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State Fiscal Reforms in India

Progress and Prospects

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CURRENCY EQUIVALENT

Currency Unit	=	Indian Rupee (RS)
US\$1	=	Rs 44.66

FISCAL YEAR

April 1 – March 31

ACRONYMS

AED	Additional Excise Duties	MAV	Multi-Axle Vehicle
APDRP	Accelerated Power Development & Reform Programme	MODVAT	Modified Value-added Tax
BE	Budget Estimates	MoU	Memorandum of Understanding
BoP	Balance of Payment	MTFP	Medium Term Fiscal Policy
CII	Confederation of Indian Industry	MTFRP	Medium Term Fiscal Reform Policy
CAG	Comptroller and Auditor General	NGO	Non-Government Organization
CENVAT	Central Excise Value-added Tax	NIPFP	National Institute of Public Finance and Policy
CST	Central Sales Tax	OECD	Organization for Economic Co-operation and Development
DC	Defined Contribution	OED	Operations Evaluation Department
GST	General Sales Tax	PE	Public Enterprises
EGS	Education Guarantee Scheme	PEM	Public Expenditure Management
EU	European Union	RBI	Reserve Bank of India
FAO	Food and Agriculture Organization	RD	Revenue Deficit
FC	Finance Commission	RE	Revised Estimates
FCI	Food Corporation of India	RR	Revenue Receipt
FRA	Fiscal Responsibility Act	RTS	Representative Tax System
FRF	Fiscal Reforms Facility	SAL	Structural Adjustment Loan
GDP	Gross Domestic Product	SEB	State Electricity Board
GoI	Government of India	SLPE	State Level Public Expenditure
GSDP	Gross State Domestic Product	STU	State Transport Undertaking
HCV	Heavy Commercial Vehicle	T & D	Transmission and Distribution
HIPC	Highly Indebted Poor Countries	URIF	Urban Reforms Incentive Fund
HIPS	Highly Indebted Poor States	VAT	Value-added Tax
IMF	International Monetary Fund	VRS	Voluntary Retirement Scheme
IMFL	Indian Made Foreign Liquor	WUA	Water Users Association
LCV	Light Commercial Vehicle		

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Definitions and Data

- Unless it is indicated to the contrary, the state-level data presented in this report is aggregated for all states.
- Much of the report focuses on 16 general category, major states, which make up 93% of the population of India.
- These 16 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, Chhattisgarh, Jharkhand, 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 source for tables and figures, unless mentioned in the text is state fiscal data published by the Reserve Bank of India (RBI) in its Annual Reports and annual *State Finances – A Study of Budgets*.
- For all states combined, and for aggregate data, we have actuals for 2002/03, revised estimates for 2003/04 and budget estimates for 2004/05. For individual states, and for most individual expenditure items, we have 2001/02 actuals, 2002/03 revised estimates and 2003/04 budget estimates. An exception is made for Uttar Pradesh where actuals are used for the year 2002/03, and revised estimates for 2003/04 (since, for this state, we had this more recent data, and the 2002/03 revised estimates and 2003/04 budget estimates are known to be inaccurate.) For Bihar, Jammu & Kashmir and Nagaland, on the other hand, even 2001/02 figures are revised estimates.
- The data for the three newly created states (created in 2000/01) of Jharkhand, Chhattisgarh and Uttaranchal have been aggregated with that of the states of Bihar, Madhya Pradesh and Uttar Pradesh respectively for comparisons over time in order to maintain consistency. However, data for Jharkhand is not available for 2000/01 and so is not included in the analysis for 2000/01 (except for debt). New-state debt as published by the RBI is included in the old-state debt for 2000/01 and 2001/02 (actuals) and 2002/03 (revised estimates).
- India's Gross Domestic Product (GDP) at *market prices* is used while referring to all state data. A GDP nominal growth rate of 13.2% has been assumed for 2003/04 and 11.7% for 2004/05.
- Gross State Domestic Product (GSDP) at *factor cost* is used for ratios involving the 16 major states, or individual states. This data is from CSO, unless otherwise indicated (see Box 1.7; and footnote 5 of Chapter 5 for estimates of growth rates in recent years).
- Revenue receipts and expenditure are expressed net of lottery expenditure; other indicators are as reported by the RBI.
- 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.

It is ironic that higher and higher deficits over time have not resulted in increasing the government's ability to spend where higher expenditure is required, for example, in the maintenance or expansion of public services. Most of the government expenditure is now committed to servicing past debt or meeting salary and other past commitments. We now have a high fiscal deficit without fiscal empowerment. A wholesale change in the government's fiscal policy and making it more responsive to changing requirements are now essential.

The process of liberalization and economic reforms, launched in 1991, and pursued actively in recent years, has yielded positive results, removed some of the structural rigidities, and created potential for higher growth. At the same time, it will be a mistake to be complacent about our recent successes. These gains can disappear very quickly unless a stronger programme is launched in the next few years to further improve our economic decision-making processes, remove scope for political discretion, reduce unproductive expenditure, and improve the quality of governance at all levels.

- Bimal Jalan, Former Governor of the Reserve Bank of India, Convocation Address
IIM-Ahmedabad, April 3, 2004.

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OVERVIEW

India, home to more than one billion people, has experienced rapid economic growth over the past two decades, averaging about 6% per year, as well as significant progress in improving its social indicators. Sustaining and accelerating this progress, as per the country's development targets, will require an improvement in government effectiveness, not only at the central but also at the state level, given the extensive responsibilities of India's state governments for infrastructure and human development. But fiscal deterioration, especially acute in the late nineties, has weakened the development effectiveness of state governments in India, by squeezing productive spending, and reducing its quality, especially in the poorer states.

In response, first a few and by now the majority of state governments have embarked on fiscal reforms, aimed not only at reducing deficits but also at more and better spending in priority areas, made possible by expenditure restructuring and enhanced revenue mobilization.

Fiscal reforms implemented thus far by states, while showing initial returns, are still a work-in-progress, and significant challenges remain. States continue to borrow in large part to finance current spending, and debt continues to rise, especially in the poorer states. If reforms were to falter, or be reversed, fiscal stress would intensify, the quality and quantity of productive expenditures would fall, and debt-levels would continue to rise. Clearly, more is needed to consolidate and continue the momentum of what is already underway. This stock-taking report aims both to share the lessons of state-level fiscal reforms to date, and to suggest what more can be done.

The fiscal reforms agenda: stabilization and fiscal empowerment

The agenda backed in this report is one that receives widespread support from both the central and state governments in India. Of course, states must reduce deficits to sustainable levels. But simply averting bankruptcy will not be enough. Striving for fiscal empowerment – that is, shifting to a fiscal stance that makes the states more effective agents of development – also requires expenditure restructuring, far-reaching expenditure management reforms, and comprehensive revenue reforms and mobilization.

While the ultimate responsibility for fiscal adjustment at the state level lies with India's states, state-fiscal reforms cannot be carried out by the states alone. The Government of India (GoI) has a critical role to play in not only promoting expenditure and tax reforms, but also in further strengthening the federal fiscal framework (the "rules of the game") so that states have both the resources to develop and the incentives to perform. This report considers implications of the state-level fiscal reform agenda for both levels of government – central and state. Our findings are summarized below.

Implications for state governments

Expenditure reforms must address the salary bill since this is such a large part of state government spending (30%). A moderate reform program, based only on real wage and hiring restraint (zero real wage growth and net hiring rather than pay cuts and retrenchment), can deliver significant fiscal savings: more than 2 percentage points of GDP over the coming decade. Pay restraint is justified by the large public-private wage differential (more than 100%, and growing); hiring restraint by the opportunities attrition offers to right-size government, and by the need to reverse the crowding out of non-salary inputs. A bolder program involving targeted retrenchment would release more fiscal space, but no state has yet been able to demonstrate the feasibility of such an approach.

Pensions are a rapidly-mounting liability, but they can be contained by both immediate (parametric) reforms and longer-term (structural) reforms. Better data on pensions, and a model for forecasting liabilities and simulating reforms are also needed.

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: attempts to reduce power subsidies to agriculture have failed repeatedly, despite the

widespread recognition that such subsidies bring few benefits. There are no easy or guaranteed solutions – if there were, they would surely have been tried – but to make further progress in power sector reforms, tackling the lack of commercial discipline in the sector has to be the top priority. Without promoting commercial discipline by distancing service providers from government through mechanisms such as corporatization and privatization, other reform remedies will not work.

Just as hiring and real wage restraint is a more feasible strategy in the Indian context for controlling salaries than wage cuts or downsizing, so too, in many cases, controlling or reducing rather than eliminating subsidies is a more realistic aim. This in turn suggests that state governments should focus more on improving subsidy targeting and management, with a focus on instilling commercial discipline into the subsidy delivery systems. This will have major efficiency gains that will themselves result in substantial subsidy savings.

Public enterprise reforms – in particular closure and sale – will have a limited immediate fiscal impact, but will stop the need for fiscal transfusions to keep loss-makers afloat, and prevent the build-up of future liabilities. Interest savings will largely follow from reduced borrowing, but states can also, with central government facilitation, take advantage of a low-interest rate regime by aggressive debt-restructuring.

The **quality of spending** must be improved. The various state-level success stories in this area need to be built upon and replicated, bearing in mind the following lessons learnt:

- Agency-specific reforms including an increased role for the private sector can improve service delivery.
- The broader enabling environment is the key to improving service delivery and the quality of spending. Reforms are required to promote effective oversight, encourage civil society to monitor government performance, promote transparency, and punish corruption.
- Improving the financial environment within which the state governments operate will be critical to improving the effectiveness of government spending.
- Capacity building reforms to address managerial and policy-making bottlenecks are likely to have enormous returns.

Spending in priority areas needs to be increased as the quality of spending is improved. Though the priority areas will vary from state to state, most states regard basic infrastructure, non-wage operation and maintenance, and social sector spending as vital. The states contribute more than half of India's general government capital spending, which is in the range of 3-4% of GDP, against the 5-6% level widely regarded as required to address India's infrastructure bottlenecks and support sustained rapid growth. Maintenance spending on state highways is at about 40% of what it should be. Social sector spending, overwhelmingly financed by the states, is also low relative to need.

State revenue performance has been sufficient to keep up with GDP growth, but there is both scope and need to boost revenues further through revenue policy and administrative reforms. The challenges facing India's states in this area are to broaden the tax base (rates are already high, in some cases too high), to simplify the tax system and to reduce corruption and evasion.

The sales tax is the most important state-level tax. A key revenue reform would be to replace the sales tax and other minor commercial levies by a consumption-type VAT on goods. Encouraging progress in sales-tax reform – which led to a large boost in revenue – has been stalled by an impasse over VAT introduction, though it is encouraging that a new date has been set for this of April 1, 2005. To prevent revenue loss, to preserve revenue autonomy, and to avoid disputes over compensation levels, states should be allowed to move to VAT on the basis of rates of their own choosing, subject only to a floor. It would be better if a large number of states move to VAT at one time, but Haryana's experience of "going it alone" with VAT introduction last year suggests that, if some states are unwilling to move forward, states could be allowed to individually shift to VAT, within an agreed framework. Even after introduction

of the VAT at the state level, India's tax system will remain very complex. The ultimate aim should be a unified center-state VAT. Eliminating tax on inter-state exports is also critical and should proceed with or without VAT.

Stamp duty collections could be improved by lowering the very high rates on property sales, and improving compliance by business re-engineering and computerization; excise on alcohol increased by better enforcement; and transport taxes by rate rationalization, and public-transport deregulation. There is also scope to increase non-tax revenues, including user charges and mineral royalties.

Tax administration reforms and improved inter-state coordination are probably even more important than tax policy reforms, and have been neglected to date. Of all the possible reforms, improved enforcement technology and procedures coupled with better staff incentives, management flexibility and effective anti-corruption institutions have the greatest potential to lead to a significant and sustained increase in state revenue.

Implications for the Central Government.

Central leadership will be crucial to the sub-national fiscal reform effort. On the expenditure side, another large wage increase could undo much of the fiscal adjustment achieved. On the tax side, central leadership is required to encourage the states to move forward with VAT introduction, and to phase out taxes on inter-state exports. The central government can help the states modernize their tax administrations – in particular, to co-ordinate better and share much more information across states as well as with GoI to improve compliance and combat evasion. Transfer to states of the right to tax services is a very positive initiative; quadrupling the constitutional limit on the professions tax (or replacing the nominal limit by a formula-based one) would lay the groundwork for the states to raise almost 1% of GDP through this much-neglected direct tax, which has the potential to serve as the state government counterpart to the central government income tax. A shift to a rules-based regime for royalty rates on major minerals would help the states in relation to this important source of non-tax revenue.

India's federal fiscal system shows many strengths, prime among them stability. However, the fiscal crisis has also brought to light a number of weaknesses, which undermine incentives for performance at the state level, and have especially hurt the poorer states. Over the nineties, tax devolution and grants to the states have declined in relation to GDP, while loans to the states have increased. These trends need to be reversed.

There is unanimous agreement on the need to harden the borrowing constraints at the state level. Progress has already been made in this direction through preventing the build-up of arrears by state power utilities to central suppliers. A major next step, one which GoI has already embarked on, would be to impose an aggregate or global borrowing cap on each state. Once aggregate caps are being effectively enforced, states can be given more flexibility to borrow, especially from the market, facing interest rates which reflect creditworthiness. In contrast, captive sources of borrowing need to be phased out. States which have difficulty accessing the market can be given a central government guarantee – at a price. GoI is better placed to act as a regulator of state borrowings, enforcing the aggregate cap, rather than as a creditor itself. Grants and loans should be delinked so that each can be given the very separate treatment it requires. While grants can be distributed on the basis of need and performance, loans need to be provided on the basis of creditworthiness.

The mechanism of financing the public sector "Plan" of each state generates incentives for states to engage in over-estimation of resources in the annual budget, and to seek additional borrowing to make up for the consequent revenue shortfall during the year, in the name of meeting annual plan targets. Adoption of a rules-based approach to capping state debt would have a disciplining impact on both the states and the center, by restricting bargaining by the states for additional loans, and discretion by the center in approving them.

Debt-restructuring on commercial principles is in line with allowing states more flexibility to manage their debt under an aggregate borrowing cap. Performance-based debt-relief will also help poor, highly-indebted states, but, however well-designed, debt relief carries the risk of undermining fiscal discipline. More grants for poorer states, and a strengthening of the already-existing Fiscal Reforms Facility (FRF) to award fiscal reformers may be better alternatives.

The center-state transfer regime is complex, and views on how it should be reformed divergent. Currently, the poorer states receive roughly the same level of transfers percapita as middle-income states. The trend toward greater progressivity in central government transfers needs to continue, but incentives for good performance also need to be strengthened. Various options can be considered, including introduction of a Representative Tax System, which is used in several federations, to provide a revenue floor for poor states, and the rationalization of the multitude of special-purpose grants now in operation.

