinant of tax performance is level of economic development (Figure 4.7).

**India's system of revenue transfers is complex, and there are various reform options. But it seems clear that grants and loans should be delinked, and informal transfers ended.**

4.24 **Reform options.** As already noted, India's system of revenue transfers is complex, with multiple issues and stakeholders, and is more amenable to a discussion in terms of options rather than clear-cut prescriptions. But from the summary diagnosis above, three recommendations are straightforward. First, loans and grants should be delinked so that they can be allocated using different criteria. Under such a scenario, either block grants would be done away with (and merged into one of the other two categories of transfers) or they would continue as a funding source for state plans, but allocated separately from loans, in line with our discussion of the borrowing regime in the previous section. Second, hidden or informal transfers should be done away with. As discussed in Chapter 3, the Central Sales Tax needs to be phased out, while procurement of farm produce, though beyond the scope of this report, clearly needs a major overhaul (World Bank, 2004). Third, grants related, albeit only partially, to actual deficit levels (the "gap-filling grants" of the FC) give incentives to poor fiscal performance and should be discontinued. These three recommendations would find widespread support, but beyond that it becomes controversial. The three much more difficult questions being asked about fiscal federalism in India are: (i) should vertical imbalance be reduced?; (ii) should horizontal imbalance be reduced?; and (iii) should grants be made conditional to provide positive incentives for good performance?

4.25 The international fiscal federalism literature has fairly clear answers to these questions. It is argued that vertical imbalance should be reduced to promote state-level accountability, that horizontal imbalance should be reduced both for equity and national efficiency reasons, and that conditional grants should be used to increase spending in particular areas where there are cross-state externalities or where national and state priorities diverge. These questions are more difficult to answer in India for three reasons. First, because own-revenue is an increasing function of per capita income, reducing vertical imbalance (by increasing the state's tax base) disproportionately benefits the better-off states, thus increasing horizontal imbalance. Second, because state government performance is viewed as low, there is a view that conditions should be tied to grants to induce

better performance; and because the performance of poor governments is seen as particularly poor, there is a reluctance to make the distribution of transfers more equitable by giving more to poorly-performing poor governments, especially if the grants are not conditional. Third, the Constitution gives no clear guidance on how to distribute central transfers, and judgments vary on how much Finance Commissions are meant to give back to each state the central taxes collected in them, and how much they are meant to redistribute such taxes on normative lines.

4.26 To illustrate the controversy, compare the position of Bagchi and Chakraborty (2003) that "in the last analysis, the task of fiscal transfers is to provide a level playing field", and that transfers should be primarily equalizing, with conditionalities kept to a minimum, with that of Godbole (2001), who contends that FC transfers already give more weight to equity than is justified by good policy or Indian's Constitution, and that "the golden rule must be not to release any funds unconditionally". Others take an intermediate position that equalizing grants are entitlements of the states, and should not be subject to conditions, but that other forms of "central assistance to states should be linked to specific action to be taken by the states to overcome the particular constraints that hold back their performance" (Ahluwalia, 2000).

4.27 Given this controversy, and underlying it the difficult issues outlined above, it would be over-optimistic to expect an easy resolution. In the paragraphs which follow, we simply present some analysis, options and suggestions for reform of the grant system which we hope is useful.

**Authority to tax services and an increase in the professions tax rate would help increase the tax/GDP ratio and reduce vertical imbalance.**

4.28 Reduction of vertical imbalance would require increasing the taxing capacity of the states. Given the need to increase India's tax/GDP ratio, it makes more sense to think of new taxes for the states rather than ones that are already being taxed by the centre. Included in this category are the suggestions made earlier that states be allowed to tax services (moves to this end are already underway), and collect a much higher amount through the professions tax (see Chapter 3.II). Better off states would benefit more from these reforms, so any such reforms would add to the weight of arguments for improving the equity of the distribution of central transfers.

4.29 Even with these reforms, the central government and Finance Commission will need to decide what further measures are required to reverse the long-term decline in central transfers to the states (a shift which would most benefit the poorer states). The most likely way this will happen is through an increase in the central tax/GDP ratio, which is the aim of current central government tax reform efforts.

**Improvements in horizontal equity will be incremental. Adoption of the Representative Tax System would be a positive step forward.**

4.30 How much equalization across states India should pursue is a matter on which, as we have noted, opinions differ. One extreme equalizing objective, which is useful as a benchmark, is revenue equalization at the level of the state with the highest per capita own-revenue. In this very equal world, the "richest" state would not actually transfer revenue to other states (there are no mechanisms for this in India), but would not receive any central transfers either. How far central formal transfers are from achieving this goal is shown by

**Figure 4.8: Actual vs. equalizing transfers for India's states**

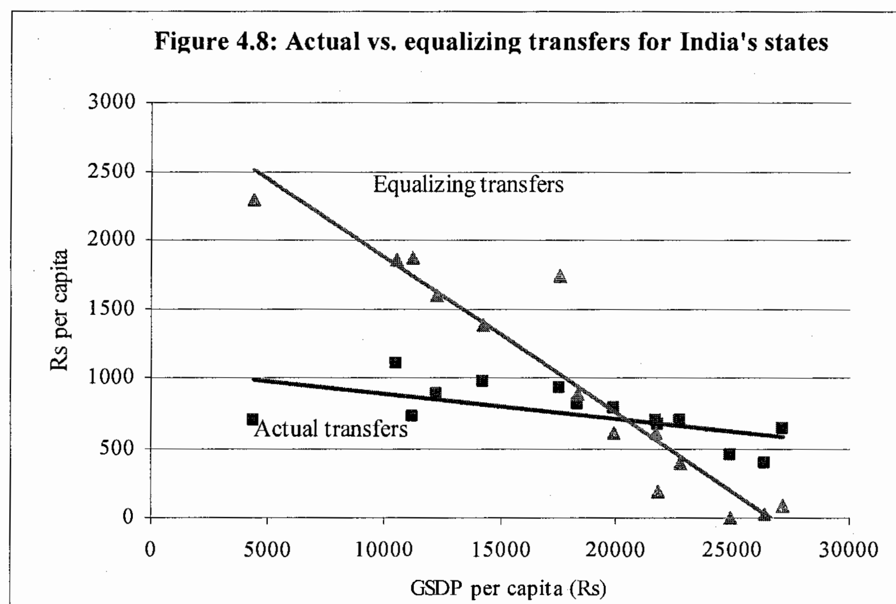


Figure 4.8, which plots actual transfers against equalizing transfers. It shows that the current system of transfers is far from equalizing both because the progressivity of existing transfers is too modest, and because they are simply too small relative to the size of own-revenues. Equalizing transfers decline much more sharply as income rises than actual transfers, and on average they are much larger than actual transfers: 30% larger in fact.[49] Moving to such a system would both disadvantage the better-off states by reducing their grants, and the central government by increasing the overall share of central taxes devolved to the states. It is also possible that more resources to the poorer states would weaken the incentives of these states to "reform and perform".

4.31 While full equalization can be ruled out as a feasible objective, there are certainly ways through which the current system can be made more progressive, and the equalization objectives of the system made more explicit. For example, the Finance Commission could dedicate some part of its transfers to a revenue capacity equalization objective, which is more modest than the benchmark considered above. The Representative Tax System, first introduced by Canada and now used by a number of other countries, including Russia (see Box 4.5), guarantees states a minimum of the *average* revenue capacity enjoyed by other states. This is an affordable goal (rough calculations suggest it might cost up to 50% of FC transfers), and one which would improve progressivity (the poorer states would get a larger FC allocation), without fully equalizing (the revenue of the richest states is almost twice that of the average). Nor would it directly weaken incentives for tax mobilization: since transfers would be made relative to the calculated revenue capacity of the state, not its actual performance, there would be no direct incentive to weaken tax effort.

**Box 4.5: RTS Approach to Fiscal Equalization**

A Representative Tax System measures the fiscal capacity of a state by the revenue that could be raised if the government employed all of the standard sources of tax and non-tax revenues, at the national average intensity. To estimate equalization entitlements using the representative tax system, information on the tax bases and tax revenues for each state is required. Fiscal capacity of the poorer states is brought up to the median, arithmetic mean, or other norm. Using the arithmetic mean of all states as a standard, the equalization entitlement of a state for a revenue source is determined by the formula:

$$E_x^i = (POP)_x[(PCTB)_{na}^i \times t_{na}^i] - [(PCTB)_x^i \times t_{na}^i]$$

where $E^I$ is equalization entitlement of state $x$ from revenue source $i$, $POP$ is population, $PCTB^I$ is per capita tax base of revenue source $i$, $t^i$ is national average tax rate of revenue source $i$, subscript na is national average, and subscript $x$ is state $x$. The equalization entitlement for a state from a particular revenue source can be negative, positive, or zero. The total of these values indicates whether a state receives a positive or a negative entitlement from the inter-state revenue sharing pool. For a federal program, as in India, negative entitlements are ignored and the federal government compensates the states with fiscal deficiencies. (In Canada 8 out of 13 provinces receive transfers under the RTS). The RTS approach has long been used by mature federations such as Canada, and has recently been adopted by the Russian Federation.

The application of the RTS to fiscal equalization in India is a doable task as data on tax bases and tax collections of states for most major taxes are available in published or unpublished form. The RTS does not impose new data requirements and can be readily implemented for a federal program. Of course, for some unusual revenue source such as lottery revenues, a determination has to be made whether or not such revenues form part of the standard basket for Indian states – if they do, then a decision on a proxy base to be used will have to be made. For the sales tax, the largest single source of the states' own revenues, there is a problem posed by the difficulty to separate tax base from the degree of compliance. Regression techniques could be used to overcome such problems. Alternatively, given that 90% of own-revenue for the major states is explained by income per capita, simple proxies for taxable capacity can be used.

A more ambitious and complex alternative to the RTS is to equalize expenditure (rather than revenue) capacity, again at some average level. This is attempted in Australia, and takes into account both differences in tax capacity and in service-delivery expenses. However, data requirements are considerably more demanding, and, some argue, the rationale less obvious.

Source: Shah (1004); Spahn and Shah (1995).

[49] This exercise assumes that all central transfers are used to equalize. Alternatively, and more realistically, if only FC transfers were used to pursue horizontal equalization, it would only allow equalization up to the own revenue per capita level Rs 2000 (rather than Rs 2600 – the highest p.c. own revenue among the states, that of Maharashtra), and the seven richest states (which currently get 30% of the FC transfers) would not receive any transfers from the FC; in the unconstrained case only Maharashtra wouldn't receive transfers. Bagchi and Chakraborti (2003) have a similar finding that transfers "meant to bring up the level of revenue expenditures in all states to at least that of middle-income states" would require an increase in central tax devolutions from 27% to 44% of the central tax revenue.

**There are various ways to improve incentives for performance, the most important being rationalization of the existing range of special-purpose and untied plan grants.**

4.32 One far-reaching step would be to reform the GoI system of untied plan grants and special purpose grants, which largely supply additional funding for developmental particular purposes. International best practice (summarized in Box 4.6) suggests replacing the large number of specific-purpose grants currently in existence with a small number of non-discretionary grants that are designed to help the state achieve certain national minimum standards in service delivery (such as universal enrollment). Such grants, as deployed in other countries, are conditional in the sense that, once they have received the grants, the states are required to achieve the standards set, but the expenses are not necessarily tied to particular expenditures, or even to the sector. Such an approach would contribute to changing the incentive structure from one that only encourages more spending to one that encourages paying attention to broad output targets, and thus, it is hoped, improve performance. In India, attention would have to be given to data limitations, weak financial management systems, and the vast disparities in service levels across states, but the idea should be to have a minimum number of grants and conditions, and to link the two to outputs as much as possible. These grants could also be made more progressive, conditional on performance, than they are now. That is, the amounts available to the poor states could be increased, with access still dependent on performance.

**Box 4.6 : Design of Conditional Grants: international experience**

Evidence from the history of transfer programs in the US and Canada over the last three decades indicates a shift from narrowly-defined matching grants toward greater use of lump-sum conditional grants, also called block grants. In Canada, federal transfers for health were converted from a shared cost program into a block grant program in 1977, in order to contain costs, allow the provinces almost complete flexibility in allocating resources within health, and to respect provincial constitutional jurisdiction within these areas.

Conditional transfers to set ***national minimum standards*** can be used to encourage the attainment of economic union or a common internal market . Such transfers that impose conditions on attainment of service standards, and broader access to these services especially by the poor and disadvantaged, can foster national efficiency and equity objectives without undermining state and local autonomy. Canada, USA and Indonesia used these transfers to create a national network of highways and link roads. Canada, Brazil, Chile and Colombia have used these transfers to widen the access of health (Canada and Brazil) and education (Canada, Chile and Colombia). The Canadian health transfer program represents an example of a simple (per capita) program with conditions on standards and access of health care but no condition on the use of funds.

*Sources: Boadway and Wildason (1984)*

4.33 As discussed earlier, there are now also special-purpose grants which impose no limits on the use of funds, but which provide funds conditional on reforms. Some analysts consider them too intrusive, but if it is accepted that GoI already has a decisive influence on the states, and that the large degree of vertical imbalance creates incentives for poor fiscal performance, and in particular makes it difficult for the central government to credibly commit not to bail out states in distress, then the need to provide positive incentives in key reform areas also seems acceptable, especially when they have a direct fiscal impact. This would call for a reforming rather than jettisoning of these schemes: some suggestions are provided in Box 4.7 using the Fiscal Reforms Facility as an example.

**Box 4. 7: Fiscal Reform Facility (FRF)**

The Eleventh Finance Commission was provided additional terms of reference to "draw a monitorable fiscal reforms programme" and link part of the Commision's grants to progress under this programme. The result was the Fiscal Reforms Facility, a fund of Rs 10,600 crore, available to all the states over a five period conditional on achieving an average 5-percentage-point per year reduction in the ratio of revenue (current account) deficit to revenue receipts. The Twelfth Finance Commission has been asked to review the FRF and "suggest measures for effective achievement of its objectives."

The FRF has been controversial from its inception, with one member of the Eleventh Finance Commission submitting a dissenting note on the creation of the Fund. It has been argued that the imposition of conditionality violates "the basic rationale of transfers meant to bridge vertical and horizontal imbalances in a federal system", and that the central government should rather focus its energies on hardening the budget constraints, which states face (Anand, Bagchi and Sen, 2003). It has also been noted that the proliferation of a number of small reform incentive schemes will have little impact on state performance (Rao, 2004).

There is not much international experience with FRF-type instruments. Russia has a Regional Fiscal Reform Fund, created in 2001, an incentive-based transfer mechanism which funds states conditional on their success in implementation of two-phase reforms of regional public finance. Targets include a mix of process and outcome indicators. The Russian Fund is rather small (about 10% the size of the FRF). Nevertheless, a June 2003 World Bank update concludes that it "has proven to provide sufficient incentives for regions to prepare and implement high quality reform programs." Australia also had a similar incentive scheme, but for structural rather than fiscal reforms. That program was considered a success, at least in its early years (Allen, 2003). There is of course a lot of international experience with adjustment lending (SALs) which also attempts to improve policies through the provision of additional funding. The experience with SALs is mixed, and its interpretation controversial. A World Bank (1992) review found that adjustment lending was associated with fiscal deficit reduction, and increases in revenue, but that general spending cuts were often at the expense of "critically important O&M" and too much spending on salary relative to non-salary inputs. A more recent analysis (Gupta, Pivovarsky and Tiongson, 2003) found a mixed impact of SALs on domestic revenue mobilization.

Judged by its own objectives, the FRF cannot be considered a success: if all states were to qualify for the FRF incentive funds, the revenue deficit of the states would be eliminated by the end of 2004-05. Clearly that is not going to happen. In fact, with interest burden rising, the revenue deficit is relatively unchanged as a percentage of GDP. However, one has to bear in mind that the FRF is a very small fund (about 0.5% of GDP spread over all states and 5 years), and one needs to judge its success by more modest yardsticks. It has clearly been useful in catalyzing states to prepare medium-term fiscal frameworks. These in turn have, for the first time, provided the central and state governments with a basis on which to discuss state-level fiscal performance in an integrated manner, rather than through the limited lens of state-plan discussions. The single-monitorable indicator approach of the FRF, while no doubt arbitrary, has the advantage of simplicity, and keeping discretion to a minimum, although it has not always been clear if the indicator is defined the same way over time and states, in particular, whether off-budget liabilities are being consistently treated.

Assuming it is decided to continue with an FRF-type facility, there are some issues which clearly need to be addressed. The first is whether a "single monitorable indicator" approach should be retained, or whether a multiple-indicator approach, as originally recommended by the Eleventh Finance Commission, should be reverted to. Consideration also needs to be given as to what that indicator(s) should be, and whether it should include interest payments and central grants, which are, to a large extent, beyond the state's control at any given point of time. The adjustment path also needs to be fitted to the initial conditions of each state. Requiring the same degree of fiscal correction from each state, as the first FRF does, results in targets that are unrealistic for some and inadequate for others. One option would be to make the FRF award contingent on adherence to the state passing and adhering to a Fiscal Responsibility Act. This would provide flexibility across states, while still promoting objectivity, and would give state-level FRAs more prominence and importance.