In a fiscally-stressed system, a critical enabler for more revenue for poorer states is for GoI to increase its tax/GDP ratio. Poor states need more revenue, but the better-off states are also fiscally stressed, and so cannot afford a reduction in transfers. And several of GoI's fiscal indicators are worse than those of the states. The only way to square this circle is for GoI to aggressively pursue its goal of increasing its tax take, something that would benefit both the centre and the states, especially the poor ones.

Finally, the central government can back the states' own efforts to institutionalize fiscally responsible behavior. Five states have already passed fiscal responsibility acts which provide time-bound deficit reduction targets. GoI can encourage other states to follow suit, and can base its assessment of state reform efforts in terms of compliance with the state's own legally-mandated targets.

Prospects for development-oriented fiscal adjustment

Scenario analysis suggests that a sustained cross-sectoral program of state and central reforms could enable states to eliminate their revenue deficit by 2007/08, while increasing their capital spending as a percentage of GSDP, and maintaining their non-wage operations and maintenance (O&M) spending. If states choose to target less ambitious fiscal goals, such as debt stabilization or fiscal-deficit targeting, they can stabilize with increases in non-wage O&M. Poor states as well as the better-off states can achieve these targets, provided they undertake the same reforms, and provided GoI is able to increase its tax/GDP ratio, a development that will be critical for successful fiscal adjustment by the poor states.

In summary, a joint central-state government reform program aimed at both fiscal adjustment and at strengthening the development effectiveness of India's states is both desirable and feasible. Anything less will jeopardize India's prospects for sustained rapid growth and poverty reduction.

EXECUTIVE SUMMARY

I THE STATE-LEVEL FISCAL CRISIS OF THE LATE NINETIES: EVOLUTION AND IMPACT

1 Following two decades of relatively rapid economic growth, and a decade of liberalization, there is growing confidence within India, as well as internationally, about the state of the economy and India's development potential. A recent report by Goldman Sachs (2003) suggested that India could become one of the world's three largest economies in less than 30 years, and that income per capita in 2050 could be 35 times the current levels. There is widespread recognition that achieving such ambitious goals demands an improvement in government effectiveness, not only at the central but also at the state level, given the extensive responsibilities of India's state governments for infrastructure and human development.

2 Especially since the late nineties, when they experienced a sharp fiscal deterioration, India's states have faced a squeeze on developmental spending, a problem that is especially acute in the poorer ones. In response to fiscal stress, first a few and by now the majority of state governments have embarked on fiscal reforms, aimed not only at reducing deficits but also enabling more effective interventions in priority areas. This stock-taking report aims to share the lessons of state-level fiscal reforms to date, and to suggest what more can be done.

States in India play an increasingly important role in devising and implementing policies to stimulate economic growth and promote human development.

3 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 16 major "general category" states, the richest has a per capita income that is five times that of the poorest state. Infant mortality ranges from a low of 16 per 1000 in Kerala, at par with East-European countries, to 87 for Uttar Pradesh, more typical of sub-Saharan African nations.

4 Under the Indian constitution, state governments are assigned significant revenue-raising powers and a share in central revenues to support a wide range of responsibilities for service provision in sectors, such as agriculture, irrigation, roads, electricity, education, health, and social welfare. India's state governments are the main 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.

5 One of the striking features of India's states prior to the 1990s was the relative uniformity of policies across them. The environment within which states operate has undergone two phases of significant change: first, over the 1970s and 1980s, the growth of regional political parties; and second, after 1991, the central government's liberalization of the trade and investment regime. These developments have given the states a larger role in attracting private investment and determining their development paths.

The performance of India's states is increasingly divergent.

6 We focus in this report on India's 16 large "general category" states, home to 92% of the country's population. Of these 16 states, the 7 poorest have a per capita income of Rs 10,000 (in 1993/94 constant prices) or less: Bihar, Chhattisgarh, Jharkhand, Madhya Pradesh, Orissa, Rajasthan and Uttar Pradesh. These are classified throughout this report as the poor or low-income states. These states are home to over 40% of India's population, and nearly 50% of India's poor. The majority of these states

Table 1: Average real per capita GSDP growth rates of India's major states (%)

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

are also slower growing than the other states (Table 1). Following the liberalization of 1991, most of the middle-and high-income states were able to take greater advantage of the new conditions than the poorer states because of better governance, infrastructure and human resources. Private investment flowed largely into the better-off states. 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 1999/2000. Unless the poor states improve their performance, it will become increasingly difficult for India to meet its ambitious development goals.

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.

7 We use the term ‘crisis’ not to be alarmist, or to suggest macroeconomic instability, but to convey the sharp deterioration in state-level fiscal performance witnessed in the late nineties. Deficits rose in all the states and, consequently, the state-level debt-stock, which had been declining, started rising rapidly. Off-budget liabilities also grew quickly. There was a liquidity crunch, not in the economy, but in state governments, who started finding it much more difficult to pay bills, and even salaries in some cases. State governments themselves certainly perceived that they were facing a crisis. Many wrote White Papers, such as the Government of Tamil Nadu did in 2001 to apprise legislators and the public “of the extent and causes of the serious financial crisis confronting the state”. There is a close parallel with the balance of payments (BoP) 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, so the state-level fiscal crisis gave enormous impetus to fiscal adjustment at the state level.

8 While the large pay awards and a slowdown in revenue growth were the immediate causes for the sharp fiscal deterioration in the late nineties, the secular worsening in the revenue (current) balance of the state governments can be traced back to political and economic developments over the past two decades, including the growth of political instability at the state level, marked by short-lived governments with short-term objectives, and the growth of populist policies, including rapid growth in public employment and the introduction in many states of free power to farmers in the eighties. In the nineties, the revenue imbalance worsened further due to higher interest rates, and a decline in revenue relative to output.

State deficits and debt levels rose sharply in the late nineties.

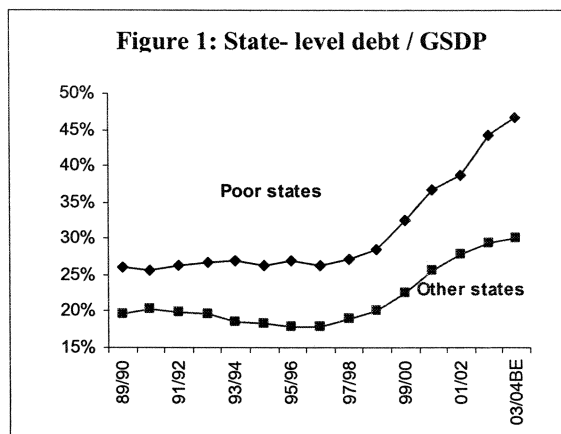
9 The sharp increase in expenditures in the latter half of the nineties alongside declining revenues could only be supported by much higher borrowing by state governments. The aggregate fiscal deficit of the states jumped from 2.9% of GDP in 1997/98 to 4.3% in 1998/99, and has hovered above 4% of GDP since. 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 ever since. Despite central government control over state government borrowings being enshrined in the constitution, state governments were able to increase their borrowing largely by drawing on sources over which GoI exercises no active control: “small savings”; central government-owned financial institutions; and state provident funds.

Off-budget liabilities also increased rapidly.

10 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 almost 1.4% of GDP by 1999/00, were met off budget, in large part through arrears to central utilities. The rise in the state-level deficits is even sharper once this is taken into account. State-government guarantees have also risen sharply since 1996, and their quality has declined because an increasing proportion of government guarantees back borrowing by government-owned special purpose vehicles whose debt servicing will revert entirely to the budget. Such liabilities are thus in the nature of actual rather than contingent state government liabilities.

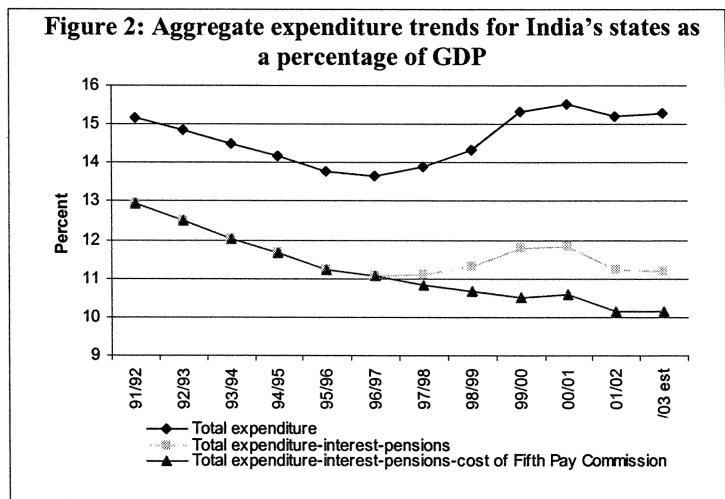
The poorer states saw the most severe fiscal deterioration.

11 The degree of fiscal deterioration has been worse in the poorer states (Figure 1). They are more reliant on central transfers and so have suffered more from the reduction in these transfers as also from their greater variability. On the expenditure side, with higher initial debt stocks and salary bills (relative to total spending), they suffered more from the shocks of the nineties: spending increased by twice as much in the poor states as it did in other states. Fiscal indicators deteriorated more in poorer than in richer states, and have reached alarming levels.



Although associated with an increase in public spending, the fiscal deterioration weakened the developmental and poverty impact of state governments, and also called into question India's overall fiscal sustainability.

12 Various studies have showed the importance of both the quantity and quality of state government expenditures for poverty reduction (see Box 1.3). Although spending increased rapidly in the late nineties, the impact on productive expenditure quantity and quality was largely negative. 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 (the cost of the Fifth Pay Commission), aggregate expenditure has continued the downward trend observed through the first half of the nineties (Figure 2). In most respects,



the overall fiscal stance weakened the developmental and poverty impact of state governments by, for example, slowing down real growth of expenditure in education, and halting real growth in health expenditure. The poorer states in particular suffered.

13 Quality of spending also worsened, as expenditures became much more salary-intensive, again especially in the poorer states. 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 state-level deficits.

The sharp fiscal deterioration gave rise to state-level fiscal adjustment effort.

14 The sharp deterioration in fiscal performance generated a sense that "business-as-usual" was not an option, and gave enormous momentum to reform efforts at the state level. Many states have now adopted medium-term fiscal reform programs, albeit to differing degrees of strength and credibility, aimed at returning deficits to sustainable levels, and more broadly to improve government efficiency and effectiveness. Five states have provided statutory backing to their fiscal adjustment plans through the passage of fiscal responsibility legislation, which mandates the achievement of prudent fiscal targets

within a fixed, typically five-year period. All states have adopted a variety of specific expenditure and revenue reform measures.

15 GoI also moved swiftly to help states undertake fiscal and sectoral reforms. The demand from several severely-stressed states for extraordinary central financing led to the birth of MoUs between GoI and many state governments in 1999/00. This practice developed further into the Fiscal Reforms Facility (FRF) starting in 2000/01, which links a portion of central grants to the fiscal performance of individual states. A number of other reform facilities have since sprung up, and external funding agencies have also tied a portion of fund transfers to the achievement of fiscal adjustment targets.

Recent years have shown some signs of improved fiscal performance.

16 The intensified revenue effort appears to be paying off. States' own-revenues have bounced back to pre-crisis levels as a percentage of GDP; central government transfers have also increased, though are yet to fully recover. Economic growth of 6%-plus, and recovery from the industrial recession of the late-nineties have also helped to boost revenues. The shock of the wage and pension increases associated with the Fifth Central Pay Commission is settling, and states are benefiting fiscally from tight hiring restraint. States are also starting to benefit from lower interest rates. Though the debt stock continues to rise, the increase is tapering off for many states. Liquidity has also improved, and states are less likely to turn to the Reserve Bank of India for overdrafts.

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 and continue to suffer from very high debt levels.

17 For all this progress, it appears that the combined fiscal deficit of the states has stayed between 4-5% of GDP, and the revenue deficit between 2-3%. 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. The debt and debt-service burdens of the states continue to increase, 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. Large volumes of off-budget debt servicing are now becoming due, adding to the fiscal difficulties in some states.

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

18 We consider a scenario in which the combined states' fiscal deficit stabilizes roughly at its current level due to revenue/GDP being flat, a resumption in salary bill growth, and a failure to reduce subsidies. In such a scenario, debt levels continue to increase, and the composition and quality of spending deteriorates further. Committed and largely unproductive spending (debt service, wages, pensions and subsidies) increases from 87% of total revenues in 2003/04 (10% of GDP) to 102% of total revenues in 2007/08 (12% of GDP). How rapidly debt would accumulate would depend on how permissive the central government is. But under a "no-reform" scenario, the choice would be between more borrowing and less non-salary productive spending, since less borrowing would simply result in a crowding out of capital expenditure and non-wage operation and maintenance expenditure.

There is a broad consensus on the fiscal challenges facing India's states.

19 A continuation and intensification of reforms is needed to achieve both fiscal stabilization and what is sometimes referred to in India as "fiscal empowerment:" a fiscal stance that makes the states more effective providers of core public services. To achieve these objectives states must free up resources for spending in priority areas, improve the quality of government expenditure, and carry out wide-ranging tax

reforms, while GoI needs to strengthen the framework for reform and development among states. We now consider each of these in turn.

II EXPENDITURE REFORMS

Salaries are such a large part of government spending that they must be at the core of any expenditure restructuring effort. Wage and hiring restraint can deliver significant fiscal savings: more than 2 percentage points of GDP over the coming decade.

20 Salaries make up 30% of state government spending. States can make significant savings in the salary bill in the coming years by ensuring that a policy package of real wage and hiring restraint is in place. A policy of public-sector wage restraint is justified by the fact that most public-sector employees in India are greatly overpaid relative to their private sector counterparts – a distortion that was exacerbated by the Fifth Central Pay Commission. India’s public-private wage differentials are in fact among the highest in the world, and now stand at over 100% averaging across all salary grades. Of course, this hides the fact that salaries of senior civil servants are low relative to the market, but this is the exception rather than the rule. About 40% of state government employees are teachers. In rural areas, where most of them live, they belong to the top decile of the income scale. It is difficult to justify further real wage increases for them given the pressing need to improve school infrastructure, and bring down pupil-teacher ratios in many states.

21 Critical for maintaining a policy of wage restraint will be avoidance of another pay commission leading to a significant increase in real wages, which in turn would sacrifice many of the hard-won fiscal 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 they are needed. Since the experience with 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.

22 Even today, however, states are not passive implementers of a central pay policy. Since the pay commission increases, several states have refused to pass on full cost-of-living allowances. And, contrary to popular belief, salaries across states are far from uniform. Salaries of teachers in some states are 25% less than in other states – as a result these states save up to 10% on their total salary bill. Some states have also saved large amounts by hiring new teachers on a contract-basis, and paying them much less than what 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 (Box 2.1). Many para-teachers have the same qualifications and responsibilities as regular teachers. Evaluations 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 wages. Governments should recognize that para-teachers might naturally graduate to become regular teachers, or that the distinction between the two might become blurred, but should also consider further extending the para-teacher principles to a wider range of new hires: lowering entry wages, and making employment contract-based, at least for an initial period of time.

23 While new hiring is needed in the civil service in priority areas, overall hiring restraint is justified (even though India’s civil service is small by international standards and therefore, likely to grow in the long term), because there are large areas of over-staffing as well as under-staffing. Even in areas where more hiring is required, there has been so much crowding out of non-salary by salary spending that it is unclear whether the marginal rupee should be spent on salaries, especially given low civil service productivity, as evidenced, for example, by high levels of absence of service delivery providers. Targeted retrenchment programs would be the best way to free up space for new hiring but have not been a success

in India so far (civil servants are reluctant to leave; and state governments reluctant to push them to do so). A second best option, through which much can be achieved, is attrition-based restructuring. Several states show attrition rates in excess of 3%, which, under a zero net hiring policy, allow significant scope for expansion of employment through new hiring in priority areas such as primary health and education.

24 Hiring restraint has been in evidence since the late nineties. Many states imposed hiring bans since the onset of the fiscal crisis, and since 1997, state employee strength shows an overall, marginal reduction of 0.7%. If a policy of zero net hiring can be sustained, and if salary increases can be restricted to the rate of inflation, then, under reasonable assumptions, the salary bill could fall by as much as 2 percentage points of GDP over the coming decade, freeing up valuable resources for deficit reduction and non-salary expenditures.

Pensions are a rapidly-mounting liability, but one which can be contained by parametric reforms and longer-term structural reforms.

25 Pensions are another major expenditure item (about 7.5% of total expenditure) and source of a fiscal vulnerability. The annual average increase in pension spending was 30% in nominal terms between 1995/96 and 2000/01, making pensions the fastest growing expenditure item in state budgets.

26 The most important parametric reform within the current pay-as-you-go system is to index pensions only to prices and not to real wages. This implies that any pay commission, if constituted, should confine itself to adjustments in the wages of civil servants currently employed. Some states have shown that additional savings can be found in the short term by reforms to the parameters governing retirement benefits. This can be done, for example, by reducing the amount of pension that can be commuted at retirement, by using less-biased discount rates for these commutations, by calculating the base pension not on the last month's salary but on the last year's or last 3 years', and by reducing the amount of accrued leave that can be encashed at retirement.

27 In the longer term, a switchover to the defined contribution scheme proposed by the center will also generate savings. 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 new employee under the existing un-funded defined benefit scheme. States have been invited to join the new scheme, and several are planning to. To maximize and bring forward the fiscal benefits of such a shift, it should be extended not only to new recruits, but to employees who have not yet been in service for long enough to qualify for the existing pension scheme (in many states, employees who have had less than 10 years of service).

Better employee and pensioner data systems would help prevent abuse and enable forecasting of liabilities.

28 Most states are completely in the dark as to the future course of their pension expenditures, since they have no data on the demographic profile of either pensioners or civil servants. Some states, notably Karnataka, Andhra Pradesh and Tamil Nadu, have developed pension projection models, and GoI is now encouraging other states to follow suit. Results from these models show that, with parametric reforms the growth in pensions can be contained as a percentage of GDP to its current levels.

29 There is evidence of abuse of both the employment and the pension system (for example, pensions being drawn after death). Better data on both current employees and pensioners would enable a crackdown on abuse, which could yield additional savings.

Subsidies have proved difficult to cut, largely for reasons of political economy. The power subsidy provides a good example of the difficulties involved in reforming subsidy regimes.

30 The largest explicit state subsidy is for the power sector. Large implicit subsidies are provided by state governments for the irrigation and higher education sectors, while other explicit subsidies are provided by many states for public transport, housing and food. These subsidies are often very inefficient:

they might lower prices, but they also lower quality. Because subsidies are expensive for government, quantity rationing is often introduced, with all the attendant inefficiencies and manifestations of adverse selection. A recent survey of farmers ranked satisfaction with money-lenders far in excess of satisfaction with irrigation and electricity services. Subsidies are also often regressive, as the poor are excluded from its benefits for instance, poor farmers typically cannot afford to invest in a pump and bore-well, to qualify for subsidized power supply. Often, in subsidized sectors, there is a break-down in commercial discipline both between the service-provider and the customer – so that even the subsidized user-charges are not paid – and between the government and the service-provider – so that, amidst counter-charges of operational inefficiency and political interference, the subsidy owed to the service-provider is often not paid.

31 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 on non-agricultural consumers, enforced collection of bills, cracked down on power theft, and ensured universal metering of domestic connections. These are key reforms and, though not all states have been able to pursue them, these are promising signs that the pattern of rising financial losses has been reversed. However, whether this reversal will be sustained remains to be seen. Attempts to reform the power sector in agriculture have repeatedly failed, and some states have recently reverted to free power for farmers (Box 2.3). Without success on this front, there can be no lasting solution to the problems of the power sector, since, at least in many states, agriculture will continue to threaten to absorb whatever savings are made in the non-agricultural segment of the sector.

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.

32 To take an extreme case, there is little point increasing tariffs if they are not paid. Privatization of distribution is an attractive option precisely because private 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 privatization is no panacea. Orissa privatized its distribution sector in 2000, but the benefits from this have been limited and delayed. 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, 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 ways in which distribution could be taken out of government hands, ranging from contracting out of metering and billing at the local level, to introduction of bulk-supply arrangements with groups of farmers or cooperatives, to part or full privatization of existing public-sector utilities. There is no guaranteed recipe for success and more experiments are needed to see what works.

33 With or without privatization, there are many other reforms required, 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. Given the difficult and complex reforms needed, a good and sustained communications strategy will be critical.

Similar recommendations and implementation difficulties apply also to most subsidies other than power.

34 One important lesson from the power sector is that subsidies are here to stay. This suggests more attention be given to subsidy management. Just as hiring and real wage restraint is a more feasible strategy for controlling salaries than retrenchment and wage cuts, so too, in many cases, controlling or reducing rather than eliminating subsidies will be a more viable strategy. There has been some success in reducing food subsidies, 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 targeting and management. The aim should be to improve commercial discipline in subsidy-receiving sectors by distancing the service-providers from the government, through mechanisms such as corporatization, privatisation and outsourcing. Service-providers must be empowered to take action against non-paying customers. Rules governing the allocation of subsidies should be clearly specified, and mechanisms put in place to ensure adherence by all parties, both government and service-providers. Such measures will have major efficiency gains which will themselves result in substantial subsidy savings.

Public enterprise reforms – closure and privatisation – will not provide large, immediate fiscal gains, but will prevent future need for budgetary support to keep loss-making public enterprises afloat.

35 Beyond the fiscal imperative, public enterprise 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. Andhra Pradesh, Karnataka, Kerala and West Bengal account for nearly half of all PEs, and all have been actively pursuing reforms in this area. There have been more cases of closure than privatisation. This is partly because it is less political, but also partly because states have few viable privatisation candidates. Many lessons have been learnt, including the importance of political commitment, since every PE will have a reason not to be included in the restructuring exercise. 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 coincidence that the two states that have made the most progress in PE reform – Orissa and Andhra Pradesh – have both benefited from extensive consultancy support in this area.

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

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

37 Some of the negotiated loans the states have taken allow for pre-payment. "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 allowing additional market borrowing – but on the basis that the states finance the debt-swaps by approaching the market on their own, and on the basis of a credit rating. In addition, some states could finance debt-swaps through reform-based adjustment loans available from external agencies.

The quality of spending must and can be improved.

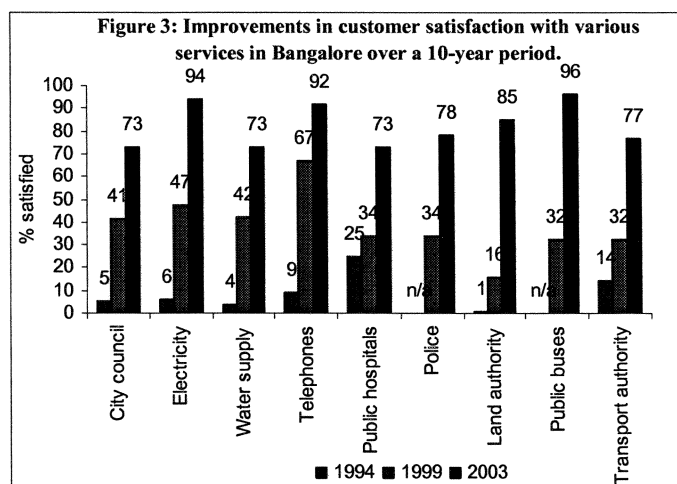
38 The strength of the case for increasing spending levels in health, education and infrastructure depends on the extent to which quality can be improved. Quality is undermined by various problems, including: skewed composition of spending towards salaries; a regressive distribution of benefits; low civil-service productivity; 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: see Annex 2 for some case studies. We highlight below some common themes and examples of ways in which expenditure efficiency can be improved across sectors.

Agency-specific reforms can improve service delivery.

39 Most government-financed 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. Several states have shown that the performance of state government agencies can be improved, at least in some contexts, and that tools such as computerization, training and citizens’ charters can deliver results, and provide employees with better incentives and resources to deliver. Similarly, experiences with privatization of solid waste management in some cities have been successful, as has deregulation of long-distance public transport. Even if governments are not ready to privatize entire services, individual service components can be outsourced: for example, several states now outsource the maintenance and cleaning of public hospitals. At the same time, success from private-sector participation or decentralization is not guaranteed. Much depends on the enabling environment.

The broader enabling environment is the key to improving service delivery and the quality of spending regardless of agency ownership.

40 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), providing effective oversight and information can be as or more important than the government’s own funding. The rapid improvement in Bangalore’s service delivery illustrates that accountability, and through it, actual service delivery can be significantly improved by encouraging civil society to actively monitor government performance and promises (Figure 3).



41 Some states have adopted legislation to make procurement processes more transparent and to provide a legislative basis for the public’s right to information. But passing legislation can only be one part of a strategy for transparency. Governments need to make much more information available on a regular basis, following agreed rules. They also need to overhaul institutional structures to reduce the scope for discretion and corruption. Service delivery improvements can also be facilitated by decreasing the discretionary nature and the volume of mass transfers of civil servants and in particular by leaving reform champions in place. Strong and independent anti-corruption commissions can play an important role, including by putting the spotlight of publicity on incidents of corruption, and thereby putting pressure on the government and its agencies to reform.

Improving the financial environment within which the state governments operate will be critical to improve the effectiveness of government spending.

42 A series of World Bank State Financial Accountability Assessments suggests that the most important improvement that states can put in place in the area of public expenditure management 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. The quality and efficiency of spending would also be

improved by enhancing departmental accountability and flexibility, including in the budgetary process. Departments should be given more flexibility to spend money as they best see fit to achieve agreed targets within an agreed envelope of resources. Lastly, India's accounting and audit arrangements are fine on paper, but neglected in practice: often, audit observations are not responded to and many local governments do not even produce accounts, let alone audits. A number of states have started to introduce far-reaching financial management reforms; much more learning across states is required to accelerate change in this area.

Limited managerial and policy-making capability greatly reduces expenditure effectiveness.

43 Many of the fiscal or, for that matter, sectoral reforms state governments are seeking to carry out, whether to improve procurement policy, or to implement fiscal responsibility legislation, simply will not be achievable without expanding analytical, policy-making and managerial capacity, through the injection of fresh staff or consultants.

India's states are currently stuck in a low-quality, low-quantity expenditure trap. Any fiscal 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.

44 Most states regard the broad areas of basic infrastructure, maintenance, and social sector spending as their priority. The states contribute more than half of India's general government capital spending, which is in the range of 3-4% of GDP, against the 5-6% level widely regarded as required to support sustained rapid growth; maintenance spending on state highways is at about 40% of what it should be. Spending on non-salary inputs in the social sector is abysmal, a fact which is reflected in poor facilities, and is one determinant of low-quality service provision. In the poorest states, even salary spending is too low: Bihar, for example, has teacher:pupil ratios of 1:90. However, while spending in all these areas is low relative to need, which particular spending areas should be increased, and by how much, will likely vary from state to state, depending on initial conditions, and specific priorities.

45 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. And human development expenditures are likely to become more progressive as they increase in size. 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 (Box 2.6).

III REVENUE REFORMS

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

46 Abstracting from cyclical factors – especially the down-turn in the late-nineties – state governments have done well to keep their own-revenue/GDP ratio almost constant, but this has not been enough to offset a decline in central transfers to the states.

47 India's tax rates are high. Stamp duties on property transactions are among the highest in the world, as are combined center and state indirect taxes. These high rates are combined with 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. Another is to simplify India's tax system and reduce corruption and evasion. India's indirect tax system is probably the most complex in the world, and surveys have shown state tax offices to be among the more corrupt government agencies in the country.

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. The case for a comprehensive sales tax reform, centered around VAT introduction, remains compelling.

48 Significant progress has been made in strengthening revenue performance since the late 1990s. The GoI-led joint decision of state governments to introduce floor rates and discontinue industrial tax incentives from January 2000 gave an enormous boost to sales tax growth in the next two years. The key reform going forward is to replace the sales tax and other minor commercial levies by a destination-based consumption-type VAT on goods. VAT will eliminate input taxes, and will allow for the value added in India's increasingly organized retail sector to be taxed. To maximize its benefits, it should replace as many existing state-level indirect taxes as possible, such as the turnover tax and entry tax. The introduction of VAT is also attractive as a vehicle for administrative reform of the sales tax regime, such as computerization. Nevertheless, even after introduction of the VAT at the state level, India's tax system will remain very complex and the ultimate aim should be a unified center-state VAT.

49 The introduction of VAT – now targeted for April 2005 – could be accomplished without compensation, if it is based on floor rather than uniform rates to avoid loss of revenue and preserve tax autonomy. It would be better if a large number of states introduced VAT at the same time, but if a consensus cannot be established to guide implementation, states should be encouraged – or at least allowed – to graduate individually into VAT, provided that they follow a common and agreed framework. Haryana has already introduced a VAT on its own, effective April 1, 2003 (see Annex 3.A).

Eliminating tax on inter-state exports is also critical and should proceed with or without VAT.

50 The Central Sales Tax (CST) on inter-state trade is levied on the basis of the origin of goods, and thus 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. It has also led to tax evasion via branch transfers and consignment sales, and is a serious impediment to the achievement of economic efficiency and a common market. While there is widespread agreement that the CST should be eliminated, it should also be noted that this will increase the incentive to use inter-state trade to evade the sales tax or VAT. A number of other options which would also avoid taxing inter-state trade, but not give rise to this incentive to evade could also be considered (Annex 3.C).