It would be desirable if the various FRF documents were publicly available. Especially given the concerns that different definitions have been used in different states, opening up the various MOUs to the state would encourage public scrutiny and consistency across states and over time. More generally, reporting requirements need to be strengthened, and more attention given to deficit-reduction through accumulation of arrears.

Since the late nineties, various multilaterals and bilaterals have provided adjustment-lending to the states (through the central government) to support state reforms, including, but not limited to, fiscal reforms. Although the SALs began before the FRF, adherence to FRF targets has now become a sine qua non for access to them. While the track-record of SALs in India is also mixed, recent analysis by the World Bank (2004) does suggest successful fiscal adjustment in Bank SAL-receiving states. One option moving forward would be to have the external funding agencies fund the FRF (Mark II) itself, as well as, or in place of, the funding of individual states.

4.34 So far we have focused on strengthening incentives in GoI grants, which are outside of the FC's jurisdiction, but there is still the issue of what to do with FC transfers: even if FC switches to the RTS system, as we have suggested, this may not exhaust all FC funds, as there would be too many big losers. The FC would face the following options for the remainder of it funds:

- First, given that the RTS would address equalization of revenue capacity, the remainder of the FC award could be distributed on an equal per-capita basis and/or to address cost disadvantages and special expenditure needs;

- Second, it would also be possible for the FC to establish its own special-purpose grants. It does already allocate small special-purpose grants, and the first of the GoI reform-based funds, the Fiscal Reforms Facility, was in fact created at the recommendation of the Eleventh Finance Commission (see Box 4.7). As recommended by some, the FC could, create large funds available to all (or only poor) states to enable them to meet minimum service-delivery standards (Bagchi and Chakraborty, 2003). The main risk to avoid here is complexity overload since one would face the prospect of a double set of (FC and GoI) special-purpose grants. The FRF -- designed by the FC and implemented by GoI -- provides a good example of coordination between the two central entities. Similarly, in the urban sector, where FC also has a mandate of supporting local governments, rather than developing its own incentive fund, it would make more sense for the FC to support – with any necessary recommendations for improvement – the recently created GoI reform-incentive urban funds, namely the City Challenge Fund and Urban Reform Incentive Fund (WSP, 2004); and

- Third, FC could continue with the approach of incorporating both performance and need in allocating resources beyond the RTS[50]. Since need and performance are the two factors which people trade-off when they make judgments about the inter-state distribution of resources, a weighting system which combines both, and makes the trade-offs explicit, has some merit. However, the disadvantage of such an approach is that it may be difficult to understand and accept by the states, compared with an approach that uses different instruments to address different policy objectives.

## IV Conclusion

**The central government has a vital role to play, particularly in setting "the rules of the game" so that they provide appropriate assistance to poorer states, and incentives to better performance.**

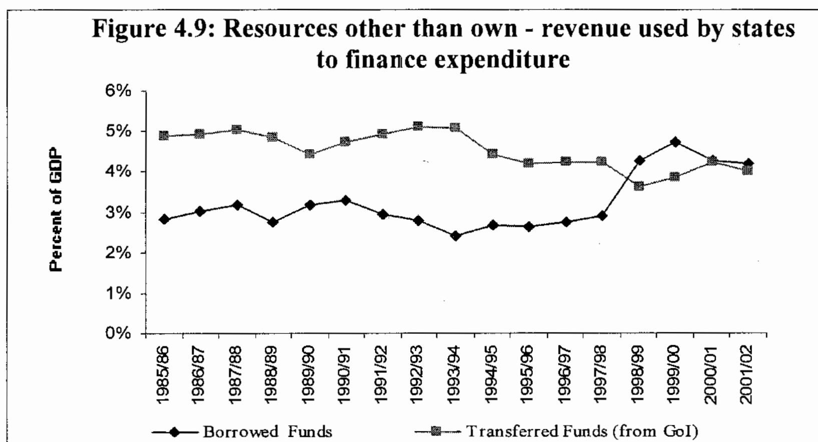
4.35 The state-level fiscal crisis cannot be solved by the states alone. While India's federal fiscal system shows many strengths, prime among them stability, the fiscal crisis has also brought to light a number of weaknesses. The regime of revenue transfers is not progressive enough, and contains few incentives for good performance. India's borrowing regime is on the one hand too strict where more flexibility could be allowed (the detailed rules governing access to different borrowing sources could be relaxed) and on the other not strict enough where control is needed (over the total borrowing a state undertakes). Credit markets play a very small role in the allocation and pricing of loans, and all states face the same interest rate for borrowing. Thus, with no penalties for profligate behaviour, states can borrow now, and worry later. Both the grant and the loan regimes are complex, and have significant amounts of discretion built in to them. Finally, grants and loans are linked together, preventing these two types of transfers from being given the very different treatment they require.

[50] Similar to concessional aid that is distributed by the International Development Association using a formula which weights both need (poverty) and performance (as measured by a country policy and institutional rating.

**The nineties have seen a "scissors movement" whereby state governments have received fewer grants but more loans.**

4.36 The nature of India's fiscal federal transfers has changed greatly in the nineties. Since 1998/99, borrowed resources now supplement a state's own revenues to a greater extent than central government revenue transfers do (Figure 4.9) . In general, central grants to the states need to recover their lost ground, while borrowing needs to be reduced to sustainable levels. This is particularly true for the poorer states, which are highly dependent on both loans and revenue transfers to supplement their own meager resources. Revenue transfers need to be made more progressive, while loans less so.

**Figure 4.9: Resources other than own - revenue used by states to finance expenditure**




**From the perspective of fiscal sustainability, no reform is more important than the centre introducing global caps on aggregate borrowing.**

4.37 Such a reform, which the centre is entitled to introduce under the constitution, will not only force fiscal deficits down, but will put an end to lobbying for loans, and significantly harden the budget constraint. It will do more to promote prudent performance than any number of special schemes directed to this end. Consistent with the autonomous approach to fiscal responsibility adopted to date, such caps could be based on the states' own fiscal responsibility laws. For efficiency reasons, and to force governments to face the costs of fiscally imprudent behavior, not in the future but today, states need to be given more flexibility in who they borrow from. Rather than having six different borrowing sources, with their own rules, as at present, states should predominantly receive debt financing through the market, at a market-determined interest-rate which reflects their creditworthiness.

4.38 Debt-restructuring along commercial principles is in line with allowing states more flexibility under a global cap. Performance-based debt-relief will also help poor, highly-indebted states, but has the risk of, however well-designed, undermining hard-budget constraints: more progressive grants, and ones which reward fiscal reformers may be a better alternative.

**The grant regime is institutionally more complex than the borrowing regime, and reforms, while needed, are likely to be incremental.**

4.39 Any recommendations concerning the system of grants must face difficult issues concerning trade-offs between the needs of poorer states for more funds, and doubts concerning their ability to effectively use them. However, some suggestions can be made. If for no other reason than to help increase the national tax/GDP ratio, the tax base of the states should be expanded, and, since this will take time, and especially if borrowing is to be reduced, the declining trend of central grants as a percentage of GDP needs to be reversed. The FC could consider introducing an explicit equalization objective to provide a floor for states; distribution of the remainder of FC funds, as now, on the basis of a formula, which reflects both need, and past performance seems appropriate. To further strengthen incentives for performance, and help poor states achieve national minimum standards, conditions on special-purpose grants should be used, but the number of such grants needs to be reduced and their distribution, while still subject to good performance, made more progressive; any special-purpose FC grants should be merged with GoI grants to avoid duplication – the FRF is a good example of this. Block grants themselves should either be discontinued (and merged with FC and special-purpose grants), or, if

continued, should be de-linked from loans so that each can be provided the different treatment it deserves. Informal transfers (such as associated with food procurement and tax exportation) should be phased out.

**There are some key institutional reforms, which would help with strengthening India's fiscal federalism.**

4.40 The difficulty with implementing such sweeping changes is that different central actors determine different components of the central fiscal framework. Rationalization of the system requires a road map covering all three formal channels of grants from the center to the states, as well as the six channels of loans. Co-ordination among the various actors involved will be critical so that win-win elements of the possible reforms can be brought about: for example, for the poorer states, fewer loans but more grants; for all states, tighter control over total borrowing, but more flexibility to manage borrowing within that global cap. Reforms to the borrowing regime may be simpler since the main central player involved is the GoI Ministry of Finance, but reforms to the transfer system are likely to be at best incremental. There are three institutional reforms which would help coordination among the main players with respect to both grants and loans:

- The first would be if the Finance Commission was made a permanent body, as it is in Australia, for example.
- The second would be if the responsibility for compiling timely state-level fiscal data were entrusted to a single agency, such as the RBI, the Planning Commission or a permanent Finance Commission. The challenge is not just to improve the timeliness and accuracy of existing data reporting (though the current situation is far from satisfactory in this regard) but also to provide credible reporting of state fiscal performance against targets, such as in the Fiscal Reform Facility or in the state's own Fiscal Responsibility Act (Hausmann and Purfield, 2004, Bagchi, Sen et al.,2003).
- The third suggested institutional reform is an overhaul of the role of the Planning Commission as Box 4.8 discusses. The one fiscal indicator state chief ministers are most familiar with is the size of the plan, and the target they have most internalized is to maximize the size of the plan, regardless of whether it is funded by over-optimistic revenue targets or unaffordable borrowing levels. The elimination of the distinction between 'non-plan' and 'plan' expenditures is long overdue, not only because the distinction lacks economic rationale, and complicates budgeting and accounting but because it would remove this incentive to fiscal imprudence. Multi-year plans, if needed, should encompass the entirety of resources available for development in the state, not just a segment artificially referred to as the "State Plan". The Planning Commission could then function much more as an overall strategy, monitoring, evaluation and reporting agency with respect to both fiscal and development outcomes.

**Box 4.8: Problems in the financing of the State Plan**

The approach to, and mechanism of, financing the public sector 'plan' of each state, continues to encourage, or fails to discourage, fiscal profligacy on the part of the states. Since (a) the size of the 'State Plan' is finalized after the annual budget is presented, (b) the Planning Commission guarantees a floor and does not impose a ceiling on every state's annual borrowing, and (c) the size of the Plan is the politically most salient and visible fiscal indicator at the state level, the system generates incentives for states to:

- engage in over-estimation of resources in the annual budget, in support of their lobbying with the Planning Commission for larger and larger size of their annual plan; and
- seek additional borrowing to make up for actual revenue shortfall during the year, with support from the Planning Commission in the name of meeting annual targets implicit in the Five-Year Plan.

The problem with this approach and mechanism has been understood for some time. A recent, very clear exposition of the problem, from a state government perspective, is provided by the Interim Memorandum submitted to the Twelfth Finance Commission by the Government of Jammu & Kashmir. This argues that,

*"There is an urgent need to change the modality and mechanics of planning since the main culprit of the fiscal crisis in the states is the Plan. The problem is that in the post fiscal reform period, the approach to financing the state plans hasn't undergone a change. All of it continues to be what it was earlier, even though the entire fiscal regime has undergone fundamental changes. The result is that it is impossible for the states to finance their plans in a manner that doesn't add to their fiscal woes. . .*

*" . . . the resource position of the states is so poor that they cannot even finance the same plan size as last year. Yet they are committed to a plan size that can't be lower than last year given that they have to meet the Tenth Five-Year Plan targets in terms of investments. Add to this the fact that no state government/political party wants a smaller plan; a bigger plan even if partially un-funded is preferred to a fully funded smaller plan.*

*" . . . while finalizing any state plan, the Planning Commission matches the overall plan outlay, i.e., revenue and capital outlay combined with the overall resources available for the plan ... resources on the revenue account are not separately matched with the revenue component of the plan. Therefore, a diversion of borrowed funds is built into the plan ... In the current context, it may be better for the Planning Commission not to determine the size of plan but focus only on the central assistance to state plans . . . states will then have no way out but to go for smaller plans which are fully funded and the diversion from capital to revenue will also get reduced."*

There is clearly an urgent need to better align the role of planning with the current macroeconomic and fiscal framework, focused on development outcomes, which are a function not merely of the size of one component of state expenditure called the 'State Plan', but of all components of public expenditure, their quantity as well as quality, and impact on the private sector. Some attempts have been made at reform, such as through the introduction of a "core plan". And now State Plans are meant to be consistent with deficit targets agreed under the Fiscal Reform Facility. But the Plan continues to put upward pressure on the deficit, and to present states with conflicting signals concerning desirable borrowing. More radical reforms are needed. De-linking of loans and grants, and cessation of the practice of providing Planning Commission approval for a "plan size" for each state, are options to be considered. The bolder option is to redefine the role of the Planning Commission altogether, and eliminate the distinction between 'plan' and 'non-plan' expenditure in government budgets and accounts, retaining only the distinction between recurring and capital accounts.

**External funding agencies are also participants in India's fiscal federalism, and we conclude with some implications of the above analysis for donors, and how government might treat them.**

4.41 Donors contribute a mix of grants, concessional and commercial loans, and they pass their funds through the central government. They have been well accommodated into the current system, but it is unclear how they would operate in a reformed borrowing regime. Donors have also been accused of concentrating their efforts in the better off states and indeed the correlation between per capita income and external assistance is

positive (Srivastav, 2001). Donors of course are passive players in India's fiscal federal system: they do not set the rules of the game. But how might they fit in a reformed system?

- For donor funds flowing to the states, it would indeed be useful if grants, concessional loans and commercial loans were distinguished between one another, rather than transferred on the same terms, as they are today (on the same terms as plan loans, i.e. for most states a 70% loan, and 30% grant, with an effective interest rate of just under 5%). Alternatively, if the government wants to pass on all aid on the same terms, setting a concessional interest rate for all of it would be consistent with de-linking grants and loans. What the interest rate should be has been a matter of much debate; the latest analysis suggests that current arrangements profit the central government at the expense of the states, though this has varied over time (Srivastav, 2001). Whatever approach is used, it would be advisable to make it automatic and transparent. One approach would be to simply operate on an expected non-profit no-loss basis, passing on to states at the same terms as faced by the center. Another would be to set an interest rate somewhat below that of the market to give states incentives to go for external financing over market borrowing despite the reform conditions imposed by donors.

- As to where donors should concentrate their financing, this depends whether the role of external financing is seen to be promoting horizontal equalization, or rewarding good performance and piloting new initiatives. These two forces will pull in opposite directions, making an easy answer to this question impossible to give, though of course donors should make every effort to promote good performance in poorer states.

- We have commented on the complexity of India's federal fiscal landscape, including on the issue of providing incentives for fiscally responsible behavior. This would suggest closer coordination between donor and government initiatives. Already, access to SALs has been made conditional on satisfactory performance under the FRF. It would be possible to go further by, for example, a merging of the donors' adjustment lending efforts with the Fiscal Reforms Facility of the central government. (Similar efforts are now underway by donors in relation to the GoI urban reform incentive fund, URIF.) Donors' grants could top up the FRF; while donor loans could be provided to finance debt restructuring for FRF-qualifying states.

- Finally, we have recommended that the central government stop playing the role of creditor to state governments. In such a scenario, what to do with official financing, since state governments are constitutionally forbidden from borrowing off-shore? As we suggested earlier, either an exception to this rule would have to be given for external financing, or a special purpose vehicle could be set up to intermediate between external financiers and state governments.

# CHAPTER 5
# CONCLUSIONS AND PROSPECTS

## I Introduction

5.1 Five years on from the onset of the fiscal crisis, many states have embarked on the reform path, but none have yet recovered. It is an open question as to whether states will continue to embrace reforms, or will tire of difficult, perhaps politically-unpopular prescriptions and look for easier solutions. All the states are home to large numbers of educated unemployed, and face enormous pressure to re-open the hiring flood-gates. Existing employees are looking for a wage increase. Farmers are increasingly vocal in demanding government support and want more subsidized power. Industry complains of a heavy tax burden. Yet, as the simulations in the next Section II shows, abandoning reforms at this half-way stage is not an option, and the states face no choice but to continue with reforms. Section III summarizes a proposed expenditure-and-revenue reform package applicable for most states, culled from the analysis and suggestions of Chapters 2 and 3. Section IV shows that with such a reform package states can emerge from the crisis, and emerge strengthened. The simulations undertaken also show, however, that care needs to be taken in the choice of fiscal targets, and that the poorer states will require special treatment from GoI, however. Section VI considers various risks to stabilization. Having summarized the reform implications for the state governments in Section III, Section VII then concludes with a discussion of implications for the central government.

## II A no-reform scenario: what will happen if reforms stop?

5.2 The case for fiscal adjustment is made by showing the consequence of not continuing with adjustment, under a base case no reform scenario. We simulate a halt in reforms by assuming that the combined states' fiscal deficit stabilizes roughly at its current level of 4.8%. Other assumptions are listed in Box 5.1.

**Box 5.1: Key assumptions and methodology underlying the no reform scenario**

*Revenues:*

No major reforms on the revenue side are implemented. Revenue/GSDP ratio remains constant.

*Expenditures:*

The civil service hiring and pay restraint is relaxed over the coming years and a new pay commission is established leading to a one-off increase in the wage and pension bill at the state level in 2006/07; the wage bill increases by 0.5 percentage point and the pension bill increases by 0.2 percentage point.

No major reform to reduce the subsidy, or pension bill, both of which gradually increase over time.

**Macroeconomic assumptions**

It is assumed that real annual GDP growth is 6.5%, real interest rates are assumed to be 6% and the rate of inflation is forecast at 4.5%.[51] The base year for the projections is 2003/04. In the base year the debt stock is 28.5% of GDP and primary deficit is 1.8% of GDP. The revenue deficit is 2.6 percent of GDP and the real growth rate is 8 percent of GDP.

**Methodology**

Debt projections are based on the difference equation for debt. Assuming a constant nominal GDP growth rate g and a nominal interest rate of r on government debt, the debt to GDP ratio evolves according to the formula

$$d_t = d_{(t-1)} * \frac{1+r}{1+g} + PD_t,$$

where d is the government debt to GDP ratio, PD is the ratio of the primary deficit to GDP, r is the real interest rate, g is the real growth rate and the subscript refers to fiscal years.

[51] Nominal interest rates for state debt in 2001-02 was calculated as interest spending in that year as a proportion of the average value of debt at the beginning and the end of the period. The figure was 11.5 percent, up from 9 percent a decade ago. Going forward, nominal interest rates of 10.5 percent are estimated taking into account the impact of the debt-swap program.

**The consequences of a halt in reforms are bad for all states**

5.3 The quality and quantity of productive expenditures would fall, and the risk of crisis would steadily build with higher and less sustainable debt levels over the medium term. The states' fiscal finances could easily spiral out of control as a self-propelling spiral of revenue deficits led to larger borrowings entailing higher outgoings on interest payments which would in turn lead to larger deficits. The only cap on the deficit would come from the limited access of the states to borrowing sources. Assuming that the combined states fiscal deficit does not, for this reason, exceed its base-year level of 4.8%, debt levels would nevertheless increase from 28.5% currently to 34.1% by the end of the forecasting period. The composition and quality of spending would deteriorate significantly over the next five years. Committed spending (debt service, wages, pensions and subsidies) would increase from 89% of total revenues in 2003/04 (10.5% of GDP) to 106% of total revenues in 2007/08 (12.5% of GDP). Other recurrent spending (excluding subsidies, as well as pensions, interest and salaries) would collapse fall from Rs 0.73 for every rupee of salary spending to Rs 0.32.

5.4 Under a "no reform" scenario, the choice will be thus between more borrowing and less non-salary productive spending: less borrowing will simply result in a crowding out of capital expenditure and O&M expenditure. Most likely, as assumed in this scenario, the forced adjustment will be by a mixture of both more borrowing and less non-salary spending.

5.5 These negative fiscal and developmental outcomes are quite likely if hiring or pay restraint is relaxed, if subsidies are not reduced and if revenue performance does not improve significantly. A particular risk built into the model is the establishment of another pay commission leading to significant real wage increases: this alone would undo much of the good work undertaken to date.

**Table 5.1: Fiscal indicators in the no reform scenario**

| | 2003/04 | 2004/05 | 2005/06 | 2006/07 | 2007/08 |
|---|---|---|---|---|---|
| Revenues/GDP | 11.8 | 11.8 | 11.8 | 11.8 | 11.8 |
| Total Spending | 16.6 | 16.6 | 16.6 | 16.6 | 16.6 |
| Interest /GDP | 2.8 | 3.0 | 3.2 | 3.3 | 3.5 |
| Wage bill / GDP | 5.2 | 5.3 | 5.4 | 5.9 | 5.9 |
| Pensions/GDP | 1.5 | 1.5 | 1.6 | 1.8 | 1.8 |
| Subsidies / GDP | 1.2 | 1.2 | 1.3 | 1.3 | 1.4 |
| Other Recurrent Spending | 3.8 | 3.5 | 3.0 | 2.2 | 1.9 |
| Capital Spending | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 |
| Interest/Revenue | 23.7 | 25.5 | 27.0 | 28.3 | 29.5 |
| Primary deficit | 2.0 | 1.8 | 1.6 | 1.5 | 1.3 |
| Fiscal deficit | 4.8 | 4.8 | 4.8 | 4.8 | 4.8 |
| Revenue deficit | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 |
| Debt stock | 28.5 | 30.2 | 31.6 | 32.9 | 34.1 |
| RD/RR | 22.9 | 22.9 | 22.9 | 22.9 | 22.9 |

## III. A States' Reform Package

5.6. In this section, we briefly summarize the revenue and expenditure reform package which emerges from the analysis in Chapters 2 and 3 of this report and focuses around revenue mobilization, expenditure reprioritization and sustainable fiscal savings in the area of salaries and subsidies.

5.7. **Key revenue reforms** are suggested in Table 5.2 below, which also indicates which reforms can be undertaken by the states only (S), which states by the centre (C), and which require joint action (C/S).

**Table 5.2: Key revenue reform recommendations**

| Area | Problem | Suggested reform |
|---|---|---|
| Sales tax | Distortionary, many rates, narrow base, tax exportation (CST), reduce evasion and corruption | • Implement VAT (C/S), possibly on a voluntary basis with floor rather than harmonized rates.<br>• Eliminate CST (C/S)<br>• Remove concessions and improve information across states. (S)<br>• Amend constitution to permit concurrent taxation of services, and start transferring service taxation to states. (C)<br>• Introduction of functional organization, large tax-payer units |
| Professions tax | Non-existence in many states, low ceiling | • Introduce professions tax in all states. (S)<br>• Amend constitution to raise ceiling and allow further future increases. (C) |
| Stamps and registration | High rates lead to low compliance | • Lower conveyance rates. (C/S)<br>• Increase rates on substitute transfer transactions (C/S)<br>• Ban physical stamps<br>• Improve procedure for establishing guidance rates. |
| Transport tax | Buses overtaxed; private vehicles undertaxed | • Raise tax rates on private 2 and 4 wheelers relative to buses (S) |
| Other taxes | Minor levies are distortionary and non-transparent | • Remove entry tax, turnover tax, and surcharges (S)<br>• Merge entertainment tax, registration fees and luxury tax with VAT on services (S)<br>• Remove concessions |
| Non-tax revenues | Significant deterioration in revenue performance | • Reform system of mineral royalties and sale of forest produce (C/S)<br>• Improve performance of user charges by close monitoring and more regular adjustments and better collection |
| Cross-cutting Administrative reforms | Weak accountability | • Inter-state coordination needs to be institutionalized<br>• Improve enforcement technology and procedures coupled with computerisation, staff incentives, management flexibility and effective anti-corruption institutions. |

5.8. **Modelling the impact of revenue reforms** We assume that, if these reforms are implemented, the revenue/GDP ratio will rise. Of course, a fair amount of guess work is involved, but the following are the assumed impacts of the above reforms:

- The implementation of VAT in 2005 raises revenues by 0.2 percentage starting in 2006/07 and a further 0.2 percentage points in 2007/08.
- Reducing stamp duty rates on sales and raising rates on substitute transactions, strengthening professions tax, and reforming of motor vehicles tax will increase revenues by an additional 0.2 percentage point of GDP in 2004/05 and a further 0.1 percentage point in 2005/06.
- Taxation of services starting in 2006 will increase revenues by 0.2 percentage points starting 2007/08.
- Cross-cutting institutional reforms will lead to a 0.1 percentage point increase annually.

- Non-tax revenues will increase by 0.1 percentage point in 2005/06 and 2006/07.

In aggregate, revenue rises from 11.8% of GSDP in 2003/04 to 13.3% by 2007/08.

5.9. **Modelling impact of expenditure reforms**. Projecting the quantitative impact of all of the above expenditure reforms is difficult. The main fiscal rationale from public enterprise reforms, for example, is not, in most cases, to make large, immediate budgetary savings, but to prevent a further unproductive investments being made in the public-sector and future losses accumulating. However, the short-term budgetary impact of some of the key reforms can be modeled, as summarized below:

- Hiring and pay restraint leads the wage bill to fall by an additional 0.2 percentage point annually (see 2.15).
- As argued in Chapter 2, the pension bill is kept constant as a ratio of GDP over the next 5 years in spite of increased retirement on account of parametric reforms.
- The impact of subsidy reforms is difficult to quantify. There are problems both estimating the existing level of subsidies and the likely impact of reforms. For sake of analysis, we estimate explicit subsidies at 1%. We assume very gradual reduction, even under the reform scenario, because of the large amount of power subsidies currently off-budget: in 2001-02, the subsidy was only 20% of the government's subsidy obligation (see Figure 2.1). Thus even with a reduction in the subsidy obligation, actual subsidy payments are likely to fall much less.

5.10. **Proposed expenditure reforms.** The key expenditure reforms from Chapter 2 are summarized below in Table 5.3.

**Table 5.3: Key expenditure reform recommendations**

| Area | Problem | Suggested reform |
|---|---|---|
| **Expenditure Restructuring** | | |
| Salaries | Salary bill is large and crowding out other forms of productive spending | • Maintain a policy of no real wage increases and no net hiring.<br>• Required hiring in priority areas to be offset by downsizing in non-priority areas<br>• No new pay commission |
| Pensions | Pension spending is a rapidly mounting liability. Short-run parametric reforms are needed as well as longer-term structural reforms | • Short-term parametric reforms include: (i) use of longer averaging periods for the calculation of benefits: (ii) use of higher discount rate; (iii) reduction in leave encashment limits: (iv) reduce scope for commutation.<br>• Shift from the current pay-as-you-go system to a defined contributions scheme.<br>• A crack-down in pension abuse. |
| Subsidies | Subsidies are fiscally costly and poorly targeted. | • Continued sectoral reform (power, irrigation) to improve commercial discipline, e.g. in the power sector through privatization, more widespread metering, greater enforcement of collection, a crackdown on theft<br>• Selective Tariff increases to reduce cross-subsidies.<br>• Strengthen subsidy management and limiting government's liabilities. |
| Public enterprise reforms | Limit the fiscal burden of public enterprises on the budget and improve their performance | • Continued privatization and restructuring.<br>• Limit generosity of VRS schemes |

| | | |
|---|---|---|
| Interest payments | Debt service accounts for a major share of recurrent spending | • In addition to fiscally responsible behavior, prepayment of high-interest loans where possible to reduce interest rates on outstanding debt. |
| Priority non-salary expenditures | Have been squeezed by the fiscal crisis | • Protect and enhance, subject to fiscal constraints, while paying due attention to improving expenditure efficiency. |
| **Expenditure quality reforms** | | |
| Agency reforms<br>Enabling framework<br>PEM reforms | Poor expenditure quality undermines government effectiveness; caused by low accountability, and weak public expenditure management. | • Agency reforms including transfer of service responsibility to the private sector or local government<br>• Promoting cost recovery and commercial discipline, encouraging citizen demand for better services, increasing transparency, cracking down on civil service transfers, and establishing strong and independent anti-corruption commissions.<br>• Budgeting realistically, implementing the budget as passed, enhancing departmental accountability and flexibility in the budget process, tightening budgetary controls over open-ended obligations and capital projects, tightening accounting and audit arrangements. |

## IV Reform Scenarios: do the reforms add up?

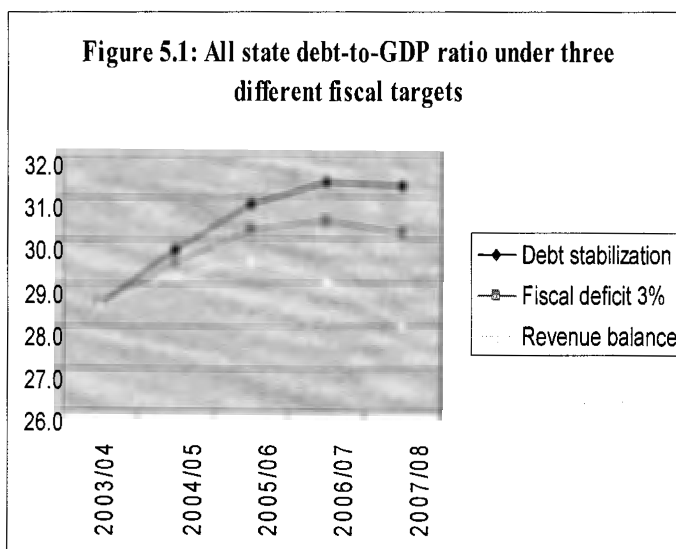
**Under the reform scenario, states can stabilize their debt, and achieve the fiscal deficit target, but cannot eliminate revenue balance until several years after the GoI target date of 2007/08.**

5.11. We run reform scenarios which implement the reform package described in the previous section (otherwise taking the assumptions described in Box 5.1). We use the scenarios to test this reform package against three different widely accepted fiscal targets:

- **Debt-stabilization.** In this scenario the goal is to stabilize the debt-GDP-ratio by cutting the primary deficit.
- **Fiscal deficit stabilization** - say at a pre-crisis level of around 3% of GDP.
- **Revenue deficit elimination.**

5.12. We take 2007-08 as the target date for achievement of these targets, since is this the year by which GoI has committed to eliminate its revenue deficit under the central FRA. Several state governments have committed to achieve revenue balance by an earlier data under their respective FRAs. The goal of the Fiscal Reforms Facility is to eliminate revenue balance by 2004-05.

Figure 5.1: All state debt-to-GDP ratio under three different fiscal targets




5.13. The debt path under each of these three reform scenarios is illustrated in Figure 5.1. As illustrated by this figure, the three fiscal targets ordered in terms of the severity of the adjustment they require, with the third target, i.e. eliminating the revenue deficit, requires the tightest adjustment.

5.14. Table 5.4 below illustrates the impact on the composition of expenditures under the various reform scenarios. It shows that

achieving the zero revenue balance objective can only take place by sacrificing the objective of protecting other recurrent spending, which mostly consists of operations and maintenance spending, and which has to be cut by some 15% to achieve revenue balance in 2007/08. As argued in Chapter 2, operations and maintenance spending, has already been squeezed, and should not be cut further.

5.15. This suggests that stabilizing debt and returning the fiscal deficit to 3% of GDP should be the first priority for the states, and are realistic targets to be achieved by 2007/08. Pursuing revenue deficit elimination by this date will lead to a sharp fall in debt, but will also crowd out productive expenditures.[52]

5.16. If the impact of the devolution of contingent liabilities is taken into account, the increase in the debt stock would be significantly higher and would extend at least a further year. Nevertheless, a reform scenario would eventually lead to lower interest payments and subsidies and would also free up more resources for priority programs.

**Table 5.4: Fiscal indicators under three reform scenarios**

| ` | 03/04 | 04/05 | 05/06 | 06/07 | 07/08 | 03/04 | 04/05 | 05/06 | 06/07 | 07/08 | 03/04 | 04/05 | 05/06 | 06/07 | 07/08 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Debt stabilization | | | | | 3% Fiscal Deficit | | | | | Zero Revenue Deficit | | | | |
| Revenues/GDP | 11.8 | 12.1 | 12.4 | 12.8 | 13.3 | 11.8 | 12.1 | 12.4 | 12.8 | 13.3 | 11.8 | 12.1 | 12.4 | 12.8 | 13.3 |
| Total Spending | 16.6 | 16.6 | 16.6 | 16.7 | 16.8 | 16.6 | 16.5 | 16.4 | 16.3 | 16.3 | 16.5 | 16.2 | 15.9 | 15.6 | 15.4 |
| Interest /GDP | 2.8 | 3.0 | 3.1 | 3.2 | 3.3 | 2.8 | 3.0 | 3.1 | 3.2 | 3.2 | 2.7 | 3.0 | 3.1 | 3.1 | 3.1 |
| Wage bill / GDP | 5.2 | 5.0 | 4.8 | 4.6 | 4.4 | 5.2 | 5.0 | 4.8 | 4.6 | 4.4 | 5.2 | 5.0 | 4.8 | 4.6 | 4.4 |
| Pensions/GDP | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 |
| Subsidies / GDP | 1.0 | 1.0 | 1.0 | 0.9 | 0.9 | 1.0 | 1.0 | 1.0 | 0.9 | 0.9 | 1.0 | 1.0 | 1.0 | 0.9 | 0.9 |
| Other Recurrent Spending / GDP | 4.0 | 4.0 | 4.1 | 4.4 | 4.6 | 4.0 | 3.9 | 3.9 | 4.0 | 4.2 | 4.0 | 3.6 | 3.4 | 3.4 | 3.4 |
| Capital Spending | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 |
| Interest/Revenue | 23.7 | 24.5 | 25.1 | 25.1 | 24.6 | 23.7 | 24.5 | 25.1 | 24.9 | 24.1 | 22.9 | 24.5 | 24.8 | 24.3 | 23.0 |
| Primary deficit | 2.0 | 1.5 | 1.1 | 0.7 | 0.2 | 2.0 | 1.4 | 0.9 | 0.3 | -0.2 | 2.0 | 1.1 | 0.4 | -0.3 | -1.0 |
| Fiscal deficit | 4.8 | 4.5 | 4.2 | 3.9 | 3.5 | 4.8 | 4.4 | 4.0 | 3.5 | 3.0 | 4.8 | 4.1 | 3.5 | 2.8 | 2.1 |
| Revenue deficit | 2.7 | 2.4 | 2.1 | 1.8 | 1.4 | 2.7 | 2.3 | 1.9 | 1.4 | 0.9 | 2.6 | 2.0 | 1.4 | 0.7 | 0.0 |
| Debt stock | 28.5 | 29.5 | 30.4 | 31.0 | 31.1 | 28.5 | 29.4 | 30.2 | 30.3 | 30.0 | 28.5 | 29.1 | 29.4 | 28.9 | 27.8 |
| RD/RR | 22.9 | 19.8 | 16.9 | 14.1 | 10.5 | 22.9 | 19.0 | 15.3 | 10.9 | 6.8 | 22.0 | 16.5 | 11.3 | 5.5 | 0.0 |

*Source: World Bank Staff Projections*

## V Scenarios for the Poor States

**The poor states can achieve only debt-stabilization, and neither fiscal nor revenue targets by these dates without compression of productive expenditures.**

5.17. The analysis so far has assumed that all states adjust at roughly equal rates. However, a recurrent theme in this report has been the divergent performance of poor and other states. This section does projections focusing exclusively on the 5 low-income states (Bihar, Madhya Pradesh, Orissa, Rajasthan and UP).