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

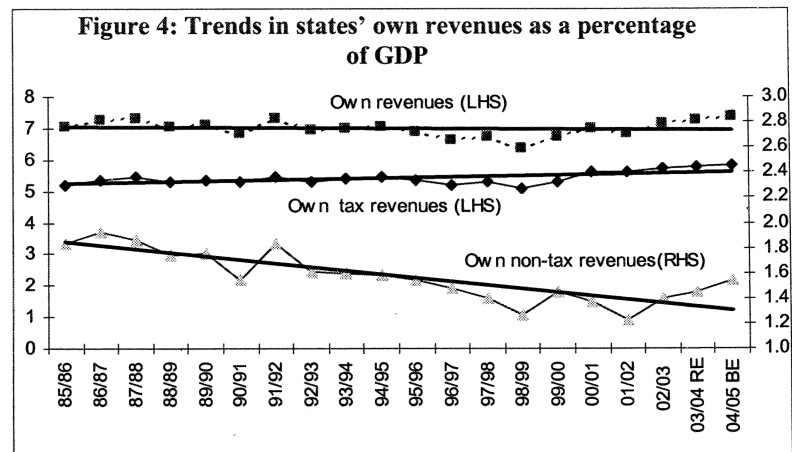
51 Until recently neither the central nor the state governments taxed services. The central government has now started to tax them, and a constitutional amendment has been made that provides a basis to authorize states to tax the fastest growing sector of the economy, and reduce India's high level of vertical imbalance. Over time, states should be allowed to integrate the taxation of services into their sales tax/VATs.

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

52 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, and needs to be raised. We estimate that potential collection from the professions tax is almost 10 times the current level (0.9% of GDP as against 0.1% currently collected) with ceiling revision and improved collection. There is also much scope to reduce evasion in state excise duties. The reform of stamp duties and registration fees requires a multi-pronged approach, including cutting stamp duties on property transactions from their current very high levels, as well as improving compliance and reducing corruption by a number of business re-engineering reforms (computerization, banning of stamp paper, etc). The transport tax can be reformed by raising the tax on private two-and four-wheelers relative to buses. Liberalizing the public transport sector would help to grow the revenue base, and reduce reliance on public-sector utilities with poor tax-payment records. Increases in the electricity tax on households are warranted to compensate for low tariffs.

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

53 In contrast to own tax revenues, there has been a marked deterioration in the performance of non-tax revenues (Figure 4), reflecting in part the low attention they have received from policy makers. Unlike tax revenues, where many problems are common across taxes and their administrations, different non-tax revenues sources have very distinct problems, though across-the-board institutional strengthening is also of importance.



54 Revenue from mineral royalties is already the fifth most important source of own revenue in some states (after the four main taxes discussed above). Measures that may further increase the importance of this source of revenue include: rule-based setting of royalty rates by the Center, 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.

55 The performance of user charges has been poor. A key reason for this is inadequate, and in many cases, deteriorating cost recovery. As already discussed, some user charges are politically very sensitive, but not all. More regular monitoring and frequent adjustments would help state governments. Of course, in areas where external benefits or merit good characteristics are unimportant, rather than attempting recovery of user charges, the government should ideally withdraw, and let market forces prevail.

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

56 Sustained improvement in the revenue performance of the states cannot be achieved without thorough institutional reforms in tax administration. The institutional structure of major revenue raising departments is currently weak. 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; tax 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 a 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 make accountability for performance difficult.

57 The report presents a large number of proposals to improve tax administration, some of them already tried in various states. These include the following:

- Strengthening departmental accountability through better articulation of departmental goals and more budgetary flexibility, and increasing individual accountability through the provision of incentives to staff.

- Attacking corruption by strengthening anti-corruption institutions and shifting to functional organizations for tax departments in place of current systems where a single officer is responsible for groups of taxpayers
- Promoting the user-friendliness of and citizen feedback to tax departments.
- Consolidating the structure of revenue departments so that fewer departments are tasked with tax responsibility, and co-ordinated better.
- Modernizing field enforcement and checkpoints: mobile squads and particularly border checkpoints, though an impediment to internal trade and a source of corruption, are required to combat evasion, and hence should be integrated, rationalized, and modernized.
- Involving the private sector in tax collection through well-structured public-private partnerships.
- Avoiding tax amnesties since they tend to reduce taxpayer compliance
- Improving dispute resolution institutions.
- Making greater use of common facilities across departments, including common taxpayer identification numbers.
- Developing tax policy and forecasting capacity, which is currently rudimentary or absent.
- Providing incentives to departments to maximize non-tax revenue collections.
- Strengthening revenue coordination across states and with the central government: the current lack of coordination has its greatest impact on revenue by limiting information available to different tax administrations to combat evasion. Some detailed proposals to strengthen revenue coordination, especially with the technology now available for information sharing, as well as some examples of how other countries handle this issue, are contained in Annex 4.

58 In summary, strengthening weak tax administration institutions will enable effective use of enforcement information, increased managerial control, and improved taxpayer services. Of all the proposed reforms, improved enforcement technology and procedures coupled with better staff incentives, management flexibility and effective anti-corruption institutions have the greatest potential to lead to a significant and sustained increase in state revenue.

IV STRENGTHENING THE FISCAL FEDERAL FRAMEWORK

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, which undermine incentives for performance, and hurt the poorer states even more than the others.

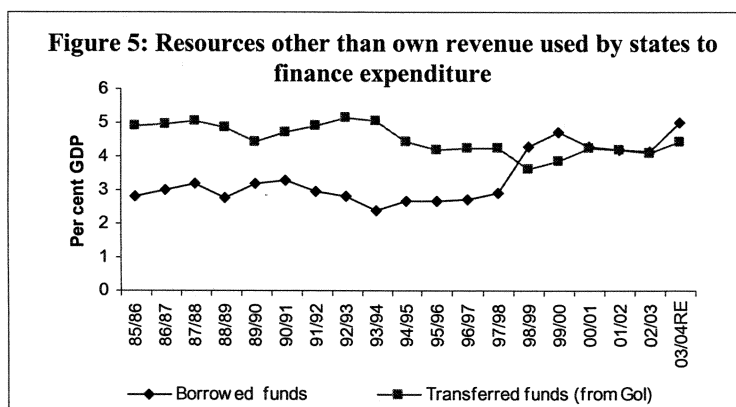
59 India's federal system stacks up well internationally by several criteria (see Box 4.1 for an international perspective). It is a very stable system, with a high degree of legitimacy provided by the constitutionally-mandated and respected Finance Commissions that are appointed every five years. It avoids some of the glaring defects which several other federations have suffered from, such as allowing state governments to "print money" or to regularly default on their debt, or borrow overseas.

60 For all its strengths, the fiscal crisis has put the weaknesses of India's fiscal federalism in stark relief. The regime of central revenue transfers to the states is not very progressive, and contains few incentives for good performance. Central transfers have been falling over time, with no offsetting increase being provided to the states through an increased tax base. India's borrowing regime is, on the one hand, too strict where more flexibility could be allowed (the detailed rules governing access to the various borrowing sources open to states could be relaxed) and, on the other hand, 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. The mechanism of plan financing also encourages states to assume an expansionary fiscal stance at all times. 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 different treatment they require.

Over the nineties, states have received fewer transfers and more loans; this trend needs to be reversed.

61 The nature of India's fiscal federal transfers changed greatly over the course of the nineties. States have suffered from a "scissors effect" whereby, since 1998/99, borrowed resources have come to supplement a state's own-revenues to an extent at least as great as central government tax sharing and grants (Figure 5). India's states are now the most leveraged sub-national governments in the world. Central transfers to the states need to recover their lost ground – it is



encouraging that they have started to do so -- 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.

States need to be given more flexibility to borrow, especially from the market, but under a centrally-imposed aggregate borrowing cap.

62 While state-level fiscal reforms are aimed at reducing the states' demand for debt financing, it is essential for the center to take steps to limit the supply. There is widespread agreement in India that the borrowing constraints facing Indian states need to be hardened. Making it much harder for states to run up arrears in the power sector has been a very positive development in this regard. From the perspective of fiscal sustainability, no reform is now more important than the center exercising greater control and restraint over the aggregate borrowings of states, as it is entitled to do so under the constitution. GoI has already started to define aggregate or global caps on borrowing for individual states. The report summarizes international experience with aggregate caps and suggests some options to accelerate and deepen the process already underway in India. For example, we suggest that it would be useful if the aggregate cap for each state could be aligned with the state's own reform objectives, for example, the targets mandated by the state's own fiscal responsibility legislation. We also consider mechanisms for enforcement of the aggregate caps.

63 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 regarding from whom they borrow. Rather than having five different borrowing sources, each with its own rules, as at present, states should have freedom to choose within the aggregate cap. They need to have greater access to credit markets, at an interest rate which reflects their creditworthiness, and access to captive sources, such as small savings, should be phased out. Tighter control over central government financial institutions lending to state governments would also help achieve this objective. States which have difficulty accessing the market can be given a central government guarantee – at a price. The GoI could act as a regulator of state borrowings, enforcing the global cap, rather than as a creditor itself.

64 Debt-restructuring along commercial principles is in line with allowing states more flexibility under an aggregate borrowing cap. Performance-based debt-relief will also help poor, highly-indebted states. At the same time, it needs to be kept in mind that however well designed the scheme, debt relief runs the risk of generating expectations of further relief in the future. The reforms discussed below – more grants for poorer states, and a strengthening of the already-existing Fiscal Reforms Facility to award fiscal reformers – may be better alternatives.

The federal transfer regime is complex, and views on how it should be reformed divergent. But a case can be made for making the system of central grants less discretionary and more progressive. Conditions on special-purpose grants can be used to strengthen incentives for performance, but the number of such grants needs to be cut.

65 The transfer regime is institutionally more complex than the borrowing regime. Any recommendations concerning it must face difficult issues concerning trade-offs between the need of poorer states for more funds, and doubts concerning their ability to effectively use them: a subject of much debate in India. There are three main types of central transfers to the states. The largest are the Finance Commission transfers they account for two-thirds of total transfers. The other two are special-purpose grants for particular schemes, and block grants that are packaged with loans to help finance state development plans. Finance Commission transfers are the most progressive of the three, but the current distribution of all transfers together is only mildly progressive. Even after central government transfers, poor states have no more than 70%, and in some cases less than 50% of the per capita revenue of the richest states. Not surprisingly, allocations across states in critical spending areas such as health and education show similarly large disparities. Though the formal transfer system is showing more progressivity over time, once one includes resources transferred through subsidized grain procurement practices (which principally benefit the rich states of Punjab and Haryana), the federal transfer system is virtually distributed across states on the basis of population, a modest outcome for such a complex system.

66 Given India's sharp and growing regional divergences, the mild progressivity of the current center-state transfer system does not seem optimal. While the other extreme of full equalization is neither feasible nor perhaps desirable, one suggestion is to introduce a "Representative Tax System" so that poor states are assured of at least average revenue, provided they put in average revenue-collection effort. This was first introduced by Canada and is now used by a number of other countries, including Russia (see Box 4.6). To strengthen incentives for performance, there is widespread agreement that the Finance Commission should stop relying on "gap filling" as a basis, albeit limited, for the distribution of resources. Many would also argue that conditions on special-purpose grants should be used to encourage good performance, but the number of such grants needs to be reduced and their "performance-conditional" distribution could also be made more progressive, i.e. poor states could be enabled to access more provided they meet the performance standards. Block grants, which fund state plans, could either be discontinued, or, if continued, should be delinked from loans. Whereas grants should be distributed on the basis of performance and need, loans should be on the basis of creditworthiness.

67 As already noted, one important response by the central government to the deterioration in state finances has been the creation of a number of reform incentive funds. The Fiscal Reform Facility (FRF) rewards fiscal adjustment, and there are now also funds to incentivize power and urban reforms, among others. These funds are controversial, and seen by some as too intrusive. However, they also counter-balance the incentives in the system for irresponsible behavior. While it is obvious that incentives against good performance should be removed where possible, some are likely to be permanent features, such as a high degree of vertical imbalance. Thus there is a good case for strengthening rather than eliminating these reform facilities, at least at the current juncture. Options to strengthen the FRF include (i) increasing transparency by, for example, making all transactions and agreements under such funds public; (ii) setting the adjustment path according to the initial conditions of each state, so that targets are not unrealistic for some and inadequate for others; (iii) defining indicators in terms of targets the states themselves use (e.g.

targets in their own fiscal responsibility legislation) and/or can control (such as the salary bill to own revenue ratio); (iv) strengthening reporting requirements, so as to restrict the scope for creative accounting practices, such as postponing payments and/or distorting expenditure through transfers to public accounts; and (v) using block plan grants, hitherto linked with loans, to enhance the total size of incentives under the FRF.

In a fiscally-stressed system, a critical enabler for more revenue for poorer states will be for GoI to increase its tax/GDP ratio.

68 Poor states need more revenue, but the better-off states are also fiscally stressed, so cannot afford a reduction in transfers relative to their output. And, in many ways GoI is more fiscally stressed than the states. The only way to square this circle is for GoI to aggressively pursue its goal of increasing its tax/GDP take. Recent statements indicate that GoI is aiming at an increase in the tax/GDP ratio of about 2 percentage points or more. As the scenarios in Chapter 5 show, this will be critical for the fiscal adjustment prospects of the poorer states.

69 It would also help states, particularly the better-off ones, if the central government were to expand the tax base of the states as per the reform suggestions made earlier in relation to the services and profession taxes.

Reforms to the federal fiscal framework will be gradual because of the complex institutional set-up; coordination among actors will help maximize the benefits from reforms.

70 Reforming India's fiscal federalism framework is a difficult task because different central actors (in particular, the Finance Commission, Planning Commission, Ministry of Finance) determine different components of the central fiscal framework. Coordination 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 transfers; for all states, tighter control over total borrowing, but more flexibility to manage borrowing within a global cap.

There are three institutional reforms which would help the functioning of fiscal federalism in India.

71 The first would be if the Finance Commission were 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. The challenge is not just to improve the timeliness and accuracy of existing data reporting (though improvements in this regard would help greatly: see Box 1.5) but also to provide credible reporting of state-fiscal performance against targets, such as in the Fiscal Reform Facility or in the states' own fiscal responsibility laws.

72 The third suggested institutional reform is an overhaul of the role of the Planning Commission. The one fiscal indicator state chief ministers are most familiar with is the size of the "State Plan", and the target they have most internalized is to maximize the plan size. Since this is often finalized after the annual budget is presented, and the borrowing agreed to for plan financing is taken as guaranteeing a floor rather than imposing a ceiling on a state's annual borrowing, the system generates incentives for states to: (a) engage in over-estimation of resources in the annual budget, in support of their lobbying with the Planning Commission for a larger plan size; and (b) seek additional borrowing to make up for any revenue shortfall during the year, in the name of meeting annual plan targets. 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 mainly because it strengthens the bias towards new investments at the expense of maintenance and generates incentives for fiscal imprudence. Multi-year plans, if needed, should encompass the entirety of resources, not just a segment artificially referred to as the "State Plan". The Planning Commission could then take on the more important role of an overall strategy, monitoring, evaluation and reporting agency with respect to both fiscal and development outcomes.