5.18. The key assumptions used for the reform and non-reform scenarios are the same as outlined in Section IV. However, the base year macroeconomic indicators are different as they are in this case limited to the fiscal indicators for the five low-income states. In the base year (2003/04), the fiscal deficit is assumed to be 6.5 percent, the revenue deficit is 4.4 percent, and the debt to GDP ratio is 50 percent.[53] Real GDP growth is lower at 5.5% annually, and inflation and real interest rates are assumed to be the same as in the baseline scenarios.

[52] Rajaraman (2003) derives similar results.

[53] Percentages are as a weighted share of GSDP for the 5 relevant states. These data are based on estimates of 2002/03 and 2003/04 revised estimates for the 5 states.

5.19. The poor states are able to stabilize their debt-stock fairly quickly because of the high initial levels of debt, which have already forced down their primary deficits; and it is primary deficits which drive the debt trajectory. (Note that in the base year, whereas the poor states have higher fiscal deficits than the average for all states, they have almost identical primary deficits.) However, it cannot be considered satisfactory to have these states running deficits in excess of 5%, and sustain indefinitely debt stocks in excess of 50% of GSDP. Yet, the only way these states can achieve the more ambitious fiscal targets which will bring about debt reduction is by cutting non-salary expenditure. For example, to achieve a 3% fiscal deficit by 2007/08 other recurrent spending has to fall from 4.6% of combined GSDP to 3.1%, and even further to 2.3% if the revenue deficit is sought to be eliminated by this year.

**Table 5.5: Fiscal indicators under three reform scenarios for the 5 low-income states**

| | 03/04 | 04/05 | 05/06 | 06/07 | 07/08 | 03/04 | 04/05 | 05/06 | 06/07 | 07/08 | 03/04 | 04/05 | 05/06 | 06/07 | 07/08 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Debt stabilization | | | | | 3% Fiscal Deficit | | | | | Zero Revenue Deficit | | | | |
| | 15.0 | 15.3 | 15.6 | 16.0 | 16.5 | 15.0 | 15.3 | 15.6 | 16.0 | 16.5 | 15.0 | 15.3 | 15.6 | 16.0 | 16.5 |
| Total Spending | 21.5 | 21.6 | 21.6 | 21.7 | 21.9 | 21.5 | 21.3 | 20.6 | 20.0 | 19.5 | 21.5 | 21.1 | 20.3 | 19.5 | 18.6 |
| Interest /GDP | 4.9 | 5.3 | 5.5 | 5.5 | 5.6 | 4.9 | 5.3 | 5.4 | 5.4 | 5.3 | 4.9 | 5.3 | 5.4 | 5.4 | 5.2 |
| Wage bill / GDP | 7.2 | 7.0 | 6.8 | 6.6 | 6.4 | 7.2 | 7.0 | 6.8 | 6.6 | 6.4 | 7.2 | 7.0 | 6.8 | 6.6 | 6.4 |
| Pensions/GDP | 1.7 | 1.7 | 1.7 | 1.7 | 1.7 | 1.7 | 1.7 | 1.7 | 1.7 | 1.7 | 1.7 | 1.7 | 1.7 | 1.7 | 1.7 |
| Subsidies / GDP | 1.0 | 1.0 | 1.0 | 0.9 | 0.9 | 1.0 | 1.0 | 1.0 | 0.9 | 0.9 | 1.0 | 1.0 | 1.0 | 0.9 | 0.9 |
| Other Recurrent Spending / GDP | 4.6 | 4.5 | 4.5 | 4.9 | 5.2 | 4.6 | 4.2 | 3.6 | 3.3 | 3.1 | 4.6 | 4.0 | 3.3 | 2.8 | 2.3 |
| Capital Spending | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 |
| Interest/Revenue | 33.0 | 34.9 | 35.0 | 34.7 | 33.9 | 33.0 | 34.9 | 34.8 | 33.8 | 32.0 | 33.0 | 34.9 | 34.7 | 33.5 | 31.4 |
| Primary deficit | 1.6 | 1.0 | 0.5 | 0.2 | -0.2 | 1.6 | 0.7 | -0.4 | -1.4 | -2.3 | 1.6 | 0.5 | -0.7 | -1.9 | -3.1 |
| Fiscal deficit | 6.5 | 6.3 | 6.0 | 5.7 | 5.4 | 6.5 | 6.0 | 5.0 | 4.0 | 3.0 | 6.5 | 5.8 | 4.7 | 3.5 | 2.1 |
| Revenue deficit | 4.4 | 4.2 | 3.9 | 3.6 | 3.3 | 4.4 | 3.9 | 2.9 | 1.9 | 0.9 | 4.4 | 3.7 | 2.6 | 1.4 | 0.0 |
| Debt stock | 50.0 | 51.2 | 52.0 | 52.4 | 52.4 | 50.0 | 50.9 | 50.7 | 49.5 | 47.5 | 50.0 | 50.7 | 50.2 | 48.6 | 45.8 |
| RD/RR | 29.3 | 27.5 | 25.0 | 22.5 | 20.0 | 29.3 | 25.5 | 18.6 | 11.9 | 5.5 | 29.3 | 24.2 | 16.7 | 8.8 | 0.0 |

*Source: World Bank Staff Projections*

5.20. This finding brings out the need for additional central government assistance to the poor states if they are to adjust successfully without compressing expenditures. Such assistance could come either through additional transfers or debt relief or restructuring. The alternative is either an unduly protracted and risky fiscal adjustment period or a slash-and-burn approach to expenditure reform, which would likely further undermine the capability of these already stretched governments.

5.21. To simulate the impact of debt restructuring, we reran the simulations in Table 5.5, but assumed a reduction in the real interest rate from 6% to 4% over the forecasting period. Under such a scenario, the 3% fiscal deficit and the zero revenue balance targets are still only feasible for the poor states through a severe compression of productive expenditures. However, the debt-stabilization target would now leave room for more significant increases, equivalent to around 1 percentage point of GDP, in public capital and operations and maintenance spending. (The impact of an increase in central government transfers is considered in 5.31)

## VI Risks

5.22. Even though interest rates have declined over the past 18 months, public debt dynamics have continued to worsen. Going forward, rates may well go up. Even a one percentage point increase in the assumed interest rate in the scenarios outlined above, would lead to a significant diversion of resources away from productive spending and to debt service purposes. For instance in the 3% fiscal deficit scenario outlined in Table 5.4, a one percentage point increase in average real interest rates over the forecasting period (from 6% to 7%), would undo

any scope for increase in productive spending: other recurrent spending would decline from 4% of GDP to 3.9% over the forecasting period, and there would be no room for any increase in capital spending.

5.23. Slower growth would speed up the deterioration of the debt dynamics and the fiscal accounts. For instance, if the average real growth rate over the forecasting period drops to 5%, from the currently forecast 6.5%, committed spending as a share of GDP would increase significantly. Again, assuming a 3% fiscal deficit target (Table 5.4), there would be no fiscal space for an increase in productive spending. It is therefore of key importance, even from a fiscal perspective, that reforms to improve the investment climate, and thus to accelerate growth are pursued - for a recent survey, see World Bank (2003, 2004).

5.24. Other risks could threaten the states' development prospects. An important risk is that the comprehensive reforms needed could be delayed due to the primacy of political concerns, including central and state elections. Political obstacles to the needed hardening of budget constraints between the center and the states, particularly in states that have considerable political power, threaten to further erode state finances and discourage reforming states.

5.25. Finally, the health of the financial sector is a concern, even though there has been an improvement in recent years. Increasingly, the banks, and especially the public banks, have ceased being genuine intermediaries and have switched to become financiers to the government.

## VII Implications for the central government

5.26. The ultimate responsibility for fiscal adjustment, and indeed for development, at the state level lies with India's states, but are too important and difficult to be carried out by the states alone. The center has a critical role to play in all three areas of expenditure reforms, tax reforms, and strengthening of the federal fiscal framework.

5.27. As we have stressed throughout this report, the states are not passive pawns driven purely by central policies and incentives. The very different performance of very similar states points to the autonomy of states with regard to not just fiscal policy, but more generally development effectiveness. Some progress has been made since the fiscal crisis hit in the late nineties, but much remains to be done before states can not only emerge from the crisis, but emerge as more effective agents of development. We have tried throughout this report to outline a package of state-level expenditure and tax reforms, and have summarized this in Section III of this chapter. In this final section, we outline the implications for the Government of India.

5.28. If not attended to, the aftermath of the states' fiscal crisis will continue to act as a drag on India's economic development, and a threat to macroeconomic stability. Whereas there are signs of a tentative improvement of the fiscal balance at the center, such signs remain largely elusive at the level of the states. It is clearly in the interests of the central government to help states in all the three areas of reforms discussed in this report: on the expenditure side, the revenue side, and with regard to fiscal federal arrangements. A large number of welcome initiatives have already been undertaken by the central government; but many more are needed.

5.27 On the expenditure side, the prime need is for GoI, given its leadership role, to lead by example. Thus the establishment of a new central pay commission should be avoided for as long as possible. Similarly, the creation of the new defined contribution pension scheme should be accelerated, and GoI could accelerate parametric pension reforms at the state level by adopting its own parametric reforms (e.g. extending the period used to calculate the final wage on which the pension is based).

5.28 There are a number of critical state-level tax reforms which require central leadership. The center can help overcome the current impasse on the VAT, perhaps by allowing states to shift to VAT individually, rather than all at the same time. The transfer of services to the states is an excellent move which should be accelerated. A constitutional amendment to lift the ceiling on the professions tax would revitalize that tax, and perhaps raise 1% of GDP, much of it from the service sector. Phasing out of the distortionary and inequitable CST will require

both central government and legislation. The centre can also help the states co-ordinate and share information on all the major taxes.

5.29 Reforming India's system of federal grants will be a long and complex task, but there is unanimous agreement on the need to harden budget constraints at the state level, something well within GoI's powers to act on.The entire agenda of federal fiscal reforms of course involves GoI centrally. We have argued for a larger, simpler and more progressive distribution of transfers from the centre to the states, and for some portion of overall transfers to be tied to performance. However, given divergent views and a complex institutional structure, reform to the transfer regime is likely to be slow. However, there is no dispute that state borrowing needs to be controlled at the aggregate level. Adopting the concept of a "global cap" on borrowing, and giving states much more flexibility and market-access provided they stay within their cap is an issue where GoI has a clear constitutional mandate, could make rapid progress, and have more direct impact on deficit reduction than any number of incentive funds or adjustment loans.

5.30 Finally, the central government can back the states' own reform efforts, especially by encouraging passage or and compliance with fiscal responsibility legislation. Now that fiscal responsibility legislation has been passed at the center, the center can set an example to the states through implementation of its own fiscal adjustments in line with the targeted timetable (see Box 1.2). It can also encourage other states to adopt fiscal responsibility legislation, and give relevance and teeth to these state-level acts by basing its own fiscal monitoring on performance against the legislated targets. More generally, much more needs to be done to develop systems of reporting state-level performance, and sharing reform experience.

**Reforms at the central government level would improve the stance of state finances and would improve the quality of the states fiscal adjustment paths.**

5.31 Higher central government tax revenues would lead to higher central transfers to the states. As outlined in the DPR, tax reforms at the center (eliminating exemptions, bringing agriculture and services into the tax net, and improving technology-based tax administration) could increase tax revenues as a share of GDP by some 2 percentage points over the next 5 years.54 Under such a scenario, it does not seem unreasonable to assume that transfers to the states would increase by 0.5 percentage points of GDP over the forecasting period. Such a scenario would leave the states with significantly more fiscal space to increase spending on capital, and operations and maintenance, while still reaching the 3% fiscal deficit target. Reforms at the center could play a critical role in pushing forward developmental spending at the state level.

[54] See also the recommendations by the Kelkar Committee, Kelkar (2002).

## ANNEX TO CHAPTER TWO: CASES STUDIES IN REFORMS TO IMPROVE EXPENDITURE QUALITY

### Case 1: E-governance: a mixed bag

In recent years, a number of Indian states have undertaken ambitious Information Communication Technology (ICT) based reforms in order to improve delivery of public services. Some have been clear successes. For example, the e-Seva project in AP and the Friends project in Kerala which bring together payment services for a number of utilities have been verified sustained successes over a number of years. The computerization of land records in Karnataka (Bhoomi) has also been well-received by its farmers. A survey of farmers by the Public Affairs Centre showed that 78% of users found Bhoomi simpler for getting copies of their land records, and that only 3% had to pay a bribe, whereas 66% had to under the old, manual system.

But a closer look at some other e-governance projects also hailed as successes shows a very different picture:

- The *Computer-Aided Administration of Registration Department (CARD) project in Andhra Pradesh (AP):* The registration process – particularly important for property transactions – is widely regarded as highly corrupt. In AP, computerization of the was seen as the solution. An ambitious state-wide project (CARD) to computerize the entire Department of Registration and Stamps (DR&S) was completed in a record time of 15 months. Though widely heralded as a success, a user survey in 2000/01 (Caseley, 2003) showed that although the time to register a document has been reduced from eight to three days (not the 1 hour claimed by government), there has been no impact on other dimensions of performance such as information transparency, staff behavior and the payments of bribes to secure document registration. Casely describes "a complete bypassing of the official CARD procedures by staff" made possible by the continuation of the old, manual system in parallel to the new, computerized system.
- *Computerized Inter-State Check Posts in Gujarat:* In late 1999, to improve the functioning of check posts, the Government of Gujarat decided to computerize 10 border check posts. The idea was to improve the processes of identification of vehicles and estimation of penalties using electronic weighbridges, video cameras and computers. The project achieved success in enhancing revenue for the state government, and again was heralded as a success. But apart from continued leakages indicating poor monitoring and misuse of technology, the government found itself simply unable to sustain this project. Computerized systems were switched off because of non-renewal of operations and maintenance contracts.
- *Gyandoot-Rural Internet Kiosks in Madhya Pradesh:* This project attempted to improve the delivery of government services to the rural community, by offering a range of services accessible on a computer at a Gyandoot kiosk on payment of a nominal transaction fee. It received several favorable write-ups, but a survey showed low usage of system, leading to losses for the private entrepreneurs running the kiosks, not to mention an absence of electricity in many rural areas, resulting in a very low coverage.

What distinguishes success from failure? No doubt, in part luck. E-governance projects are inherently risky; world-wide about half fail. But factors that help success are: (i) re-engineering of backend processes; (ii) outside pressure; (iii) use of pilots; (iv) discontinuation of the manual system making the use and success of the automated system not an option, but a must.

The other lesson is for the reform observer, who is quick to claim victory, and propose replication. Independent, survey-based results, and re-visits, provide useful supplements to the accounts of reform champions.

*Sources*: Caseley (2003), Panneervel and Bhatnagar (2001), Bhatnagar and Vyas (2001); Bhatnagar and Chawla (2004)

**Case 2: Right to Information: an effective tool for promoting performance?**

Right to Information (RTI) Acts have been enacted in the last few years by 6 states. Others, including Madhya Pradesh and Uttar Pradesh, have passed executive orders for providing access to information. The Government of India also enacted a Freedom of Information Act in January 2003. This is applicable to all states of India (except Jammu and Kashmir), but is not yet effective.

A recent review of experience in the states which have introduced them clearly shows that the introduction of RTI has enabled citizens to obtain information from government which would have been withheld in the absence of these laws, and that this has been a force for greater transparency and accountability in government functioning. But merely passing an RTI law is not itself a guarantee of its effective implementation. RTI laws have been better implemented in states like Rajasthan and Delhi which have witnessed both sustained efforts by civil society to use the RTI, and political commitment towards proper implementation of RTI laws. In these two states, citizens groups have actively encouraged citizens to use their right to access Government records to address individual and community level grievances. This has formed the basis of several social audits, which have exposed misuse of resources and large-scale corruption in Government works.

Several problems remain even in the better-performing states, the most significant being the lack of willingness among elected representatives and Government employees to share information. Although the RTI Acts provide for penalties for non-compliance, there are no cases yet in which action has been taken against officials violating the provisions of the RTI laws. Training to educate and re-orient elected representative and civil-servants to a new more open regime would also help, as would more publicity for RTI Acts, creation of an independent appellate authority, more resources for record management, limiting the exemptions under RTI Acts, amending other Acts where they contradict the RTI, and ensuring fees for information access are not prohibitive. The Delhi experience shows the contribution that an active State Council for "Right to Information" can make as an advocacy group and monitor of RTI.

Finally, it is important that governments make public more information automatically: with or without a request (so-called *suo moto* provision). As the experience of Rajasthan illustrates, there is a lot of critically important information that can be easily provided to people on a regular basis. *Suo moto* display and dissemination of information needs to be mandated by the RTI law to help ensure transparent governance.

*Source:* Anjali Bhardwaj (2003).

## Case 3: Successful health care initiatives: with and without private sector participation

***Contracting out of urban health centers in Andhra Pradesh***

In July 2000, Andhra Pradesh established 192 Urban Health Centers (UHCs) in 74 municipalities, each covering a population of 15-20,000. NGOs were contracted to run these centers, but the responsibility for monitoring them and setting performance benchmarks was put on an advisory Committee and the District Health Officer (DHO). The government provided the UHC building, equipment, furniture and fixtures, and drugs. The UHC was allowed to charge Rs 2 per visit, and was provided with a modest budget.

In their first few years of operation, the contracted UHCs have shown an impressive performance. The proportion of pregnant women visited by a health worker has risen from a baseline of 10 percent to 95 percent, and the number of children fully immunized has increased from a baseline of 31 percent to 85 percent . The success of the UHCs can be attributed to several factors. UHCs were able to recruit staff on contract at half the government rate, allowing them to cut costs. Setting benchmarks provided the NGOs with a powerful incentive to focus on results and outputs. NGOs that did not meet expected minimum standards did not have their contracts renewed. Involving the community also allowed the NGOs to respond effectively to local demand. The program illustrates that even NGOs with no previous experience in health could successfully take on the management of health care, and achieve significant improvements in health care provision at a low cost.

***Improving public sector performance in Punjab hospitals***

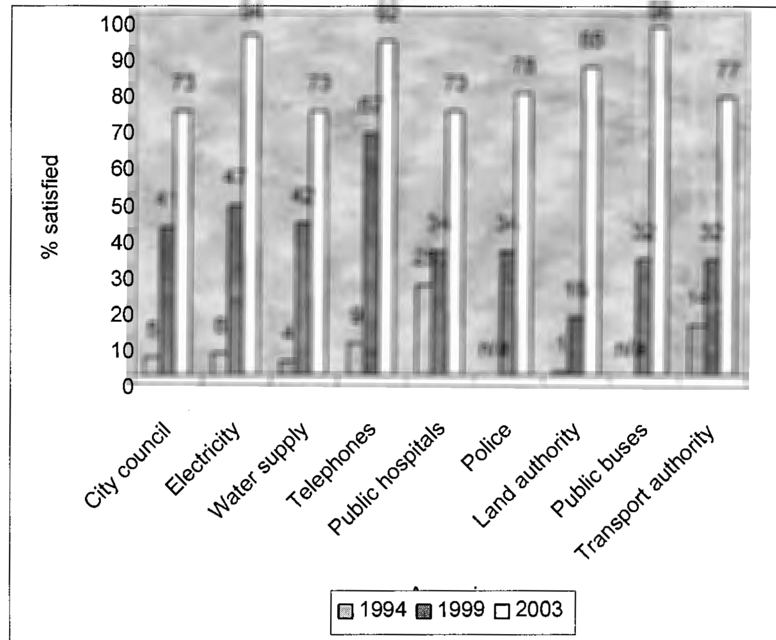
In 1996, Punjab embarked on an ambitious program to improve the state's public hospitals. It established the Punjab Health Systems Corporation (PHSC) to take control of a number of hospitals. User charges were introduced at all the facilities, and the revenue generated was retained at the facility level to provide drugs, patient facilities, equipment and building maintenance. Hospital records were computerized and published on the internet (www.punjabhealth.org), with each facility being graded on key indicators. The Corporation also introduced non-monetary incentives such as letters of appreciation to outstanding health workers that had far surpassed targets. Several non-clinical services such as ambulances and sanitation were outsourced.

The results of the reform program have been impressive with tremendous increases in key performance indicators. In the last two years alone, surgeries have increased by 58 percent, the number of deliveries by 36 percent, and the number of laboratory tests by 82 percent. Outsourcing sanitation has resulted in very clean hospitals, as confirmed by a recent patient satisfaction survey, which indicated that 71 percent of PHSC patients were satisfied with the cleanliness of the toilets compared to 42 percent in non-PHSC facilities. This program is an example of successful introduction of some private sector management techniques like measuring performance and instilling a results-oriented culture into a public-sector bureaucracy.

*Source:* World Bank (2004)

**Case 4. The Bangalore service delivery miracle**

The Public Affairs Centre in Bangalore has been conducting surveys of satisfaction with service delivery over the last ten years. The three surveys show a dramatic improvement across the entire gamut of services. In 1994, only 6% of Bangalore residents were satisfied with the electricity services they were getting; in 1999, this proportion had increased to 42% and in 2003 to 94%. What lies behind this astounding turn-around?




In several cases, the improvement in performance mainly comes post-1999, which was a period during which intense efforts were made to improve service delivery in Bangalore. The Bangalore Agenda Task Force was established in 2000 by the government as a civil-society watch-dog to interact with government agencies and track their performance. The BATF has held annual meetings, which the Chief Minister of the state and other dignitaries have attended, during which city agencies have had to report on their performance in the last year, and make promises for the coming year. This clearly put agency heads under a lot of pressure to perform. The BATF as well as the PAC reports themselves also made agency performance news. Newspapers began highlighting agency problems, and themselves organizing interactive sessions to bring together agencies and the public. The appointment of a dynamic Ombudsman in 2002 only helped the process along: his high-profile public raids of agencies such as the transport authority made great front-page stories.

Thus in large part the story would seem to have to do with a combination of political commitment to reform and civil society pressure – pressure which was encouraged by the government as a tool for reform. However, it is unlikely that this is the whole story, if only because the improvement trend started in 1994. There was also no doubt a gradual build-up of pressure on agencies to perform associated with the growth of a demanding middle-class in Bangalore, of which the Public Affairs Centre was itself one expression.

Whatever the reasons, these results augur well for the potential of service delivery improvements in India's thriving cities – and note that separate surveys of slum-dwellers also show large increases in satisfaction. There are other stories of service delivery improvement in India's cities: see Caseley (2003) for the case of the Hyderabad Water Supply Board, where it seems a similar mix of ingredients was involved.

The real challenge now is to replicate these results across cities and in rural areas.

*Sources:* Paul (2004); Ravindra (2003); Chand (2003); Caseley (2003)

**Case 5: How to beat corruption in drugs procurement, and thereby improve rural health service delivery: The Tamil Nadu Medical Services Corporation**

Procurement in general, and drug procurement in particular, is an area riddled with problems in several states. In several states, drug procurement has been plagued by accusations of corruption, focusing on drug adulteration, tampering with minimum support prices, and alleged pay-offs to health officials to procure expired or unneeded drugs for the state's hospitals. Tamil Nadu appears to have found a way to reduce both costs and corruption in the process, while ensuring regular supply of the right drugs at the right time. The Tamil Nadu Medical Services Corporation (TNMSC) provides a model not only for procurement of drugs, but more generally for eliminating discretion and maximizing transparency in government procurement.

TNMSC was established in 1994 as a government company to procure, store, and distribute drugs, as well as surgical and suture items, to all government hospitals and Primary Health Centers (PHC's) across Tamil Nadu. TNMSC procures some 268 drugs in bulk directly from manufacturers, significantly reducing their price in the process. These drugs are drawn from the WHO's model list of essential drugs by a panel of medical doctors. Tender notifications are issued on the web and elsewhere (using generic, not brand names); after scrutinizing technical bids and winnowing the field, financial bids are opened and the lowest bidder awarded the contract unless TNMSC asks the nearest competitors if they want to match the winner's quoted price. TNMSC has also created a list of approved laboratories across the country to test sample drugs before issuing them; drugs are rotated randomly across these laboratories and, if they fail laboratory tests, these drugs are returned and the supplier blacklisted. Drugs are supplied in strips, rather than packages, to distribution in the right quantities to hospitals, and marked with the TNMSC logo to prevent their unauthorized sale outside hospital dispensaries. Stock management is entirely computerized. Stocks are monitored daily; drugs are also tracked by their expiry dates. Hospitals are given passbooks, allowing them to draw drugs of their choice, up to a pre-determined monetary value, from the warehouse in their area; deviations from past consumption patterns that suggest pay-offs by drug manufacturers to hospital administrators to overstock a particular drug are investigated by TNMSC's field staff. Anyone can view the current stock by drug or warehouse at TNMSC's website (www.tnmsc.tn.nic.in).

A survey of PHCs to examine the impact that TNMSC has had at the field-level found that (Lalitha, 2003):

- Many of the surveyed patients reported improvements in the quality of the medicines provided by the PHCs. As a result, they had stopped buying medicines from pharmacies, and were also recommending that their neighbours also to go to PHCs. (Indeed, official data on use of PHCs does show a tremendous increase in the last few years.)
- The tablets and capsules are dispensed in their original blister packs, well before their expiry dates. All the medicines carried the logogram TG meaning Tamil Nadu government either written in Tamil or in English. The list of available medicines and their shelf-life status was displayed clearly in all the PHCs.
- In some of the PHCs, long-serving doctors and pharmacists observed that before TNMSC came into existence, PHCs used to be dumped with medicines that all looked alike and many of these drugs used to arrive at the PHCs close to the end of their shelf life.

*Source:* World Bank (2004); Lalitha (2003)

**Case 6: Karnataka's Ombudsman**

The Karnataka Lok Ayukta is probably the strongest of all ombudsman offices in the country. As in Madhya Pradesh, Karnataka has placed the Vigilance Department under the full control of the independent Lok Ayukta, to strengthen his capacity for autonomous action. In addition, the Karnataka Lok Ayukta Act vests the Lok Ayukta with wide statutory powers-from investigating corruption to addressing citizen grievances against any public servant, including the Chief Minister. He also has the right to initiate prosecution directly. Karnataka's Lok Ayukta is appointed for a fixed five-year term by the Chief Minister in consultation with the Speaker of the House, the Leader of the Opposition, and the Chief Justice. Once appointed, he can be removed only for "proven misbehavior" or " incapacity" by the Governer, after a two-thirds majority vote in both chambers of the legislature.

The Lok Ayukta in Karnataka has been very active in investigating corruption in health and education facilities around the state, regularly visiting districts to hear complaints, unearthing large financial scams in Karnataka's city municipal corporations, and raiding regional transport and stamps and registration offices to catch people red-handed. The growing activism of the Lok Ayukta has forced many departments to furnish effective redress to citizens to avoid further investigation and adverse media attention. The growing credibility of the Lok Ayukta as a channel for redressing grievances is reflected in the dramatic increase in complaints in just one year-from 303 in January 2002 to 1,026 in December 2002.

*Source:* World Bank (2004)

**Case 7: Some reforms to improve expenditure management.**

**Zero Based Investment Review in Orissa.** The Government of Orissa carried out, in June-July 2002 (and repeated in 2003-4), an exercise which it called a Zero-Based Investment (ZBI) Review, led by a high-powered committee headed by the Chief Secretary. An examination of 149 physical infrastructure projects (of over Rs 4 crore each) being implemented by six departments showed that about Rs 3600 crore of additional financing was required for their completion: far in excess of what was affordable. The ZBI Review required each departments to place the projects under four categories: (i) full funding for fast track completion; (ii) funding on slower track for now, could graduate to fast track in future; (iii) minimal funding until redesign or restructuring; and (iv) scrap or shelve indefinitely. About 25 per cent of the budgeted resources for the subset of investment projects covered by this ZBI Review was reallocated from the least to the highest priority projects in the revised budget for 2002-3, while 83 projects were scrapped. As a result, a significant number of investment projects have been completed and begun to yield benefits. For example, the PWD found resources within its budget to complete eight bridges which significantly enhance the mobility of the population in several poorly connected rural areas of Orissa. The success of this exercise, compared to the failure of similar exercises carried out in other states, shows that when the total budget allocation is held constant, positive incentives are created for a department to reallocate towards priority projects, rather than hide white elephants to protect budgetary resources.

**AP Budget Management Reforms.** In xxx, The AP Finance Department decided to make 6-month budget releases at the beginning of the financial year, and quarterly releases in the second half of the year. This replaced an old case-by-case release system which undermined planning, reduced efficiency in the use of limited resources available, and prevented line departments from being held accountable for performance. Discussions with line departments indicate that the system has improved the predictability of fund-flows, and has reduced the bureaucracy and discretion over releases that had previously been exercised by the Finance Department. The system now provides more assurance to line departments that they will receive the funds budgeted, when they are required.

**Computerization of accounts and cash management** A number of states have moved ahead with computerizing and in some cases networking their treasury system. Karnataka has networked the entire state through satellite, and so has the capability for real-time accounting and control. Goa has integrated different sources of information (from the treasuries, but also from RBI, and from those departments which operate outside the Treasury (so-called "LoC departments") to get an integrated view of its overall cash position.

**Promoting financial compliance.** Karnataka has developed a computerized data-base for tracking responses by departments to auditor's objections. It has backed up this system with a new Office of the Controller (Accounts Management) which monitors responses, and, with the backing of the Chief Secretary and Principal Secretary (Finance) chases delinquint departments. The database is now being web-enabled and extended to the reports of the Public Accounts Committee. There has been a substantial improvement in audit responsiveness as a result: the backlog was reduced by 43% in the six months following the establishment of the system in October 2002. Andhra Pradesh has attempted to incentivize compliance with financial management rules by linking fund release to prior adherence with financial management requirements, using self-certification. For example, the system provides that no funds will be released after the $10^{th}$ of the month to a Drawing and Disbursing Officer unless s/he certifies that s/he has undertaken a reconciliation (between departmental and Treasury figures) of accounts for the previous month.

*Sources:* Mathur and Ravishankar (2003); various World Bank state reports

## Annex to Chapter 3: Institutions for revenue coordination

Where uniformity and coordination are good for a federation, central laws serve a useful role. Otherwise they limit fiscal autonomy. The current system with its mix of central and state laws governing state taxes and important non-tax revenue sources, creates 3 problems: (1) The Centre (e.g. in the case of coal and petroleum) has been slow to revise laws, including specific rates of taxes, royalties and fines. This adversely affects state revenues. (2) In some important cases, fiscal autonomy is constrained even when there are no discernable uniformity or coordination benefits. (3) There is no uniformity in revenue administration: 29 states implying 29 sets of forms and procedures and correspondingly, 29 sets of channels for corruption both of which imply high private sector compliance costs and fiscal barriers to a common market in India.

In the absence of inter-state agreements and except in areas deemed to be crucial to national interest (e.g. forest conservation), tax rates, concessions and tax thresholds (as well as royalty rates, most fees and charges) should typically be left to the discretion of states in a federation. However, without materially reducing state sovereignty, a national common market will be fostered if procedures to administer these levies, as well as rates of fine and penalty, are uniform across states.

As in some other countries, a central Indian Revenue Administration Act covering all major state and central levies and laying down uniform administration procedures, forms, penalties and fines will facilitate cross-state coordination and reduce private compliance costs. In addition, this act can provide a statutory basis for inter-state and centre-state institutions to improve administrative coordination. This act, which should replace most administration provisions in different central and state revenue laws, can also lead to a drastic simplification if tax laws in India.

In certain other cases common central acts or concurrent state and central acts to lay down rates of different levies could continue, as at present (but shorn of administrative provisions). This includes the Motor Vehicles Act,[55] the Indian Stamp Act, the Indian Registration Act, The Forest Conservation Act, the Mines and Minerals (Development and Regulation) Act.

A constitutional body, such as the Finance Commission, could be entrusted with the task of recommending revisions to central revenue laws as they apply to states and monitoring compliance with central revenue laws by states as well as timely central action on its recommendations. This should preferably be done annually. This would, of course, require a constitutional amendment. Such an institutional arrangement would ensure that specific rates and thresholds do get revised at regular intervals. Furthermore, the institution would provide states and centre a forum in which problems in administering revenue laws could be aired and corrected. As a by-product, regardless of whether Finance Commissions are entrusted with this specific role or another body created, Finance Commission will be in a better position to analyse revenue performance and, if considered necessary, improving the incentive structure of its awards.