Finally, the central government can back the states' own reform efforts, especially by encouraging passage of and subsequent compliance with fiscal responsibility legislation at the state level

73 Now that fiscal responsibility legislation has been passed at the center, GOI can set an example to the states through implementation of its own fiscal adjustment in line with the legislated timetable. GoI 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. This would greatly strengthen the usefulness of such acts, experience with which in India, though only recent, is already mixed (Box 1.4). More generally, much more could be done by way of developing systems of reporting state-level performance, and sharing experiences of fiscal adjustment.

There are also implications for official funding agencies.

74 Funding agencies are participants in India's fiscal federal system, and in some ways are part of the problem. We briefly consider the implications of our analysis and recommendations for them:

- External funds to state governments pass through the central government as mixed loans/grants, forcing the central government to act as creditor to the states, and linking loans and grants, when these two needed to be treated separately. Should the central government decide to no longer act as a creditor to the states, as suggested here, either an exemption would need to be given for official agencies, or official loans could be transferred through an off-budget vehicle.
- Resources from funding agencies are concentrated in the middle- and high-income states. Whether this is a problem depends on whether one believes such funds should reward and promote good performance, or be allocated on the basis of need, but at a minimum external agencies need to be on the look-out for good performance and innovation in the poorer states.
- The rate at which external financing is passed on has been a matter of much debate. Whatever approach is used, it would be advisable to make it automatic and transparent. One approach would be to simply operate on an expected no-profit no-loss basis. Another would be to set an interest rate somewhat below that of the market to give states incentives to go for external financing even if it means reforms. Much depends on the extent to which the central government wishes to use such agencies as levers for state reforms.
- We have commented on the complexity of India's federal fiscal landscape, including on the issue of providing reform incentives. This would suggest closer coordination between donor and government initiatives. Already, access to external agency structural adjustment lending has been made conditional on satisfactory performance under the GoI FRF. It would be possible to go further by, for example, a merging of the donors' adjustment lending efforts with the FRF.

V PROSPECTS FOR FISCAL ADJUSTMENT AT THE STATE LEVEL

75 Six years on from the onset of the state-level fiscal crisis, many states have embarked on the reform path, but none has fully recovered yet. While all state governments now accept the necessity for reform, it is an open question as to whether states will start to 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 floodgates. Civil servants are looking for a real wage increase. Farmers are increasingly vocal in demanding government support and want more subsidized power. Industry complains of a heavy tax burden. We have already reported the simulations which show that, without continued reforms, the fiscal situation will deteriorate, despite good economic growth (para 18). We conclude with the opposite question. If the states continue with reforms, will they be able to stabilize and will this require sacrificing productive expenditures?

A multi-year cross-government state-level reform package developed in the report summarizes the key reforms suggested.

76 In our reform scenario, we assume that states will undertake a sustained, cross-sectoral reform effort centered around revenue mobilization and expenditure reprioritization. Critical revenue reforms would include the introduction of the VAT, the introduction of the taxation of services at the state level, the revamping of the professions tax, an increase in motor-vehicle tax rates on private vehicles, a crackdown on excise evasion, rationalization of stamp duties, and institutional reforms in tax administration and inter-state tax coordination. On the expenditure side, it is assumed that hiring and pay restraint would continue, parametric pension reforms would keep the pension bill in check, subsidies would be controlled, and non-salary capital and recurrent spending protected, and indeed expanded subjected to fiscal constraints. Thus we do not target aggregate expenditure, but rather the composition of expenditure, which we seek to improve as much as possible, subject to fiscal constraints. We also assume that the central government continues with comprehensive tax reforms to raise an additional 1.5-2% of GDP, which in turn will generate an additional 0.5% of GDP for transfers to the states.

The scenarios show that this reform package will allow the achievement of a zero revenue deficit by 2007/08, but will leave little room for a much-needed increase in productive spending.

77 Pursuing revenue deficit elimination by 2007/2008 will lead to a sharp fall in debt, but will also leave limited scope for an increase in productive expenditures. Some state governments may prefer a less tight fiscal adjustment path, which would leave greater room for increases in productive spending at the expense of a delayed achievement of the zero revenue deficit target. For instance, some state governments could first aim to achieve a debt stabilization target, or a 3-4% fiscal deficit target, which would leave more room for both capital spending and operations and maintenance spending to increase.

78 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.

There are risks, but the scenarios illustrate that the ambitious national agenda of development-oriented fiscal adjustment by state governments is feasible if based on a joint central-state government reform program.

79 This is not the first time that a fiscal stabilization scenario has been drawn up for the state governments. The Eleventh Finance Commission drew up a similar set of revenue-deficit-elimination scenarios about five years ago. Sadly, reality subsequently disappointed. What will happen in the next five years? Fiscal adjustment will not be easy. States are now burdened with higher levels of debt than they had five years ago, a solution to controlling power sector subsidies remains elusive, and there are clear signs of “reform fatigue,” based on perceptions, misplaced or otherwise, that reforms are costly in electoral terms. In other regards, however, the prospects for state-level fiscal reform look much more promising today than they did five years ago. Good economic growth, better revenue performance, and lower interest rates – not to mention the progress in fiscal adjustment made to date and the much more widespread recognition of the need for reform – are all conducive for further fiscal adjustment, as is the fact that the system today is not absorbing a fiscal shock, as it was five years when public sector wages were increased. Grasping these opportunities, and staying the reform course, will be critical to meeting one of India’s most important national challenges: the reversal of what has been described by a former Deputy Chairman of India’s Planning Commission as “the dwindling capacity of many state governments to intervene effectively for poverty eradication”¹.

¹ Pant (2003).

CHAPTER 1 THE STATE-LEVEL FISCAL CRISIS OF THE LATE NINETIES

I INTRODUCTION

1.1 India, home to one billion people, is a federation of 28 states and 7 union territories. The largest state 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 16 (general category) major states, the richest has a per capita income that is five times higher than that of the poorest state. Infant mortality ranges from a low of 16 per 1000 in Kerala, at par with East European countries to 87 for Uttar Pradesh, more typical of Sub-Saharan African nations. In an era of liberalization, each state's own policies and quality of governance is increasingly critical for its development. Especially since the second half of the nineties, when the slow secular deterioration in state-level fiscal performance was catalyzed into a crisis by the Fifth Central Pay Commission awards, fiscal policy has become a critical determinant of development performance and prospects at the state level.

1.2 The fiscal stress of the late nineties gave rise to an intense state-level reform effort. This report documents the many initiatives undertaken by the states to restore fiscal sustainability. It outlines successes, lessons learnt, and highlights further challenges, on both the expenditure side (Chapter 2) and the revenue side (Chapter 3). It also analyzes the incentive and resource framework within which the states operate (Chapter 4), and asks whether there is a feasible reform package that will help the states not only to emerge from the fiscal crisis, but to better meet the development challenges which confront them (Chapter 5).

1.3 This chapter begins with a brief discussion of the role and performance of India's state governments. It then analyzes, 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 expenditure, and 86% of public education expenditure. 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 (Ahluwalia, 2000).

The performance of India's states is increasingly divergent

1.6 This report focuses on the 16 major, "general category" states, home to 92% of India's population. Annex 1 deals briefly with the 11 "special category" states, the small state of Goa, the National Capital Territory of Delhi and 6 other union territories. Of the 16 major states, the 7 poorest have

a per capita income of Rs 10,000 (in 1993/94 constant prices) or less: Bihar, Chhattisgarh, Jharkhand, Madhya Pradesh, Orissa, Rajasthan and Uttar Pradesh. These are classified in this report as the poor or low-income states. They are home to over 40% of India's population, and nearly 50% of India's poor. These states are growing slower than the other states (Table 1.1). Following the liberalization policy 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. Several of the poorer states failed to improve their state-level policies to offset their initial disadvantage in attracting new investment. As a result, average per capita income in the poor states relative to the others has decreased from 71% in 1980/81 to 54% in 1999/00.

	1980/81-89/90	1990/91-99/00
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 pertaining to infrastructure, and investment climate (Table 1.2). They also have much worse social indicators than the other states. For example, average infant mortality is almost twice as high; in fact infant mortality in the best-performing poor state is higher than in the worst-performing medium or high-income states. Although human development indicators improved in all states, progress on these broader indicators was also in some cases faster in the fast-growing states, though in others, such as for literacy, 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 throughout 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.

	Population (millions.)	Per capita income ^b (Rs)	Composite performance index ^a	Investment climate index ^a	Infrastructure penetration index ^a	Financial sector index ^a	Literacy rate ^c	Female literacy rate ^d	Underweight children ^e	Infant mortality ^f
Medium / high income states	495	13,471	2.4	2.4	2.5	2.7	75.8	66.7	41.9	47.0
Andhra Pradesh	76	10,598	2.1	2.3	2.1	1.6	61.1	51.2	37.7	65.8
Gujarat	51	15,768	2.5	2.4	2.3	2.2	70.0	58.6	45.1	62.6
Haryana	21	15,304	2.3	2.5	2.0	1.7	68.6	56.3	34.6	56.8
Karnataka	53	12,614	2.4	2.7	2.4	2.0	67.0	57.5	43.9	51.5
Kerala	32	11,360	2.8	2.8	2.5	2.1	90.9	87.9	26.9	16.3
Maharashtra	96	17,107	2.8	2.3	2.8	3.5	77.3	67.5	49.6	43.7
Punjab	24	16,659	2.7	2.9	2.5	2.2	70.0	63.6	28.7	57.1
Tamil Nadu	62	13,756	2.7	3.1	2.6	2.4	73.5	64.6	36.7	48.2
West Bengal	80	10,226	1.7	1.2	2.0	2.0	69.2	60.2	48.7	48.7
Low income states	477	7,211	1.1	1.4	1.0	0.9	58.8	44.3	52.7	83.2
Bihar	83	4,846	0	0.4	-	0.3	47.5	33.6	54.4	72.9
Jharkhand	27	8,566	0.8	1.0	0.6	1.0	54.1	39.4	-	-
Madhya Pradesh	81	9,037	1.3	1.8	1.2	1.1	64.1	50.3	55.1	86.1
Chhattisgarh	21	8,188	1.1	1.9	1.1	0.6	65.2	52.4	-	-
Orissa	37	6,602	0.9	1.7	0.8	1.0	63.6	51.0	54.4	81.0
Rajasthan	56	9,716	1.5	1.6	1.3	1.2	61.0	44.3	50.6	80.4
Uttar Pradesh	172	7,149	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.

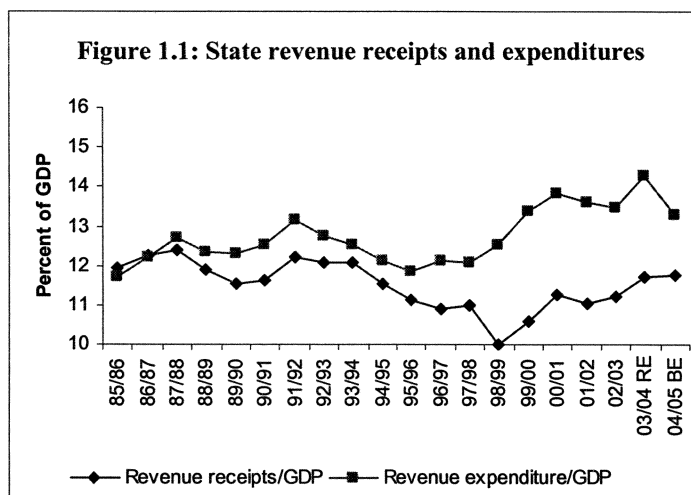
III GENESIS OF THE FISCAL CRISIS

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 in the economy, but in state governments, who started finding 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 the state-level fiscal crisis gave an enormous impetus to reforms at the state level.

1.9 The Fifth Central 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 freeze on hiring (Figure 1.7), 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 (Figure 1.9).

1.10 While the coincidence of large pay awards (Figure 1.7) and revenue shortfalls (Figure 1.5) were the immediate cause for the sharp fiscal deterioration, the secular worsening in the revenue (current) balance of the state governments can be traced as far back 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 during 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 during 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. (See also RBI, 2003a, Lahiri, 2000, and Rao, 2002.)



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 are four reasons why we call what happened a fiscal crisis.

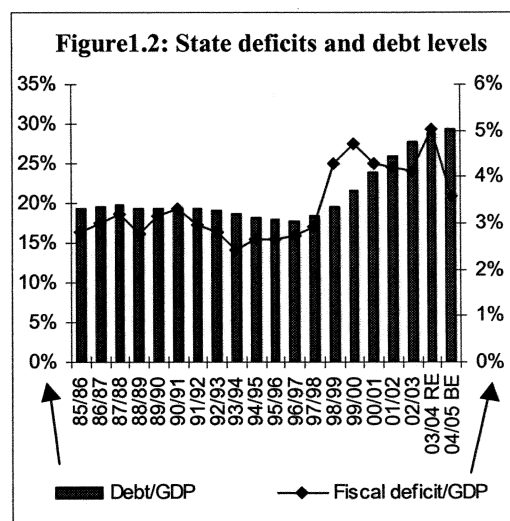
- First, the sharp deterioration in budgetary fiscal indicators, even sharper if off-budget liabilities are included.
- Second, the liquidity shock as state governments struggled to pay the salary increases they had agreed to. State governments, with limited borrowing sources, experienced severe liquidity 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 nineties 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 provident funds. Borrowing from these provident funds tripled in nominal terms between 1997/98 and 1999/00 (reaching 0.9% of GDP). State governments lacked the cash to pass on the promised salary increase to workers, and were only able to do so by promising to pay part of the increase (with interest) when the employees retired. There were also several reported cases in which GoI provided states with medium-term loans basically as a bail out. Finally, one can also note a sharp accumulation of arrears. Page 5 discusses the case of the power sector. Comprehensive data on arrears on salaries and other bills is not available. The Government of Tamil Nadu (2003) claimed 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.
- 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 p. 3 for an example.
- Fourth, the impact of the crisis. just as the BoP crisis of 1991 gave rise to a decade of central government reforms push, so the state-level fiscal crisis gave an enormous impetus to reforms at the state level.

It is true that certain cyclical factors operated to make 1998/99, a particularly bad fiscal year, with low revenue from both states’ own sources and from GoI. But the crisis can by no means be explained simply as a cyclical phenomenon. In 1998/99, state governments borrowed 68 % 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 fluctuated around this level since (Figure 1.2). At least half of the fiscal deficit is accounted for by the revenue deficit, implying that at least half of states’ borrowing is to finance current expenditure.

1.12 Despite Government of India control over state government borrowings being enshrined in the constitution, state governments were able to increase their borrowing in the late nineties largely by drawing on sources over which GoI exercises no active control, “small savings” loans, and provident funds.¹ States also



¹ In 1998/99, state government borrowings from “small savings” rose by 53%, and provident fund borrowing by 92%. See chapter 4 for more details.

used short-term debt and non-debt sources of deficit financing, such as cash balances and public account transactions discussed further in chapter 4.

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 ever 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 by 2001/02 almost one quarter of state revenues were pre-empted by interest payments.

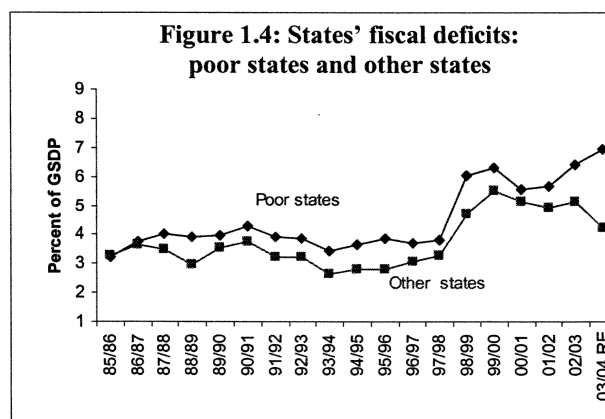
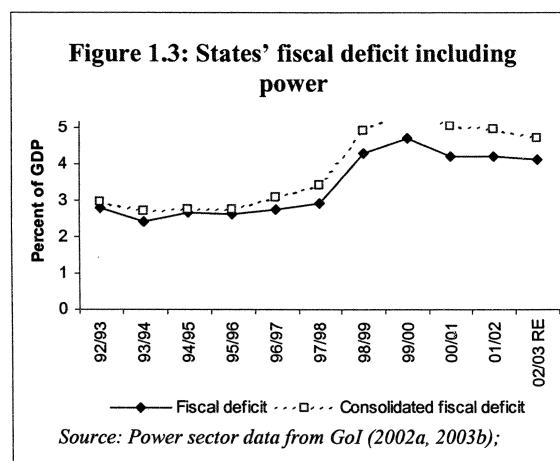
Off-budget liabilities also increased rapidly.

1.14 The most significant off-budget liability for state governments is in the power sector. During 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 almost 1.4% of GDP by 1999/00, were met off-budget, in large part through arrears to central utilities (Figure 2.1). If the full amount of the losses, or subsidy obligation, were included, the combined states' fiscal deficit increases even more sharply over the crisis period (Figure 1.3).

1.15 State-government guarantees have also risen sharply since 1996, and their quality has declined because an increasing proportion of government guarantees have gone to back borrowing by government-owned special purpose vehicles whose debt servicing will revert entirely to the budget. Such liabilities 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).

The poor states saw the most severe fiscal deterioration.

1.16 The poor states are more reliant on central transfers (in poor states central transfers account for just over a half of all revenues, versus about 30% in the other states), and so they have suffered more from the reduction in these transfers over the nineties (see Chapter 4). They have also experienced greater variability in revenues, including in their own revenues (Figure 1.5 and Table 1.3).² While there is yet no stabilization in the fiscal deficit of the poorer states, there are signs of a tentative improvement, or at least stabilization, in the deficits of the other major states (Figure 1.4).



² 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.

1.17 On the expenditure side, with higher initial debt stocks and salary bills (relative to total spending), poor states suffered more from the expenditure shocks of the nineties. Many of their fiscal indicators have reached alarming levels (Table 1.3). In 2001/02 the debt to GSDP ratio was 39% in the poor states, versus 28% in the other states. Interest payments as a share of own revenues are nearly twice as high in the former than in the latter, and are still increasing. In Bihar and Orissa, debt service preempts more than 90% of own revenues.

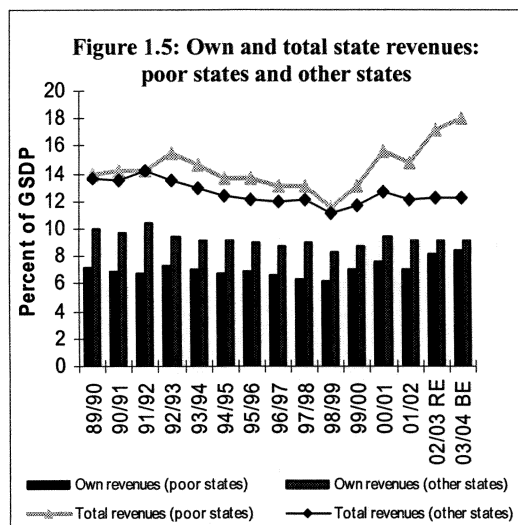
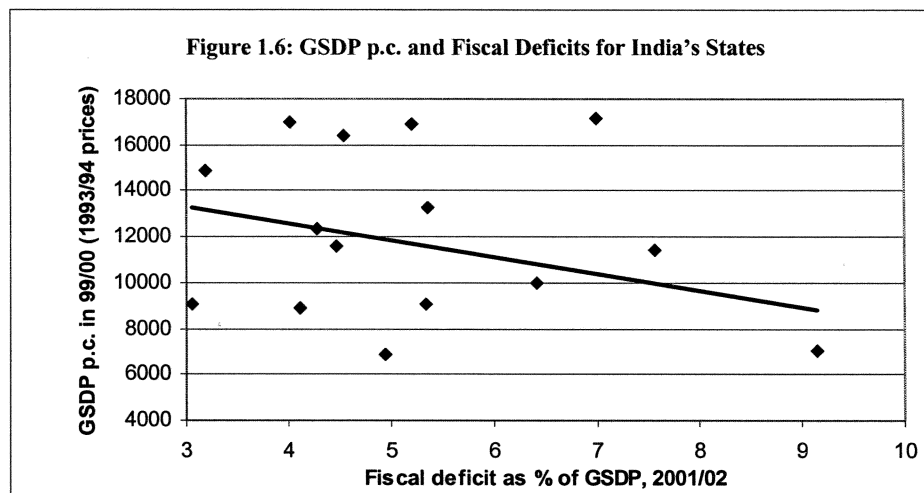


Table 1.3: Fiscal indicators: poor states and others (2001/0 % GSDP)

	Gol transfers	Own revenues	Fiscal deficit	Revenue deficit	Debt
Poor states	7.60	7.10	5.70	3.50	38.60
Other states	2.90	9.20	4.90	3.40	27.90

1.18 Of course, it is not simply the case that all poor states have worse fiscal indicators than all better-off states; far from it, in fact, as Figure 1.5, which plots deficits against income per capita, shows. Evidently, policies and performance vary greatly among better-off and poorer states alike.



Nevertheless, it is also clear that on average, poor states do show worse fiscal indicators than better-off ones: the trend line in Figure 1.5 is negative, even if the variation around that trend line is large.

1.19 The deterioration in state finances in the late nineties was coupled with a worsening of central government finances, though over time the states have become a larger part of India's combined central-state deficit (see Box 1.2, which compares central and state government performance). The combined effect was to significantly weaken India's overall macroeconomic performance, which was otherwise strong.

Box 1.2: States and Centre: relative fiscal performance and combined impact

This box puts state fiscal reforms into the context of India's general (combined central and state) fiscal performance.

India has run high fiscal deficits for the last two decades, with states making up an increasingly large part of the general government deficit. Whereas in the early nineties the states made about one-third of the general government deficit, today it is close to one-half. Unlike the central government, state governments saw no improvement in their fiscal performance in the first half of the nineties, and their deterioration in the second half has been sharper.

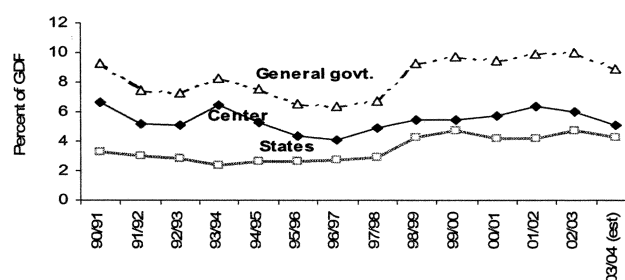
The central government still has worse fiscal indicators than the states. The debt/revenue ratio of the central government is almost three times that of the combined state governments, and worse than that of the most indebted of the 16 major states. But signs of fiscal adjustment at the central level are stronger. Though the central government still has a large revenue deficit, interest/GDP fell in 2002/03 and 2003/04 for GoI, and its debt/GDP ratio stabilized in 2003/04.

At about 9% of GDP, India's general government fiscal deficit is one of the largest in the world, and around the level reached in the crisis year of 1991. The risk of macro crisis in India is mitigated by the country's strong external position, high reserves, limited capital account convertibility, low inflation and the presence of a pliant financial system. However, it is widely agreed that fiscal reforms – to bring down the deficit and improve the composition of expenditure – are nevertheless needed because the current fiscal stance puts long-run development prospects in jeopardy (Pinto and Zahir, 2004).

Given fiscal stress at both the centre and states, reform at one level cannot be at the expense of another. The reduction in central transfers to the states (relative to GDP) can be interpreted as the centre shifting some of the burden of adjustment to the states (Singh and Srinivasan, 2004). But proposals to increase transfers to the states, and to provide states with debt relief, also have to be scrutinized for their impact on the central government. As we argue throughout the report, an increase in the central government tax/GDP ratio is critical to successful adjustment at both the central and state government levels.

Key fiscal indicators (2001/02)			
% GDP	GoI	States	General
Debt	64.9	25.8	80.3
Fiscal deficit	6.3	4.2	9.9
Revenue deficit	4.4	2.6	7.0
Primary deficit	1.6	1.5	3.8
Interest	4.7	2.7	6.2
Revenue	11.2	11.0	17.1
Expenditure	17.6	15.2	27.0
Salaries	1.5	4.3	5.7
Pension	0.7	1.2	1.9
Debt/Revenue	581.4	198.0	469.9

Source: Budget documents. Notes: GoI revenue defined on gross basis (i.e. pre-devolution), and expenditure adjusted to include devolutions. External debt is at current exchange rates. Fiscal deficit at the center excludes divestment revenues. Central salaries include posts and railways. State salaries are as per Figure 1.7.

General, GoI and state fiscal deficits**IV IMPACT OF THE FISCAL CRISIS**

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.

1.20 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 1.3).

Box 1.3. 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, 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 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. Maintenance spending on state highways is about 40% of what is considered optimal, despite very high returns, with a cost:benefit ratio estimated at 1:7 (World Bank, 2004b). Education and health funding are 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 surveyed 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 (poor) 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. Nine states spend two times or more on education per capita than them; Punjab and Maharashtra spend 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 (2004a) 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.

1.21 Although aggregate spending grew quickly in the late nineties, the impact on productive 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 (Figure 1.7). 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. Interest and pension payments continue to rise. One might well argue that any measure of productive spending should exclude interest and pension payments, since, though they are contractual obligations of governments, they are not in any sense developmental. Similarly, one could make a case for excluding the large real salary increase in the second half of the nineties (the cost of the Fifth Pay Commission). Aggregate expenditure, thus adjusted, as shown in Figure 1.8, has continued the downward trend observed through the first half of the nineties, thus confirming that the increased spending of the late nineties did little if anything to promote development.³

1.22 The fiscal crisis also weakened the developmental and poverty impact of state governments by slowing down real growth of education expenditure and halting real growth of health expenditure. At first glance, health and education spending appear to have done very well in the years from 1996/97 to 2002/03 with average real increases of 6.1% and 4.7%, 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 1.4% in the five years post 1996/97, and health of 0.7%, both significantly less than the pre-1996/97 rates of growth.

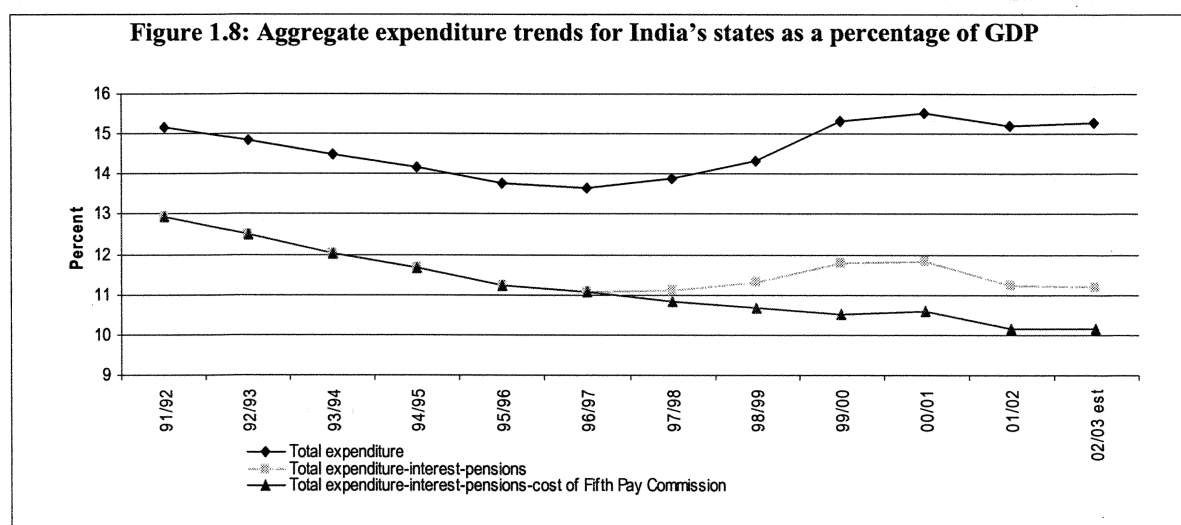
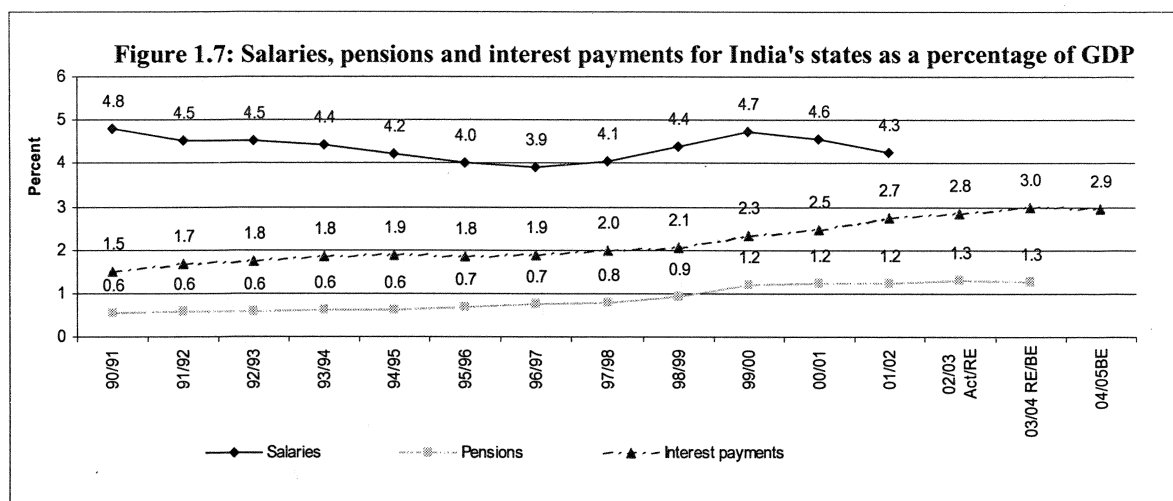
1.23 The only positive fiscal development in the post-1996/97 period is an increase in real growth in state-level capital expenditure. Capital investment by state governments was virtually flat in real terms in the first half of the nineties, but resumed growth in the second half of the nineties with an annual average real growth rate of 4.7%. 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, 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 1.9%, while average irrigation maintenance growth fell from 4.8% to –0.7%.