Current problems in achieving inter-state and centre-state coordination which require resolution, whether through a Central administration Act or otherwise, include:

(a) The severely limited sharing of information between:
- Central Income Tax and state Sales Tax and Stamp Duty Departments: to ensure that reported purchases, sales and turnover are consistent.
- Central Excise – and state Sales Tax Departments; to ensure that production and sales data are consistent.
- Sales Tax Departments in different states: Current compliance and administration difficulties caused by documentation of inter-state sales via "C Forms" and "F Forms", as well as problems with fake documents, can be greatly reduced by increased computerisation and improved, perhaps on-line, information sharing. These problems will get exacerbated when the VAT is introduced, given zero rating of exports.
- State Excise Departments in different states: To reconcile production, export and import data for liquor and possibly sugar and molasses by different producers and traders to curb non-duty paid liquor and smuggling across state borders.
- Motor Vehicles Departments in different states and indeed, in different districts within states: Currently, (a) it is almost impossible to prevent multiple driver's licences from being issued to the same individual from different Regional

[55] The need for common administration legislation is illustrated by the startling fact that vehicle licence plates in conformity with rules in one state may be illegal and subject to penalty in others. See Malik (2004).

Transport Offices (RTOs); (b) to transfer registrations across states;[56] (c) to verify genuineness of permits; etc. All of this requires systematic computerisation and data networking both within states and across states.
- State sales tax administrations and the Indian Railways to curb sales tax evasion on goods sent by rail.

To facilitate information sharing, Central coordination and facilitation may be necessary. An example of such a coordination arrangement is the European Union's VIES.[57]

(b) As discussed above, common revenue administration legislation can make possible common taxpayer identification numbers, classification nomenclature for commodities and services, tax forms, procedures, fines and penalties.

(c) Common or coordinated road check-posts: The need to check both inward and outward goods traffic when a VAT is introduced will result in two check-posts at state borders unless states can run joint check-posts or have check-posts in only one direction, with the other state's check post examining compliance with laws of both states for goods vehicles travelling in the other direction. Furthermore, there is already a need for coordination to check transit vehicles for compliance with both sales and transport taxes.

(d) Administration associations: Where "best practices" can be shared possibly by introducing a system of cross-state deputation assignments for tax department staff and secondly, effectiveness and efficiency can be compared to introduce an element of healthy rivalry. Examples of associations of this kind with successful track records are the Latin American Association of Tax Administrations (CIAT)[58] and the Intra-European Organisation of Tax Administrations (IOTA).

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[56] To transfer a vehicle registration from one jurisdiction to another, whether intra- or inter-states a "No Objection Certificate" must be obtained from the original RTO. A separate application is needed for a motor vehicle tax refund, where applicable. Both are the responsibility of the vehicle owner not that of the destination RTO! Given the high probability of original documents being "misplaced", most vehicle owners find it necessary to make use of agents in the original jurisdiction, or simply do not comply with the law. The latter results in regulatory non-compliance and revenue loss in the destination state and inaccurate vehicle records in both states.

[57] For a description of the VIES see Hutchison (1996) and European Union (2002).

[58] See http://http.ciat.org. Links to IOTA are available through this site.

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**WSP-SA - FY04** **PROJECT/PRODUCT FINANCING , BUDGET AND ACTUALS**

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| PROJECT | PM | PIN | Category | Product | Product Description | Revised completion Date | Original Budget (July/Aug 03) | Revised MYR Budget (Jan03) | SOF | TF # | IO# | Pre-MYR Order allocation (as of Dec03) | MYR allocation (Jan03) | Staff Cost as of 30th April04 | Variable Costs as of 30th Apr 04 | Actual as of 30Apr2004 | FY04 Commitments as of 30 Apr 04 | Pending Repostings with RMA | Available Balance as of 30th Apr04 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1/SA/BA: Utility Reform Jul-02 to Jun-05 (Year 2 of 3) | TA | 1 | KM | LE | a. Workshop on PPP for urban utility management | May-04 | 21,256 | 27,262 | SDC-B | TF051522 | 2038787 | 21,256 | 27,262 | - | - | - | - | - | 27,262 |
| | | 2 | | S | b. Support to Institutional Review Study Phase II and conduct dissemination workshop | Jun-04 | 45,752 | 21,572 | SDC-B | TF051522 | 2038788 | 45,752 | 21,572 | 5,590 | 8,433 | 14,023 | - | - | 7,549 |
| | | 3 | | FN | c. FN on community managed infrastructure improvement | Aug-04 | 4,634 | 1,477 | SDC-B | TF051522 | 2038789 | 4,634 | 1,477 | - | - | - | - | - | 1,477 |
| | | 4 | | FN | d. FN on challenges to introdue PPP in urban WSS | Jul-04 | 24,034 | 3,647 | SDC-B | TF051522 | 203[illegible] RJain: to save Danida | [illegible] | 3,647 | 172 | 1,725 | 1,897 | 493 | - | 1,258 |
| | | 5 | IS | IS | e. Support to WB- BAMWSP and MSP projects (*) | Contd. | 15,518 | 11,518 | SDC-B | TF051522 | 203[illegible] | [illegible] | 11,518 | 6,157 | 16,880 | 23,037 | 24,883 | - | (36,403) |
| | | 6 | | IS | f. Support to DANIDA coastal belt towns project | Contd. | 16,565 | 11,987 | SDC-B | TF051522 | 2038792 | 16,565 | 11,987 | 230 | 4,195 | 4,425 | 369 | - | 7,193 |
| 2/SA/BA: Solid waste management Jul-02 to Jun-05 (Year 2 of 3) | SAA | 7 | KM | LE | a. Workshop on efficiency monitoring | May-04 | | | Danida | TF052065 | 2038825 | 32,402 | | | | | | | - |
| | | | | | | | 32,402 | 25,404 | AusAID | TF052137 | 2041103 | - | 25,404 | - | - | - | - | - | 25,404 |
| | | 8 | | LE | b. Training of professionals on waste management | Mar-04 | 5,361 | 11,250 | Danida | TF052065 | 2038793 | 5,361 | 11,250 | 4,231 | - | 4,231 | 11,250 | - | (4,231) |
| | | 9 | | FN | c. One FN on SWM Policy Guideleines | Mar-04 | 17,724 | 8,965 | AusAID | TF052137 | 2038794 | 17,724 | 8,965 | 2,119 | 147 | 2,266 | - | - | 6,699 |
| | | 10 | IS | IS | d. Support to scale up SWM approaches under MSP | Jun04 | 14,309 | 31,855 | Danida | TF052065 | 2038795 | 14,309 | 31,855 | 11,046 | 223 | 11,269 | 2,867 | - | 17,719 |
| | | 11 | PS | LE | e. Workshop for preparation of SWM guidelines | Oct-04 | 6,438 | 3,553 | Danida | TF052065 | 2038796 | 6,438 | 3,553 | 2,771 | 98 | 2,869 | - | - | 684 |
| 3/SA/BA: LG based community WSS service Jul-02 to Jun-05 (Year 2 of 3) | KM | 12 | KM | LE | a. National workshop on total sanitation demonstration project | Oct03 | 36,370 | 50,757 | SDC-B | TF051522 | 2038797 | 36,370 | 50,757 | 27,436 | 14,725 | 42,161 | 651 | - | 7,944 |
| | | 13 | | P | b. Design, initiate, and support implementation of demonstration project on Total Sanitation Campaign | Oct03; Feb04; Jun05 | 46,370 | 85,832 | SDC-B | TF051522 | 2038798 | 46,370 | 85,832 | 41,974 | 31,365 | 73,339 | 3,230 | - | 9,264 |
| | | 14 | | LE | c. Total sanitation progress review workshop | Apr04 | 10,809 | 42,903 | SDC-B | TF051522 | 2038799 | 10,809 | 42,903 | 33,377 | 2,995 | 36,372 | - | - | 6,531 |
| | | 15 | | LE | d. Practioners Workshop on local government based service delivery | May-04 | 13,843 | 16,557 | DFID-Arsenic | TF024827 | 2038800 | 13,843 | 16,557 | 1,466 | - | 1,466 | - | - | 15,091 |
| | | 16 | | FN | e. Asset creation under SIPP Project (*) | dropped | 13,408 | 2,803 | DFID-Arsenic | TF024827 | 2038801 | 13,408 | 2,803 | 2,792 | 11 | 2,803 | - | - | - |
| | | 17 | | S | f.Tool kit for community WSS design and operation (publication) | Apr-04 | 11,258 | 16,604 | DFID-Arsenic | TF024827 | 2038802 | 11,258 | 16,604 | 14,713 | - | 14,713 | - | - | 1,891 |
| | | 18 | | FN | g. Dissemination of good practices on decentralized WSS | Jun-04 | | | DFID-Arsenic | TF024827 | 2038803 | 7,000 | 14,000 | 1,177 | - | 1,177 | - | - | 12,823 |
| | | | | | | | 14,097 | 15,777 | SDC-B | TF051522 | 2038804 | 7,097 | 1,777 | - | - | - | - | - | 1,777 |
| | | 19 | IS | IS | h. Designing and implementing local government based service delivery projects | Contd. | | | DFID-Arsenic | TF024827 | 2038805 | 15,253 | 25,000 | 26,073 | 5,734 | 31,807 | - | - | (6,807) |
| | | | | | | | 31,087 | 46,677 | SDC-B | TF051522 | 2038806 | 15,834 | 21,677 | 2,111 | 936 | 3,047 | 667 | - | 17,963 |
| | | 20 | PS | - | i. Policy dialogue with GOB and partners on role of LGI incl. 1 workshop | Contd. | | | DFID-Arsenic | TF024827 | 2038807 | 10,000 | 12,000 | 1,393 | 4,986 | 6,378 | - | - | 5,622 |
| | | | | | | | 18,968 | 22,173 | SDC-B | TF051522 | 2038808 | 8,968 | 10,173 | - | - | - | - | - | 10,173 |
| | | 21 | | N | j. Three LCG meetings on decentralization and water | Feb, 04, April, 04 June, 04 | | | DFID-Arsenic | TF024827 | 2038809 | 26,330 | 6,500 | 990 | - | 990 | - | - | 5,510 |
| | | | | | | | 40,659 | 7,797 | SDC-B | TF051522 | 2038810 | 14,329 | 1,297 | - | - | - | - | - | 1,297 |
| 4/SA/BA: Arsenic Mitigation Jul-02 to Jun-05 (Year 2 of 3) | KM | 22 | KM | S | a. Demand assessment for Nawabganj town and field note on WTP | May-04 | | | DFID-Arsenic | TF024827 | 2038811 | 34,337 | 40,000 | - | 6,225 | 6,225 | 5,360 | - | 28,415 |
| | | | | | | | 55,674 | 70,942 | SDC-B | TF051522 | 2038812 | 21,337 | 30,942 | 402 | 16,297 | 16,699 | - | - | 14,244 |
| | | 23 | | S | b. Regional Report on institutional responses to Arsenic | May, 04 | | | DFID-Arsenic | TF024827 | 2038813 | 21,070 | 24,300 | - | 14,548 | 14,548 | - | - | 9,752 |
| | | | | | | | | | AusAID | TF052137 | 2041298 | | 14,421 | - | 2,200 | 2,200 | 6,600 | - | 5,621 |
| | | | | | | | 41,926 | 38,722 | SDC-R | TF051521 | 2038814 | 20,856 | 1 | | | | | | 1 |
| | | 24 | IS | IS | c. BAMWSP Supervision mission for formulating DRA based rural water supply schemes (*) | Dec03 | 24,441 | 20,865 | DFID-Arsenic | TF024827 | 2038815 | 24,441 | 20,865 | 11,457 | 434 | 11,891 | - | - | 8,974 |
| | | 25 | PS | - | d. Policy, technical and management support for new generation DRA based rural water supply schemes | Contd. | 19,634 | 17,944 | DFID-Arsenic | TF024827 | 2038816 | **19,634** | **17,945** | **12,181** | **420** | **12,601** | - | - | **5,344** |
| | | 26 | | S | e. Document latest knowledge on arsenic detection, mitigation, causes and magnitude of problem in South Asia | Jul-03 | - | - | UN Danida | UN003475 | roject close | - | | | | | | | - |
| 5/SA/BA: Institutionalizing Performance Improvements Jul-02 to Jun-05 | TA | 27 | KM | LE | a. National Workshop on PIP | May-04 | 23,072 | 10,027 | SDC-B | TF051522 | 2038818 | 23,072 | 10,027 | - | - | - | - | - | 10,027 |
| | | 28 | | FN | b. Field Note on Benchmarking | Oct-04 | 16,667 | 1,189 | SDC-B | TF051522 | 2038819 | 16,667 | 1,189 | - | 255 | 255 | - | - | 934 |
| | | 29 | PS | S | c. Technical assistance to conduct benchmarking and PIP | Contd. | 19,602 | 24,472 | SDC-B | TF051522 | 2038820 | 19,602 | 24,472 | - | 3,078 | 3,078 | 617 | - | 20,777 |
| | | 30 | | S | d. Strategy paper on performance based financing for municipal infrastructures | Contd. (Jun-05) | 30,063 | 22,007 | SDC-B | TF051522 | 2038821 | 30,063 | 22,007 | - | - | - | - | - | 22,007 |
| | | 31 | | LE | e. Regional Study Tour to well performing utilities | Dec-04 | 8,229 | 4,524 | SDC-B | TF051522 | 2038822 | **8,229** | **4,524** | - | - | - | - | - | **4,524** |
| 18/SA/IN: Sustainable rural water | | 32 | KM | S | a. Study/strategy for restructuring of MJP in Maharashtra (*) | Sep. 03 | - | - | (*) | | | | | | | | | | - |
| | | 33 | | LE | b. Workshop in Maharashtra on MJP restructuring | Nov-04 | | | Danida | TF052065 | 2041148 | 10,321 | | | | | | | - |
| | | | | | | | 10,321 | 12,427 | DFID-Rural | TF022457 | 2041226 | | 12,427 | - | - | - | - | - | 12,427 |
| | | 34 | | S | c. Study for restructuring Kerala Water Authority | dropped | | | Danida | TF052065 | 2038769 | | | | | | | | - |
| | | | | | | | 25,847 | 1,740 | DFID-Rural | TF022457 | 2040115 | 25,847 | 1,740 | 1,740 | - | 1,740 | - | - | - |
| | | 35 | IS | IS | d. Software prototype for M&E of RWSS national programme | Dec-03 | 5,762 | 5,882 | DFID-Rural | TF022457 | 2038770 | 5,762 | 5,882 | - | 4,400 | 4,400 | - | 1,482 | 1,482 |
| | | 36 | | P | e. M&E system pilots in 2 States (Tamil Nadu, Uttar Pradesh) | Jul-04 | | | Danida | TF052065 | 2038771 | | | | | | | | - |
| | | | | | | | 123,803 | 202,009 | DFID-Rural | TF022457 | 2039876 | 123,803 | 202,009 | 1,070 | 109,955 | 111,025 | 39,560 | 54 | 51,424 |
| | | 37 | | N | f. Jal Manthan on the RWSS National M&E system | Apr-04 | 26,274 | 4,300 | DFID-Rural | TF022457 | 2040116 | 26,274 | 4,300 | - | - | - | - | - | 4,300 |
| | | 38 | | IS | g. State-level review of RW programs in 3 states | Jun-04 | 23,005 | 20,552 | DFID-Rural | TF022457 | 2040117 | 23,005 | 20,552 | 12,475 | 2 | 12,477 | - | - | 8,075 |
| | | | | | | | [illegible] | [illegible] | DFID-Rural | TF022457 | 2038772 | 46,535 | 7,826 | - | 7,829 | 7,829 | - | - | (3) |