1.24 The poor states in particular suffered on this count. They show negative real spending growth post-crisis in irrigation maintenance, and almost no real growth in the critical sectors of education and health (Table 1.5).

³ The 2003/04 revised estimates and 2004/05 budget estimates show an increase in productive spending, but expenditure estimates are normally biased upwards, and it remains to be seen if they will be confirmed by actuals.

⁴ State capital expenditure as a ratio of GDP was 2.0%-2.1% of GDP for 1991/92 to 1995/96 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 Financing via “other Public Accounts” 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 Box 1.5 and para 4.9). 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.



Notes and source: Salary data has been provided by N.J Kurian. Salary data is for 14 major states and does not include the newly formed states. Other data is for all states. See the notes to Table 1.4 for estimation of the cost of the Fifth Pay Commission.

	Table 1.4 Average real growth rates of expenditures in some key sectors (16 major states)		
	1990/91- 1996/97	1996/97- 2002/03RE	
		Adjusting for price increases only	Adjusting for price and wage increases
Education	3.1%	6.1%	1.4%
Health	2.5%	4.7%	0.7%
Irrigation maintenance	4.8%	-0.7%	---
Roads maintenance	0.9%	1.9%	---
Capital expenditure	0.1%	4.7%	---

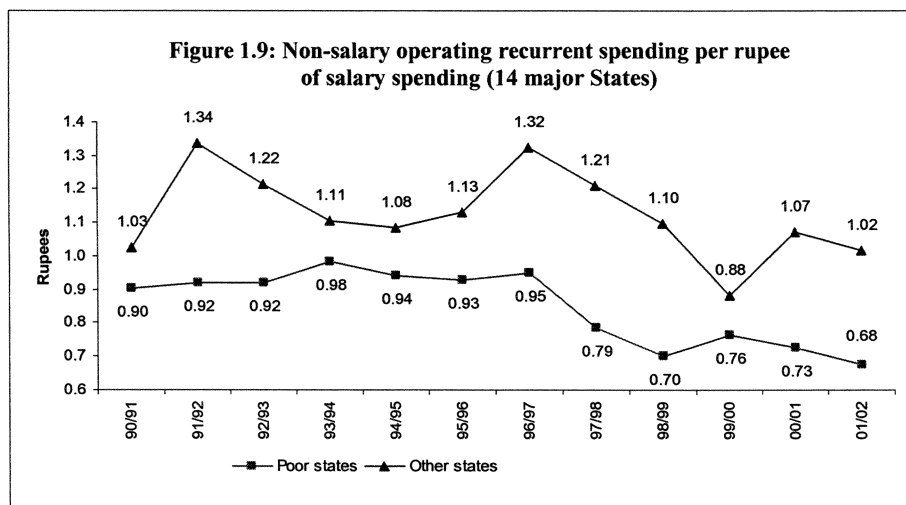
Notes: We assume that the ratio of salary to total current spending in education is 90% and in health 75%. We calculate wage inflation using data from Figure 1.7 on the assumption that there was no net hiring post 1996-97 and that any excess in the increase of the wage bill over the rate of inflation 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. For capital expenditure, the growth rates are calculated for the period 1996/97- 2001/02, since the r.e.s appear to be very unrealistic. Maharashtra is excluded from roads maintenance calculations, since the figures display lack of comparability over time.

Table 1.5: Average real growth rates of expenditures in some key sectors
(poor states and others)

	Poor states		Others	
	1990/91- 1996/97	1996/97- 2002/03RE	1990/91- 1996/97	1996/97- 2002/03RE
Education	2.8%	0.6%	3.3%	1.8%
Health	2.2%	0.3%	2.8%	0.9%
Irrigation maintenance	2.6%	-2.4%	6.0%	0.1%
Roads maintenance	1.5%	2.8%	0.4%	1.4%
Capital Expenditure	-3.8%	5.4%	2.8%	4.3%

Notes: See Table 1.4. For capital expenditure, the growth rates are calculated for the period 1996/97- 2001/02, as revised estimates appear unreliable. We adjust for price and wage increases.

1.25 The quality of spending also worsened, as expenditures became much more salary-intensive, particularly in the poorer states (Figure 1.9). 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 1.1, was marginally better than at the start of



the nineties, but for the poor states it had fallen precipitously to 0.7, 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 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). Local governments also suffered as state governments passed on their fiscal stress to them, and were unable to pass on to them their agreed entitlements (World Bank, 2003e).

V THE STATE-LEVEL REFORM EFFORT

1.26 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.

1.27 These reform programs go far 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, aims to improve the investment climate, and thus accelerate growth. For a recent survey, see World Bank (2003g, 2004c). An attempt to contextualize fiscal reforms in the broader paradigm shift underway at the state level is undertaken in Table 1.6.

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	Tighter limits 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)

1.28 A central part of the reform programs of most states is the adoption of medium-term fiscal plans or frameworks. 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 1.4 summarizes the emerging experience with fiscal responsibility legislation in India's states. As in other countries, the experience has been mixed (see Webb, 2004, on the Latin American experience with fiscal responsibility at the sub-national level). Agencies external to the state governments, such as GoI bodies and official funding agencies, can help increase the impact of fiscal responsibility legislation at the state level by judging state fiscal performance against the targets the states themselves have legislated.

Box 1.4: 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 fiscal policy rules to choose from: 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 suggests the former approach. This has been the one taken in India, where all acts passed at the central and state level do have, though to differing degrees 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 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 acts share some common features and a central committee has been established to draft a model state FRA. The acts 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 its 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 (2004) estimates that many of the FRA targets are overly ambitious. Performance as measured by processes is also varied. Tamil Nadu is the only state which has so far 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, but in all states the FRAs is referred to in documents such as the budget speech. Karnataka's Chief Minister has referred to its FRA as a "fiscal constitution for the state".

One lesson is that perhaps FRAs 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 these with legal backing. 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, Comptroller and Auditor General (CAG), creditors, multilaterals and bilaterals, and rating agencies, can play an active role by judging state performance against FRA targets.

In summary, 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.

1.29 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 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 revenue receipts through revision of tax rates, broadening the tax base, and improving tax compliance.

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

1.30 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

1.31 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 utilities 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

⁶ For a more detailed review and assessment of the FRF, see Annex 5, and also GoI (2003).

budget constraints faced by state governments. Arrears and part of the accrued interest owed by the states utilities 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.

1.32 Concern about the increasing interest burden of the states has prompted the introduction of a debt-swap scheme. 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. As of end-March 2004, an estimated Rs. 604 billion has been refinanced, about two-thirds of which has been financed through additional market borrowings (at interest rates below 6.5%) with the remainder financed through issues of special securities to the National Small Savings Fund (at a fixed 9.5% rate).

1.33 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 (RBI, 1999), which recommended placing limits to contain the further growth of guarantees. Statutory or administrative ceilings on guarantees have been put in place by a large number of states, though many of these are not binding. A few states have also set up guarantee redemption funds and have started charging guarantee fees.

1.34 The RBI has also assisted in advising state governments in areas such as cash, debt, and pension management and budgetary practices (Reddy, 2001 and RBI, 2001, 2002b, 2003b, 2003d, 2004). 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, has also been revised twice in recent years in consultation with the state governments (RBI 1998, 2004b).

VI CHALLENGES BEFORE THE STATES

Limitations in state budgetary data make it difficult to judge the extent of fiscal correction.

1.35 State budgetary data in India are subject to a number of limitations and distortions, summarized in Box 1.5. These, apart from making a strong case for improvements in the timeliness, quality and comprehensiveness of state fiscal data, make it difficult to judge the extent of fiscal correction in recent years.

⁷ See Rastogi (2003) for a more in-depth discussion.

Box 1.5. Factors which distort and complicate budget analysis at the state level in India

Off-budget borrowing. This is borrowing by state-owned enterprises, debt servicing for which fully reverts to the budget. In general, one knows neither the quantum of fresh borrowing, nor the amount of debt-servicing, which is treated above the line as capital expenditure. For example, 50% of Karnataka's reported budgetary capital expenditure in 2002/03 was actually debt-servicing of off-budget debt.

Power sector losses. Budgetary subsidy payments, which should, by law, cover power sector losses are, in fact, only about 40% of power sector losses. This practice artificially reduces budget deficits. Several states have decided to fully meet their power subsidy obligations on budget. This increases their budget deficit, but not their real (consolidated) deficit.

Arrears. In an accounting system that is largely cash based, states can reduce their deficits by deferring bill payments. As Box 1.1 illustrates, these can amount to as much as 2% of GSDP.

Debt reporting. It is unclear how the bonds issued through the RBI by the state governments amounting to 1.5% of GDP to take over their power utility dues to central undertakings (see para. 1.31) in 2003/04 are being accounted for. Different states appear to have adopted different practices.

Imputed interest. Another departure from cash accounting is the practice in many states of showing notional interest payments on irrigation assets from the Irrigation Department to the Finance Department. Interest payments can also include notional transfers to "Sinking Funds": in the case of UP, these have exaggerated the fiscal deficit by 0.7% of GSDP in recent years.

Lotteries. States are bound by law to include lottery payouts as expenditures, and receipts gross of these payouts are therefore shown as non-tax receipts.

(Non-Provident Fund) Public Accounts. Under the Indian accounting system, states can incur expenditure by transferring funds to a Public Account. For example, in Maharashtra revenues raised for the state's Employment Guarantee Scheme (EGS) are automatically routed to an EGS fund in the Public Accounts. The balance on this account is now above Rs 5,400 crore (Krishnaraj, Pandey, Kumar, 2004) which is about 2% of state GSDP, and five times what is annually spent on the EGS. The state is not in any position to actually expend this amount. The balance in the account is not backed by any actual financial resources: it has been "borrowed" for other expenditure needs. The sums involved in Public Accounts "borrowing" can be very large (about 10% of annual deficit financing, or 0.5% of GDP), but the liability created is very unclear. (The clear exceptions here are provident and insurance funds, also part of the Public Account, which represent clear, time-bound, interest-bearing obligations; these are excluded from the 0.5% figure.) RBI, when it measures a state's debt, excludes Public Accounts, except for the provident and insurance funds.

Timeliness. The RBI volume which provides cross-state budgetary figures is indispensable, but it provides individual state-level data (actuals) only with a long lag, normally two years.

Conclusion. In a few cases (such as lotteries), it is relatively easy to make adjustments. In most others it is not, or only with a great lag (power sector losses). In some cases, one is at a complete loss for hard data (arrears, off-budget borrowing, imputed interest). A project to improve the timeliness and quality of India's state-level fiscal data is clearly warranted; and some initiatives along these lines are already underway.

Nevertheless, there are signs of improved fiscal performance.

1.36 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. Central government transfers have also rebounded, though are yet to fully recover (Chapter 3). Economic growth of 6%-plus, and recovery from the industrial recession of the late-nineties, have also helped to boost revenues. The shock of the wage and pension increases associated with the Fifth Central 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 debt stock continues to rise, but there are signs that the rate of increase is tapering off (Figure 1.2). Indicators for some states suggest successful fiscal stabilization (see Box 1.6 for the examples of Haryana and

Karnataka). There are also early signs of a reduction in power sector losses (Figure 1.3). In 2002, outstanding guarantees of state governments fell to 7.2% of GDP, up from 6.8% of GDP in 2000, but below the 2001 peak of 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 improved management of cash flows, and reduced fiscal stress.

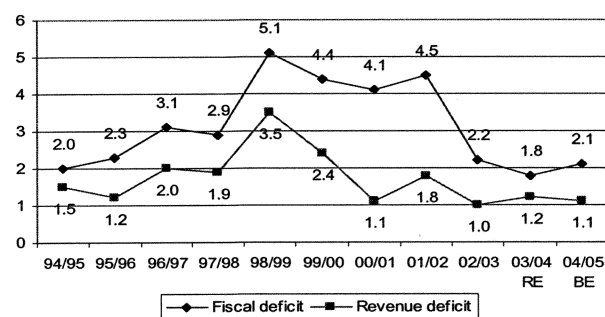
Box 1.6 Fiscal adjustment in Haryana and Karnataka

The north Indian state of Haryana, with a population of 21 million, and the south Indian state of Karnataka, with a population of 55 million, both experienced the fiscal deterioration which swept across the Indian states in the late nineties. Haryana was the first to recover. Its fiscal deficit, having risen to 5.1% in 1998/99 fell to 2% of GSDP in 2002/03. The state is now running a primary surplus (0.6% of GSDP in 2002/03), and the debt stabilized as a percentage of GSDP in 2002/03.

Karnataka, according to pre-actuals for 2003/04, has reduced its fiscal deficit to 3.2% of GSDP from a high of 5.4% in 2001/02, and, unlike Haryana, has virtually eliminated its revenue deficit.

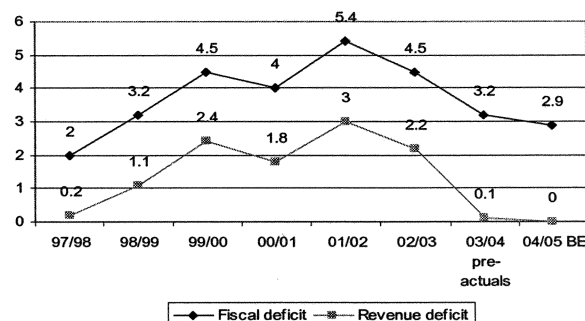
Budget numbers should never be taken at face value (Box 1.5), and Karnataka's good budgetary performance reflects in part a large and growing off-budget liability in the power sector. There is also always the possibility that the adjustment achieved to date will be reversed in coming years. Nevertheless, the fiscal adjustment achieved by these two states does hold out promise for all states.