**WSP-SA - FY04** PROJECT/PRODUCT FINANCING , BUDGET AND ACTUALS

new IO | alternate IO: closed | exhausted/ 2nd priority: not to use | dropped: IO closed

| PROJECT | PM | PIN | Category | Product | Product Description | Revised completion Date | Original Budget (July/Aug 03) | Revised MYR Budget (Jan03) | SOF | TF # | IO# | Pre-MYR Order allocation (as of Dec03) | MYR allocation (Jan03) | Staff Cost as of 30th April04 | Variable Costs as of 30th Apr 04 | Actual as of 30Apr2004 | FY04 Commitments as of 30 Apr 04 | Pending Repostings with RMA | Available Balance as of 30th Apr04 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| services - Apr-03 to Jun-05 (Year 1 of 2) | VS | 39 | | LE | h. 10 training programs on the use of PRA technics in RWSS projects | Nov 03 | 46,535 | 7,826 | Danida | TF052065 | ~~2038773~~ | | | | | | | | - |
| | | 40 | PS | IS | i. Advisory support to GOI | Ongoing | 14,885 | 86,232 | DFID-Rural | TF022457 | 2038774 | 14,885 | 86,232 | 33,693 | 11,082 | 44,775 | - | 19,534 | 41,457 |
| | | | | | | | | | Danida | TF052065 | ~~2038775~~ | | | | | | | | - |
| | | 41 | | LE | j. National workshop on GoI Swajaldhara programme / Social fund | Jan. 04 | 25,885 | 31,247 | DFID-Rural | TF022457 | 2040118 | 25,885 | 31,247 | 11,171 | 9,062 | 20,234 | 243 | - | 10,770 |
| | | 42 | | LE | k. Policy workshop on performance-based financing options for RWS national programs | Mar-04 | 23,228 | 17,057 | DFID-Rural | TF022457 | 2040119 | 23,228 | 17,057 | - | - | - | - | - | 17,057 |
| | | 43 | | - | l. Policy Support to states, including support (on-going) by State coordinators in 3 States | Contd. | 87,211 | 174,879 | DFID-Rural | TF022457 | 2038776 | 87,211 | 174,879 | 42,137 | 60,958 | 103,095 | - | 34,230 | 71,784 |
| | | | | | | | | | | | | | | | | | | | - |
| | | 44 | | LE | m. Workshop on institutional implementation structure in Andhra Pradesh | Sep. 04 | 10,518 | 72,365 | Danida | TF052065 | ~~2038777~~ | | | | | | | | - |
| | | | | | | | | | DFID-Rural | TF022457 | 2040120 | 10,518 | 72,365 | 17,133 | 23,420 | 40,553 | 26,052 | - | 5,760 |
| | | 45 | | - | n. Policy dialogue initiated in other States | Contd. | 33,699 | 138,814 | DFID-Rural | TF022457 | 2039877 | 33,699 | 138,814 | 12,790 | 1,711 | 14,501 | - | 353 | 124,313 |
| 19/SA/IN: Supporting innovations and learning in RWSS - Apr-03 to Jun-04 (Year 1 of 1) | VS | 46 | KM | S | a. Study on institutional options for Multi-Villages WS schemes management in AP | Dec-04 | 14,148 | 28,518 | DFID-Rural | TF022457 | 2040121 | 14,148 | 28,518 | 1,740 | - | 1,740 | - | - | 26,778 |
| | | 47 | | FN | b. Jal Manthan on institutional options for Multi-Villages WS schemes management in AP | dropped | 13,019 | - | DFID-Rural | TF022457 | ~~2040122~~ | 13,019 | - | | | | | | - |
| | | 48 | | S | c. Study (ongoing) on fluoride mitigation in Maharashtra | Aug-04 | 20,873 | 28,339 | DFID-Rural | TF022457 | 2038778 | 20,873 | 28,339 | - | 13,659 | 13,659 | 6,703 | 769 | 7,977 |
| | | | | | | | | | Danida | TF052065 | ~~2038779~~ | | | | | | | | - |
| | | 49 | | FN | d. Field note on Fluoride/Arsenic issues similarities | Jan 04 | 5,285 | 2,371 | DFID-Rural | TF022457 | 2038780 | 5,285 | 2,371 | 468 | 2,928 | 3,396 | 774 | - | (1,799) |
| | | 50 | | S | e. Study on bacteriological contamination in Kerala | May-05 | 79,869 | 57,727 | Danida | TF052065 | ~~2038781~~ | | | | | | | | - |
| | | | | | | | | | DFID-Rural | TF022457 | 2039874 | 79,869 | 57,727 | - | 28,762 | 28,762 | 2,775 | 54 | 26,189 |
| | | 51 | | S | f. WTP study (ongoing) on Arsenic mitigation in West Bengal | Dec-04 | 83,497 | 91,423 | AusAID | TF052137 | 2038782 | 53,497 | 6,423 | 1,260 | 2,351 | 3,611 | 3,384 | - | (573) |
| | | | | | | | | | DFID-Rural | TF022457 | 2039878 | 30,000 | 85,000 | 497 | 6,208 | 6,705 | - | 20,333 | 78,295 |
| | | 52 | | S | g. Study (ongoing) on the evolution of the World Bank supported RWSS projects design | Jul-04 | 15,248 | 7,222 | Danida | TF052065 | ~~2038783~~ | | | | | | | | - |
| | | | | | | | | | DFID-Rural | TF022457 | 2040123 | 15,248 | 7,222 | - | - | - | - | - | 7,222 |
| | | 53 | | FN | h. Innovative approaches to institutional arrangement for RWS services management in 2 States | dropped | 9,418 | - | DFID-Rural | TF022457 | ~~2039879~~ | 9,418 | - | | | | | | - |
| | | 54 | | FN | i. Innovative approaches for scaling up sanitation services | Jun. 04 | 11,646 | 21,435 | DFID-Rural | TF022457 | 2040124 | 11,646 | 21,435 | 435 | 5,073 | 5,509 | - | - | 15,927 |
| | | 55 | | FN | j. Review of water conservation measures – situational analysis on knowledge and practices across India | dropped | 8,630 | - | DFID-Rural | TF022457 | ~~2040125~~ | 8,630 | - | | | | | | - |
| | | 56 | | S | k. Assessment of technology options for safe and hygienic sanitation | May-04 | 20,241 | 25,616 | AusAID | TF052137 | ~~2038784~~ | | | | | | | | - |
| | | | | | | | | | DFID-Rural | TF022457 | 2040126 | 20,241 | 25,616 | 1,740 | 25 | 1,765 | - | - | 23,851 |
| | | 57 | | FN | l. Three "Jalvaani" newsletters | Oct 03; Mar03; Jun04 | 28,516 | 17,631 | Danida | TF052065 | ~~2038785~~ | | | | | | | | - |
| | | | | | | | | | DFID-Rural | TF022457 | 2039875 | 28,516 | 17,631 | - | 7,730 | 7,730 | 1,765 | - | 8,137 |
| | | 58 | | S | m. Study on behavioral change and improved sanitation practices | Dec-05 | 74,776 | 103,850 | AusAID | TF052137 | 2038786 | 20,000 | 20,000 | 647 | 85 | 731 | - | | 19,269 |
| | | | | | | | | | DFID-Rural | TF022457 | 2040127 | 54,776 | 83,850 | 35,132 | 109,909 | 145,041 | 8,000 | | (69,191) |
| | | 132 | | S | n. Achieving the MDGs: Support of WB to GoI | Dec. 04 | - | 46,218 | DFID-Rural | TF022457 | 2041104 | | 46,218 | - | - | - | 10,887 | | 35,331 |
| 20/SA/IN: Sustainable Rural Sanitation- Apr-03 to Jun-05 (Year 1 of 2) | VS | 59 | KM | LE | a. 2 Study tours on approaches to scaling up total sanitation practices | Mar-04 | 98,681 | 34,168 | AusAID | TF052137 | ~~2038759~~ | | | | | | | | - |
| | | | | | | | | | DFID-Rural | TF022457 | 2040128 | 98,681 | 34,168 | 907 | 6,092 | 6,999 | 5,761 | - | 21,408 |
| | | 60 | | FN | b. Jal Manthan on lessons from the Maharashtra pilot | Apr-04 | 20,466 | 15,118 | AusAID | TF052137 | ~~2038760~~ | | | | | | | | - |
| | | | | | | | | | DFID-Rural | TF022457 | 2040129 | 20,466 | 15,118 | 910 | 969 | 1,880 | - | - | 13,239 |
| | | 61 | IS | IS | c. Sanitation module in the National M&E system | Jul-04 | 44,259 | 117,118 | DFID-Rural | TF022457 | 2038761 | 44,259 | 117,118 | - | 55,864 | 55,864 | - | 176 | 61,254 |
| | | | | | | | | | Danida | TF052065 | ~~2038762~~ | | | | | | | | - |
| | | 62 | | P | d. Piloting the state strategy on rural sanitation in Maharashtra (ongoing) | Jun 04. | 48,018 | 50,142 | DFID-Rural | TF022457 | 2038763 | 48,018 | 50,142 | 5,156 | 23,615 | 28,771 | 2,377 | 2,239 | 18,995 |
| | | | | | | | | | Danida | TF052065 | ~~2038764~~ | | | | | | | | - |
| | | 63 | | P | e. Pilot initiated in another State (AP) | Mar-04 | 23,762 | 624 | AusAID | TF052137 | ~~2038767~~ | | | | | | | | - |
| | | | | | | | | | DFID-Rural | TF022457 | 2039880 | 23,762 | 624 | - | 624 | 624 | - | - | (0) |
| | | 64 | | LE | f. 2 training programs on participatory approaches in sanitation projects | Aug. 04 | 29,477 | 12,700 | DFID-Rural | TF022457 | 2040130 | 29,477 | 12,700 | - | - | - | - | - | 12,700 |
| | | 65 | PS | - | g. Policy Note to inform national policy on sanitation | Jun-04 | 12,747 | 5,018 | DFID-Rural | TF022457 | 2040131 | 12,747 | 5,018 | - | - | - | - | - | 5,018 |
| | | 66 | | IS | h. 2 Advisory and review missions of National/State sanitation programs | Nov-03; May04 | 10,918 | 23,278 | Danida | TF052065 | ~~2038768~~ | | | | | | | | - |
| | | | | | | | | | DFID-Rural | TF022457 | 2039881 | 10,918 | 23,278 | 3,940 | 4,538 | 8,479 | - | 1,580 | 14,799 |
| | | 67 | | - | i. State level consultations and strategy development in 2 States | Dec-04 | 25,350 | 28,841 | DFID-Rural | TF022457 | 2039882 | **25,350** | **28,841** | **21,334** | **36,858** | **58,192** | - | **2,611** | **(29,351)** |

## PROJECT/PRODUCT FINANCING , BUDGET AND ACTUALS

new IO | alte e IO closed | .auste .d prio. to use | .iot ( .ed: IC closed

| PROJECT | PM | PIN | Category | Product | Product Description | Revised completion Date | Original Budget (July/Aug 03) | Revised MYR Budget (Jan03) | SOF | TF # | IO# | Pre-MYR Order allocation (as of Dec03) | MYR allocation (Jan03) | Staff Cost as of 30th April04 | Variable Costs as of 30th Apr 04 | Actual as of 30Apr2004 | FY04 Commitments as of 30 Apr 04 | Pending Repostings with RMA | Available Balance as of 30th Apr04 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 21/SA/IN: Informing the Reform of Water and Sewerage Services -Mar-03 to Jun-06 (Year 1 of 3) | SZ | 68 | KM | LE | a. Reform approaches for improving WSS services - Study Tours/Staff Exchanges | Jun-04 | 43,764 | 42,939 | SIDA | TF051599 | 2038727 | 43,764 | 42,939 | 870 | 4,575 | 5,445 | - | - | 37,494 |
| | | 69 | KM | S | b. Techno-economic strategies for improving water services in 2-3 towns & cities (including cost-effective reduction of unaccounted-for-water or non-revenue water, reduction of energy costs, and preparation of Geographical Information Systems (GIS) to bui | May-04 | 268,223 | 256,971 | SIDA | TF051599 | 2038728 | 268,223 | 256,971 | 68,647 | 274,608 | 343,255 | 55,037 | - | (141,320) |
| | | 70 | KM | S | c. Designing a management information system to benchmark and monitor performance of UWSS service providers - with the aim of institutionalizing the process of performance regulation | Dec-06 | 81,339 | 14,778 | SIDA | TF051599 | 2038729 | 81,339 | 14,778 | 7,277 | 889 | 8,166 | 4,836 | - | 1,776 |
| | | 71 | KM | S | d. Financial Recovery - Approaches to flat rate charging | Aug-04 | 61,753 | 60,268 | SIDA | TF051599 | 2038730 | 61,753 | 60,268 | 461 | 1,407 | 1,869 | 5,411 | - | 52,989 |
| | | 72 | KM | S | e. Prospects for PSP - (i) Identify barriers to PSP & (ii) Assess local PS capacity to design, build & operate modern WSS systems | dropped | 58,802 | 14,961 | SIDA | TF051599 | 2038731 | 58,802 | 14,961 | 11,856 | 3,204 | 15,059 | - | - | (99) |
| | | 73 | KM | S | f. Assessment of fiscal health of the WSS sector in three states (Cross cutting) | Jun-04 | 56,398 | 43,799 | SIDA | TF051599 | 2038732 | 56,398 | 43,799 | 2,330 | 4,800 | 7,130 | 3,000 | - | 33,669 |
| | | 74 | IS | IS | g. Assist 1-2 cities develop comprehensive city WSS sector reform and investment plans | Sep-04 | 292,792 | 191,908 | SIDA | TF051599 | 2038733 | 292,792 | 191,908 | 19,814 | 5,732 | 25,546 | 11,922 | - | 154,440 |
| | | 75 | IS | IS | h. Implementation support to Gantok-Shillong WSS projects | Contd. | 23,821 | 23,871 | AusAID | TF052137 | 2038734 | 23,821 | 23,871 | - | - | - | - | - | 23,871 |
| | | 76 | IS | P | i. Improved quality of water services: Implementation support for achieving 24 hour water supply in 2 towns/cities and assessing impact on consumer behaviour and welfare | Jun-06 | 75,071 | 201,186 | SIDA | TF051599 | 2038735 | 75,071 | 201,186 | 18,394 | 11,786 | 30,180 | 1,603 | - | 169,404 |
| | | 77 | PS | S | j. Support GoI effort to catalyze state/city level WSS sector reforms - Draft PSP Guidelines discussed at 4 dissemination workshops and finalized | May-04 | 93,780 | 111,647 | SIDA | TF051599 | 2038736 | 93,780 | 111,647 | 18,768 | 1,207 | 19,975 | - | - | 91,673 |
| | | 78 | PS | IS | k. Support 2 state governments to develop suitable frameworks for modernizing urban WSS services | Dec-04 | 178,253 | 90,468 | SIDA | TF051599 | 2038737 | 178,253 | 90,468 | 29,273 | 36,494 | 65,766 | 118,954 | - | (94,252) |
| | | 79 | PS | N | l. Support to 2-3 National institutions for capacity building in WSS sector, for eg. supporting Change Management Forum | Dec-04 | 66,242 | 76,583 | SIDA | TF051599 | 2038738 | 66,242 | 76,583 | 37,540 | 9,732 | 47,272 | - | - | 29,310 |
| | | 130 | PS | S | m. Performance benchmarking of water utilities - preparation of baseline data (*) | Jul-04 | 310,783 | 73,185 | Dutch | TF50533 | 2039829 | 300,000 | 68,185 | 1,933 | 21,459 | 23,393 | 16,975 | - | 27,818 |
| | | | | | | | | | SIDA | TF051599 | 2039810 | 10,783 | 5,000 | - | - | - | - | - | 5,000 |
| | | 131 | PS | LE | n. Initiate a public awareness program for UWS reform (*) | dropped | 100,000 | - | Dutch | TF50533 | 2039830 | 100,000 | - | | | | | | - |
| | | 133 | PS | LE | o. Strengthening Vertical Accountability Frameworks in public services, particularly UWSS | Oct-04 | | 51,282 | SIDA | TF051599 | 2041299 | | 51,282 | 13,729 | 21,385 | 35,114 | 3,239 | - | 12,929 |
| 22/SA/IN: Urban Sanitation Services to the Poor-May-03 to Jun-06 (Year 1 of 3) | SGM | 80 | KM | S | a. Assessment of various models and approaches for provision of urban sanitation in low-income communities | Apr-04 | 63,379 | 57,365 | SIDA | TF051599 | 2038739 | 13,379 | 7,365 | 4,774 | 16,990 | 21,764 | - | - | (14,400) |
| | | | | | | | | | Cities Allianc | TF023588 | TA-P082094 | 50,000 | 50,000 | | | | | | 50,000 |
| | | 81 | KM | LE | b. Think tank (Nagari) to discuss on approaches to urban sanitation and scaling up options and field note | Mar-04 | 38,127 | 25,280 | SIDA | TF051599 | 2038741 | 22,147 | 9,300 | 6,266 | 6,599 | 12,865 | 36,135 | - | (39,699) |
| | | | | | | | | | Cities Allianc | TF023588 | TA-P082094 | 15,980 | 15,980 | | | | | | 15,980 |
| | | 82 | KM | LE | c. Learning and knowledge sharing exchanges on community sanitation in low-income areas | Feb-04 | 77,810 | 53,620 | SIDA | TF051599 | 2038743 | 40,401 | 16,211 | 2,893 | 420 | 3,313 | - | - | 12,898 |
| | | | | | | | | | Cities Allianc | TF023588 | TA-P082094 | 37,409 | 37,409 | | | | | | 37,409 |
| | | 83 | IS | P | d. Demonstration to design and implement universal sanitation: one pilot initiated in one city-Nov03 | Contd. | 96,111 | 52,322 | SIDA | TF051599 | 2038745 | 1,403 | 1 | 468 | 622 | 1,090 | - | - | (1,089) |
| | | | | | | | | | Cities Allianc | TF023588 | TA-P082094 | 94,708 | 52,322 | | | | | | 52,322 |
| | | 84 | PS | S | e. Strategy paper for one city on provision of universal minimum sanitation to the poor, including accessing funds from centrally sponsored scheme | FY05 | 39,324 | 303 | SIDA | TF051599 | 2038747 | 34,324 | 1 | 234 | 303 | 537 | - | - | (536) |
| | | | | | | | | | Cities Allianc | TF023588 | TA-P082094 | 5,000 | 303 | | | | | | 303 |
| 10/SA/IN: Options for Slum Upgrading Jul-02 to Jun-06 (Year 2 of 4) | VS | 85 | KM | S | a.Wealth and wealth being impacts of slum upgrading (ongoing) | Mar-04 | 100,192 | 100,192 | SIDA | TF051599 | 2038749 | 100,192 | 100,192 | 7,979 | 50,836 | 58,815 | 26,393 | - | 14,984 |
| | | 86 | KM | LE | b. Workshop on lessons learnt on slum upgrading and scaling up | Oct03, Nov03 | 72,255 | - | SIDA | TF051599 | 2038750 | 72,255 | | | | | | | - |
| | | 87 | IS | IS | c. Assist one city to design appropriate institutional framework for city-wide slum upgrading and service delivery to the poor | dropped | 83,175 | - | SIDA | TF051599 | 2038751 | 83,175 | - | | | | | | - |
| | | 88 | PS | S | d. Policy support including analysis and documentation of various models for city wide scaling up of upgrading servcie to slums | dropped | 35,032 | 126 | SIDA | TF051599 | 2038752 | 35,032 | 126 | - | 126 | 126 | | | - |
| 11/SA/IN: Options for Municipal Solid Waste Management Reform - Jul-02 to Jun-06 (Year 2 of 4) | VS | 89 | KM | LE | a. Three training event/workshops on technology and institutional models for MSWM | May-04 | 87,335 | 55,322 | SIDA | TF051599 | 2038753 | 87,335 | 55,322 | 2,630 | 7,502 | 10,132 | - | - | 45,190 |
| | | 90 | KM | LE | b. Exposure visits on best practices in MSWM | dropped | 37,003 | - | SIDA | TF051599 | 2038754 | 37,003 | - | | | | | | - |
| | | 91 | IS | IS | c. Capacity support to 1-2 cities for design and implementation of MSWM reforms, including the design of safe disposal of MSWM | Dec-04 | 95,517 | 61,908 | SIDA | TF051599 | 2038755 | 95,517 | 61,908 | 4,431 | 5,166 | 9,597 | 40,309 | - | 12,002 |
| | | 92 | IS | IS | d. Assist GOI to revise guidelines on MSWM | dropped | 46,036 | - | SIDA | TF051599 | 2038756 | 46,036 | - | | | | | | - |
| | | 93 | PS | - | e. Policy Note for design and implementation of MSWM reform plans including for accessing CCF/other incentive funds | dropped | 35,104 | - | SIDA | TF051599 | 2038757 | 35,104 | - | | | | | | - |

**WSP-SA - FY04**

## PROJECT/PRODUCT FINANCING , BUDGET AND ACTUALS

new IO | alternate IO: closed | exhausted/ 2nd priority: not to use | dropped: IO closed

| PROJECT | PM | PIN | Category | Product | Product Description | Revised completion Date | Original Budget (July/Aug 03) | Revised MYR Budget (Jan03) | SOF | TF # | IO# | Pre-MYR Order allocation (as of Dec03) | MYR allocation (Jan03) | Staff Cost as of 30th April04 | Variable Costs as of 30th Apr 04 | Actual as of 30Apr2004 | FY04 Commitments as of 30 Apr 04 | Pending Repostings with RMA | Available Balance as of 30th Apr04 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 94 | | S | f. Identification of technical and institutional options of modern MSWM for a cluster of small towns in 1 state | Jan-04 | 28,018 | 15,522 | SIDA | TF051599 | 2038758 | 28,018 | 15,522 | - | - | - | - | - | 15,522 |
| 14/SA/PA: Operationalizing systems and procedures for improved service delivery in a decentralized environment- Jul-02 to Jun-05 (Year 2 of 3) | RRA | 95 | KM | FN | a. Field Note on wealth creation in the context of slum upgrading | Feb-04 | 32,249 | 6,945 | AusAID | TF052137 | 2038707 | 32,249 | 6,945 | 5,881 | 1,238 | 7,119 | - | - | (173) |
| | | 96 | KM | P | b. Scaling up of an ongoing pilot on community based rural sanitation (*) | Apr-04 | 3,000 | 3,000 | Danida | TF052065 | 2038708 | 3,000 | 3,000 | - | - | - | - | - | 3,000 |
| | | 97 | KM | LE | c. W&S roundtable on experiences in transition to mainstream best practices | Jul-03 | 33,424 | 21,390 | BB | BB | 2038709 | **16,712** | **21,390** | **5,241** | **16,150** | **21,390** | - | - | - |
| | | | | | | | | | Danida | TF052065 | 2041149 | 16,712 | | | | | | | - |
| | | 98 | KM | FN | d. Field Note on mgmt of W&S between village based & union council or multi-village based systems | Dec-03 | 15,245 | 14,245 | AusAID | TF052137 | 2038710 | 15,245 | 14,245 | - | - | - | - | - | 14,245 |
| | | 99 | IS | IS | e. Implementation support to AJK-CISP & Policy advice on design on decentralization framework of W&S services (*) | Cont. | | - | (*) | | | | | | | | | | - |
| | | 100 | IS | IS | f. Design support for NWFP & Balochistan CIP(*) | Cont. | | - | (*) | | | | | | | | | | - |
| | | 101 | PS | IS | g. Policy advice support to DFID RWSS Project on implementation of W&S service delivery in the context of devolution, and establishing linkages with a capacity building framework | Cont. | 8,593 | 6,311 | SDC-P | TF051523 | 2039108 | 8,593 | 6,311 | 2,935 | 184 | 3,119 | - | - | 3,192 |
| | | 102 | PS | LE | h. Sharing of experience and "best practices" among Local Governments on large city W&S utilities | Jan-04 | 29,431 | 38,622 | AusAID | TF052137 | 2038712 | 29,431 | 38,622 | 4,037 | 11,946 | 15,983 | 2,394 | - | 20,245 |
| | | 103 | PS | IS | i. Policy support on W&S or SWM to City Districts and TMAs (Utilities reforms including regional utilities, PPP, regulation, etc.) | Cont. | 27,013 | 14,785 | AusAID | TF052137 | 2038713 | 27,013 | 14,785 | 3,653 | 2,612 | 6,265 | - | - | 8,520 |
| | | 104 | PS | S | j. Policy and technical advice support to the W&S component of Devolution ESW | Oct-03 | 10,812 | 2,912 | AusAID | TF052137 | 2038714 | 10,812 | 2,912 | 2,912 | 123 | 3,035 | - | - | (123) |
| | | 105 | PS | FN | k. Decentralization: creating space for W&S sector reform | Dec-03 | 3,755 | 3,755 | SDC-P | TF051523 | 2038715 | 3,755 | 3,755 | - | 1,611 | 1,611 | - | - | 2,144 |
| 15/SA/PA: Capacity building of institutions (including local govts.) for improved W&S service delivery (Year 2 of 3) | FMK | 106 | KM | N | a. ESA roundtable(s): capacity building framework and programs in a decentralizing environment | Nov-03 | 12,500 | 1,730 | SDC-P | TF051523 | 2038716 | 12,500 | 1,730 | 461 | - | 461 | - | - | 1,268 |
| | | 107 | KM | P | b. Dera Ismail Khan pilot on strengthening of local governments for developing and implementing multi-year W&S plan within a framework of IDP for a TMA | Mar-04 | | | SDC-P | TF051523 | 2038717 | ~~28,800~~ | 38,000 | 18,51 | 13,053 | 31,566 | 23,965 | - | (17,531) |
| | | | | | | | | | AusAID | TF052137 | 2041105 | | 51,491 | - | - | - | - | - | 51,491 |
| | | | | | | | 83,656 | 99,491 | Danida | TF052065 | 2038718 | 54,856 | 10,000 | 8,753 | 4,449 | 13,203 | - | - | (3,203) |
| | | 108 | KM | N | c. W&S roundtable: challenges in scaling up HH sanitation and bringing about behavioral change | Feb-04 | 38,560 | 42,697 | AusAID | TF052137 | 2038719 | 38,560 | 42,697 | 1,269 | 2,144 | 3,413 | 4,176 | - | 35,108 |
| | | 109 | IS | IS | d. Advocating support to new SDC Capacity Building initiative and other ongoing initiatives | Cont. | 24,361 | 21,253 | SDC-P | TF051523 | 2038720 | 24,361 | 21,253 | 18,959 | 2,892 | 21,852 | - | - | (599) |
| | | 110 | PS | S | e. Preparation of detail manual on systems and procedures for operationalizing decentralized W&S service delivery | Dec-03 | 19,147 | 16,705 | Danida | TF052065 | 2038721 | 19,147 | 16,705 | 4,090 | 4,629 | 8,719 | 1,511 | - | 6,475 |
| | | 111 | PS | IS | f. Policy support to GoNWFP on Capacity Building framework for Local Governments | Cont. | 25,355 | 32,981 | SDC-P | TF051523 | 2038722 | 25,355 | 32,981 | 12,698 | 2,994 | 15,692 | - | - | 17,289 |
| 23/SA/SAR Communicationand dissemination- July2003 to June2006 (Year 1 of 3) | VM | 112 | KM | FN | a. Produce and disseminate quality knowledge and communications products, and receive feedback through ACCESS newsletter, Annual report, SA website, SA & Country Brochures, translations of selected products in regional languages. | Jun-04 | | | Danida | TF052065 | 2038723 | 14,156 | 24,376 | 3,149 | 6,059 | 9,208 | - | - | 15,168 |
| | | | | | | | 28,311 | 24,376 | Danida | TF052065 | ~~2041150~~ | 14,155 | | | | | | | - |
| | | 113 | KM | S | b. Develop SA communication strategy on the basis of assessment of effectiveness of WSP-SA's communication products and tools | Sep-04 | 18,591 | 18,591 | Danida | TF052065 | 2038724 | 18,591 | 18,591 | - | - | - | - | - | 18,591 |
| | | 114 | KM | N | c. Support to WSS initiatives eg. WWDay, IAWG, UN Events, exhibitions/conferences etc. | Jun-04 | 18,296 | 18,896 | Danida | TF052065 | 2038725 | 18,296 | 18,896 | 1,398 | 11,333 | 12,731 | - | - | 6,165 |
| | | 115 | KM | N | d. Software enhanced, management of the public in formation center and water help desk | dropped | | | Danida | TF052065 | ~~2038726~~ | 11,764 | - | | | | | | - |
| | | | | | | | 23,527 | - | Danida | TF052065 | ~~2041151~~ | 11,763 | | | | | | | - |
| | | 130 | | | Visual Imagery Project: to provide visual expression to the Program's mission | | - | 41,748 | Danida | TF052065 | 2041106 | 44,250 | 41,748 | - | - | - | - | - | 41,748 |
| 17/SA/SAR: Regional knowledge sharing and exchange - July2002 to June2006 (Year 2of 4) | JKA | 116 | KM | LE | a. Regional knowledge sharing and exchange on WSS services reform | Aug-03 | 44,250 | 59,898 | AusAID | TF052137 | 2039104 | 11,122 | 59,898 | 28,769 | 35,801 | 64,570 | 19,512 | - | (24,183) |
| | | 117 | KM | S | b. Study on economic analysis of rain water harvesting | dropped | 11,122 | - | SDC-R | TF051521 | ~~2038658~~ | 17,317 | - | | | | | | - |
| | | 118 | KM | FN | c. Documenting various approaches for dealing with water quality issues such as arsenic, fluoride etc | dropped | 17,317 | - | SDC-R | TF051521 | ~~2038659~~ | 49,997 | - | | | | | | - |
| | | 119 | PS | LE | d. Bring international experience on innovative ways of delivering WSS to the region - Jan2004 | Oct-04 | 49,997 | 30,508 | SDC-R | TF051521 | 2038660 | 49,320 | 30,508 | 11,308 | 3,700 | 15,008 | - | - | 15,500 |
| | | 120 | PS | | e. Exploring reform opportunities in existing WSP-SA countries of operation and seeking to expand WSP-SA operations in other SAR countries | Contd. | 49,320 | 35,659 | AusAID | TF052137 | 2038661 | 18,523 | 35,659 | 614 | 582 | 1,196 | 10,000 | - | 24,463 |
| | | 121 | PS | N | f. Exploring partnerships with other local infrastructure agencies to support direct investment in the WSS sector | Contd. | 18,523 | 18,817 | AusAID | TF05 | 662 | | **18,817** | 1,416 | - | 1,416 | - | - | **17,401** |

RJain: to

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**WSP-SA - FY04**

## PROJECT/PRODUCT FINANCING , BUDGET AND ACTUALS

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| PROJECT | PM | PIN | Category | Product | Product Description | Revised completion Date | Original Budget (July/Aug 03) | Revised MYR Budget (Jan03) | SOF | TF # | IO# | Pre-MYR Order allocation (as of Dec03) | MYR allocation (Jan03) | Staff Cost as of 30th April04 | Variable Costs as of 30th Apr 04 | Actual as of 30Apr2004 | FY04 Commitments as of 30 Apr 04 | Pending Repostings with RMA | Available Balance as of 30th Apr04 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 134 | | S | g. Regional Sanitation Study | May-04 | - | 62,790 | AusAID | TF0[illegible] | [illegible]300 | | 62,790 | 1,677 | 26,043 | 27,721 | 15,042 | - | 20,027 |
| 24/SA/SAR : Sector Coordination, reporting and monitoring - Jan2003 to June2006 (Year 1of 3) | JKA | 122 | - | N | a. Liaison with client governments to seek their approvals and buy-in for WSP activities | Contd. | 25,352 | 39,272 | Danida | TF052065 | 2039056 | 25,352 | 39,272 | 47,204 | 21,496 | 68,701 | - | - | (29,429) |
| | | 123 | | N | b. Dialogue with local donors for securing funds and keeping them informed of sector developments and reporting for trust funds | shifted | 36,706 | - | Danida | TF052065 | ~~2039057~~ | 18,353 | 1 | | | | | | 1 |
| | | | | | | | | | Danida | TF052065 | ~~2041152~~ | 18,353 | | | | | | | - |
| | | 124 | | N | c. Coordination with Bank operations and sector work | Contd. | 19,642 | 33,243 | Danida | [illegible] | [illegible]5 | 9,821 | 33,243 | 56,382 | 740 | 57,121 | - | - | (23,878) |
| | | | | | | | | | Danida | [illegible] | [illegible]3 | 9,821 | | | | | | | - |
| | | 125 | | | d. Development of annual business plan, mid year review, year end review and other monitoring reports; creation of new trust funds and preparation of Bank TF reports | shifted | 56,340 | - | Danida | [illegible] | [illegible]6 | 28,170 | 1 | | | | | | 1 |
| | | | | | | | | | Danida | TF052065 | ~~2041154~~ | 28,170 | | | | | | | - |
| 25/SA/SAR : Secretariat Sustaining Costs | JKA | 135 | - | | Liaison with Donors and Fund Raising (Donor Reports, Drafting of funding proposals, handholding) | Contd. | - | 50,695 | Danida | TF052065 | ~~2038891~~ / 2039057 | | 50,695 | 63,757 | 4,092 | 67,849 | - | | (17,154) |
| | | 136 | | | Personnel Management (OPE, recruitment, etc) | Contd. | - | 13,909 | Danida | TF052065 | 2038892 | | 13,909 | 9,200 | - | 9,200 | - | - | 4,709 |
| | | 137 | | | Workprogram Management (Business Plan, Mid-Year Review, Year end Review) | Contd. | - | 49,985 | Danida | TF052065 | ~~2038893~~/ 2038666 | | 49,985 | 72,130 | 9,128 | 81,258 | 878 | - | (32,151) |
| | | 138 | | | Financial Management (Budget Planning exercise, Mid-Year Review, Year End Review) | Contd. | - | 56,000 | Danida | TF052065 | 2038894 | | 56,000 | 33,273 | 6,455 | 39,729 | - | - | 16,271 |
| | | | | | | | | | | | | | | | | | | | - |
| | | | | | | | | | | | | | | | | | | | - |
| | | | | | TOTAL PROJECTS | | 5,265,822 | 4,726,763 | | | | 5,265,825 | 4,726,769 | 1,096,482 | 1,344,917 | 2,441,398 | 566,556 | 83,415 | 1,718,815 |
| Secreteriat | JKA | 126 | | | Management | Jun-03 | 102,996 | - | Danida | TF052065 | 2038823 | 102,996 | | 11,346.81 | 667.81 | 12,015 | | | (12,015) |
| Training | JKA | 127 | | | Training | Jun-03 | 214,363 | 198,827 | Danida | TF052065 | 2038824 | 135,792 | 198,827 | 36,338 | 76,601 | 112,939 | - | - | 85,888 |
| | | | | | | | | | Danida | TF052065 | ~~2041155~~ | 78,571 | | | | | | | - |
| Resource Management | JKA | 128 | | | ACS staff time | | | | | | 2028645 | | | | | | | | |
| | | 129 | | | RM staff time | | | | | | 2025135 | | | | | | | | |
| | | | | | NON PROJECTS | | 317,359 | 198,827 | | | | 317,359 | 198,827 | 47,685 | 77,269 | 124,953 | - | - | 73,873 |
| | | | | | TOTAL | | 5,583,181 | 4,925,590 | | | | 5,583,184 | 4,925,596 | 1,144,167 | 1,422,185 | 2,566,352 | 566,556 | 83,415 | 1,792,688 |

Comment (row 134): to be changed in WPA

Comment: RJain: IO mapping to be changed in WPA