Haryana fiscal and revenue deficits (% GSDP)



Source: Gov't of Haryana, *Budget at a Glance 2003/04*

Karnataka fiscal and revenue deficits (% GSDP)

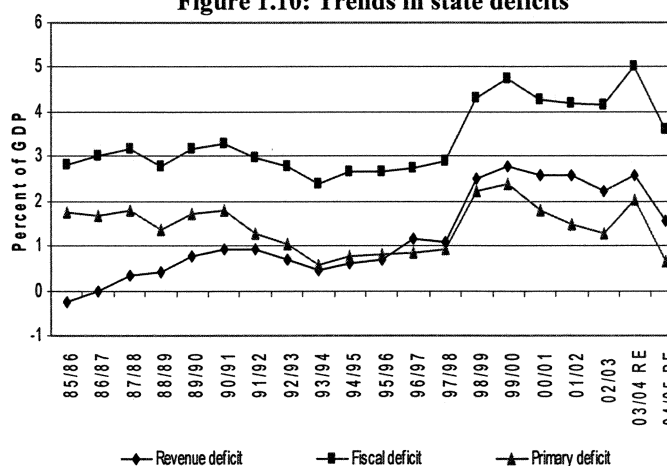


Source: Gov't of Karnataka, *Medium Term Fiscal Plans*

But concerns about the level and composition of the fiscal deficit remain. Poor states show fewer signs of recovery than richer states.

1.37 For all this, unambiguous evidence of deficit reduction is still elusive. Actuals up to 2002/03 do show a decline in the fiscal, revenue and especially primary deficit relative to 1999/00, but these nevertheless remain high: the fiscal deficit at above 4 per cent, the revenue deficit about 2 per cent of GDP (Figure 1.10). Revised estimates for 2003/04 suggest a fiscal deterioration: while actuals

Figure 1.10: Trends in state deficits



might show a better picture than revised estimates (which are often biased by inflated expenditure numbers), it is unlikely that they will show an improvement over 2002/03.⁸ Budget estimates for 2004/05 target a sharp improvement, but whether this will be achieved remains to be seen. Needless to say, India will fall far short of the national goal – embedded in the Fiscal Reforms Facility – of eliminating the revenue deficit at the state level by 2004/05.

1.38 The few states that have been able to show significant and sustained deficit reduction are outnumbered by the majority which have been unable to sustain an improvement. Several states 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 1.4). 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 (and in some cases increasing) revenue and fiscal deficits, as well as very high levels of salary-intensity in their expenditure. Furthermore, the gap between the fiscal deficits in poorer and richer states appears to be on the increase (Figure 1.4). 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 Rs. 440 billion of the market borrowings by state-level entities guaranteed between 1995 and 2002 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.

1.39 Whatever improvements have been made to date would be lost without further reforms. We simulate this by assuming that the combined states' fiscal deficit stabilizes at its current level of approximately 4.5% of GDP, that there are no improvements in revenue performance, and that salary spending takes off again. (Key assumptions are listed in Box 1.7.)

1.40 The results of this illustrative scenario are summarized in Table 1.7. The quality and quantity of productive expenditures would fall, and risks would steadily build with higher and less sustainable debt levels over the medium term. The states' fiscal finances could easily spiral out of control with 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 4.5%, debt levels would nevertheless increase from 28.5% of GDP currently to 33.1% by the end of the forecasting period. Debt service, wages, pensions and subsidies would increase from 87% of total revenues in 2003/04 (10% of GDP) to 102% of total revenues in 2007/08 (12% of GDP). Other recurrent spending (excluding subsidies, as well as pensions, interest and salaries) would fall from Rs 0.72 for every rupee of salary spending to Rs 0.33.

1.41 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. Most likely, as assumed in this scenario, the forced adjustment will be by a mixture of both more borrowing and less non-salary spending.

⁸ The deficits for 2003/04 are also pushed up by the securitization of power sector arrears discussed in para 1.31. This securitization will have no impact on the consolidated deficit.

Box 1.7: Key assumptions underlying the no-reform scenario

Revenues: No major reforms on the revenue side are implemented. Revenue/GSDP ratio remain constant.

Expenditure: Civil service hiring and pay restraint is relaxed over the coming years 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 points and the pension bill increases by 0.2 percentage points. No major reform to reduce the subsidy or pension bill, both of which gradually increase over time. (For estimation of the subsidy bill, see para. 5.8.) Capital spending is held constant, and other recurrent spending (proxy for non-wage O&M) is determined residually given revenue, borrowing (assumed fiscal deficit of 4.4% of GDP), and other expenditure.

Base year: Budget estimates for 2003/04 are used, with some adjustments where they look unrealistic, and extrapolations from earlier data for salaries. The debt stock is 28.5% of GDP and primary deficit is 1.3% of GDP. The revenue deficit is 2.1 percent of GDP. While we could have used 2003/04 revised estimates, as we have done elsewhere in the report (since they are likely to be more accurate than budget estimates), we stuck with budget estimates for this exercise. This is because the revised estimates show a significantly worse fiscal outcome for 2003/04 than the budget estimates (the revenue deficit, for example, is 25% higher), and we wanted to show that, even with optimistic starting numbers, without reform the fiscal position of the states will further deteriorate.

Macroeconomic assumptions: Real GDP growth of 8.1% is assumed for 2003/04. It is assumed that, going forward, 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%. 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%, up from 9% a decade ago. Going forward, nominal interest rates of 10.5% are estimated taking into account the impact of the debt-swap program.

Table 1.7: Fiscal indicators in the no-reform scenario (% of GDP)

	2003/04	2004/05	2005/06	2006/07	2007/08
Revenue receipts (RR)	11.6	11.6	11.6	11.6	11.6
Total spending	16.0	16.0	16.0	16.0	16.0
Interest	3.1	3.1	3.1	3.3	3.4
Wage bill	5.0	5.1	5.2	5.7	5.7
Pensions	1.3	1.3	1.4	1.6	1.6
Subsidies	0.8	0.8	0.9	1.0	1.0
Other recurrent spending	3.4	3.3	3.0	2.0	1.8
Capital spending	2.3	2.3	2.3	2.3	2.3
Fiscal deficit	4.4	4.4	4.4	4.4	4.4
Revenue deficit (RD)	2.1	2.1	2.1	2.1	2.1
Primary deficit	1.3	1.3	1.3	1.1	1.0
Debt stock	28.5	29.7	30.8	31.8	32.7
Interest/revenue	26.7	26.7	27.0	28.1	29.0
RD/RR	18.1	18.1	18.1	18.1	18.1

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.

1.42 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.

1.43 This positive agenda for fiscal reform is in line with international experience with fiscal adjustment. As Box 1.8 summarizes, the empirical literature finds that more successful fiscal adjustments rest at least part on restructuring of recurrent expenditures. Fiscal consolidations achieved through cutting selected recurrent expenditures (the wage and subsidy bills) tend to be more lasting 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. This suggests that, while increasing revenue is critical for India's states, the revenue side cannot bear the entire brunt of adjustment.

Box 1.8: International experience with fiscal adjustment

Over the past decade a number of studies of fiscal adjustment have been undertaken. This work is based largely on OECD experience, although one study has found the same results for low-income countries (Gupta *et al.*, 2002).

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 1970-95. 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 including cuts in government transfers and wages are more likely to succeed in reducing the primary structural balance. In addition, such adjustments not only last longer, but can also be expansionary; on the other hand adjustments relying more heavily on tax increases and cuts in public investment tend to be contractionary and unsustainable (von Hagen, Hallett and Strauch, 2001).

1.44 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.

1.45 This report tries to look at reforms that can work at the state-level in the Indian context. It goes without saying that for reforms to take off they have to be politically viable. Reforms face many political challenges in the vibrant democracy that characterizes India. These constraints, some of which are enumerated in Box 1.9, are taken as givens in the report. While it is difficult to draw generic lessons across states 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 does not. One aim of this report is to help share these lessons more broadly.

Box 1.9 The political economy of reforms for India's states

It goes without saying that reforms have to be politically viable. Any would-be reformer faces two options: to mould reforms to political realities, or to attempt to change what is politically viable. While this report takes the first approach, it is also of interest to ask what the key political constraints are to reform, and more generally to good performance. A survey of the literature suggests the following factors:

- There is clearly a lot of ignorance about reforms, as well as divides in opinion. Kumar (2004) reports that in 1998, only 26% of India's voters said that they had heard about economic reforms. This minority was fairly evenly divided in their opinions on reform.
- India, like many other countries, has powerful interest groups. Farmers represent 60% of the labour force. Rich farmers are politically powerful (Lal, 2003), and are able to resist efforts to increase power tariffs even though such an increase would affect only a minority of farmers.
- It has been argued that governments in India suffer from low credibility (Keefer and Khemani, 2004). If governments promise that they will both increase power tariffs and improve the quality of power supply, farmers tend only to believe the former. This makes it difficult to craft and pursue complex reform packages. Similarly, it has been argued, governments find it difficult to improve health and education services, they focus on promises they can deliver on: private transfers and subsidies
- Unlike in many other countries, where the incumbent often has the advantage over the challenger in an election (Kumar 2002), in India there appears to be a high level of anti-incumbency. If governments think they are going to lose whether or not they reform, they are unlikely to incur the pains of reforms, and will indulge in myopic, fiscally profligate behavior.
- Elections are not fought only on economic policy issues. Other issues (relating to caste, communalism and coalition politics, for example) are also very important.
- Lack of awareness and assertion of rights also leads to poor performance by governments. Dreze (2004b) attributes the relatively good quality of health and nutrition services in Tamil Nadu compared to other states to "the prominence of social development issues in Tamil Nadu politics" and the neglect of such issues in much of the rest of India.

This report does not attempt to address these constraints. Any such effort would clearly need to be built around strengthening the incentives to reform and perform through improved monitoring and information (Keefer and Khemani, 2004), better packaging, timing and communication of reforms (Lal, 2003, Desai, 2003), and social mobilization around development issues (Dreze, 2004b).

CHAPTER 2 EXPENDITURE REFORMS

I OVERVIEW AND INTRODUCTION

2.1 Using 2000/01 as a reference year, state governments taken together spend 16% of India's GDP, 68% of which is funded by current revenue, and the remaining 32% by borrowing. Ninety percent 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 state expenditure grew at a nominal average rate of 13% over the nineties, roughly in line with GDP growth. 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% in current prices) 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 seven low-income states relative to output (21% of GSDP vs. 20% of GSDP) 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 expenditure on salaries (41% of current expenditure) and interest payments (21%).

2.3 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 to improve the quality of spending. We consider these in turn in the sections which follow. Our focus in this chapter is on areas where expenditure can be saved rather than where it should be increased. This is not because we think there are no areas of under-funding. Clearly, the analysis of the previous chapter suggests the opposite. Most states regard the broad areas of basic infrastructure, maintenance, and social sector spending as their priority. As spelt out in Box 1.3, spending in all these areas is low, but which particular spending areas should be increased, and by how much, will likely to vary from state to state, depending on initial conditions, and specific priorities.¹ The areas where savings can be made have much more in common across states, and so are the focus of this chapter.

2.4 We examine in turn 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. Section V examines cross-cutting techniques by which the quality of government expenditure can be improved. The focus of this chapter is on non-interest expenditure. Interest savings are explored in Chapter 4 (debt restructuring) and Chapter 5 (deficit reduction).

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 problem, and one exacerbated by the Fifth Central Pay Commission. Survey data shows that the ratio of the average public to private sector wage is 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

¹ It is also important to bear in mind that sectors influence each other: thus the best way to spend money to improve health, for instance, may be on safe drinking water supply.

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 the 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, 1998).

2.6 The two trends observed in the 1990s of lower public sector hiring and a greater public-private wage differential have both reduced the quality of service delivery (by making it less likely that vacancies will be filled) 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 tension and demonstrations.² While we argue for both reducing the public-private wage differential and restraining public sector hiring, 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 another pay commission leading again to a significant across-the-board increase in real wages.

2.7 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 experience with 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 The Government of India'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 the full cost-of-living or dearness allowance. For example, Orissa's cost-of-living allowance is at 51% of basic salary, well below the GOI allowance of 59%, resulting in 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, basic salary

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
<i>All India</i>	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

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 (1996a); various state governments.

² A tracer study in Karnataka (World Bank, 2002c) 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).

for teachers (i.e. net of dearness and other allowances) 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. More rigorous and extensive evaluations are required, but those conducted to date (summarized in Box 2.1) suggest that the fiscal savings accruing from the employment of para-teachers 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 wages. Governments should recognize that para-teachers might naturally graduate to regular teachers, or the distinction between the two become blurred, and plan accordingly, but they should also consider further extending the para-teacher principles to a wider range of 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. (For a survey of international experience, see Mehrotra and Buckland, 1998.) 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 one km.

Leclerq (2003) and Gopalkrishnan and Sharma (1998) report that the EGS in Madhya Pradesh 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 examinations 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% for para-teachers vs. 20% 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% of the population which is low by international standards. The Organization for Economic Co-operation and Development (OECD) average is 7.7%, 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. Perversely, some reports suggest that constraints on hiring in tax departments are causing a disproportionate loss of revenue to state governments. There is also emerging evidence that India's civil service is grossly under-managed (see para 2.45).

2.10 It is one thing to say that over time India's government workforce will and should grow, but a different matter to say that the marginal rupee should now 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% in 1995/96 to 70% in 2001/02; the proportion of salaries in road maintenance for the same state and period has increased from 7% to 14%. Salary spending is also high in health: from 60% in some states, to over 90% in others. 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).³ In most states, salaries are by far the single largest element of expenditure on primary education: they account for about 90% 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).

New hiring will be needed, but should take place within a context of overall hiring restraint.

2.11 Clearly, pupil-teacher ratios of 90:1, such as are found in Bihar, are simply intolerable. However, 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% of filled positions in the Irrigation Department, 73% in the Public Works Department and 53% 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% 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% 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,

³ Kingdon and Muzzamil (2000, p.42) 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."

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, that is about 5% of the civil service. However, this was more of an early-retirement program: the majority of departees were aged around 55, and about 40-45% of them have been replaced by new, younger employees. Clearly, such a scheme will generate limited fiscal savings.

2.14 That states are only able to control civil service growth by attrition 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, it still 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 sometimes to fill even priority posts, with negative consequences for revenue collection and service delivery. While these deficiencies should be studied and acted on where possible, 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 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 25-33 percent of the civil service will leave in the next 10 years (World Bank, 2003b).⁴ Several other states also appear to show attrition rates in excess of 3%. In such a situation, a *zero net* hiring policy – i.e. one in which hirings in priority areas are compensated by not filling emerging vacancies in non-priority areas – will help control the salary bill while allowing significant scope for expansion in priority areas, such as health and education.⁵

Governments also fund the salaries of many employees of private (so-called 'aided') institutions. Reforms are needed here too.

2.15 Many states rely heavily on publicly-funded non-government institutions to deliver public services, especially for secondary education. This policy has served some states well, but even in these states there is a case for shifting funding away from salaries towards students (World Bank, 2003a). In some other states, however, the establishment of such institutions, without adequate safeguards relating to service delivery and educational outcomes, has become a significant source of fiscal drain. The Government of Orissa, for instance, has shown that a large number of secondary aided institutions have had not a single student pass the final examination. In such cases, a major rationalization is called for. More generally, states need to strengthen their efforts to plug loopholes in the system that are exploited for back-door entry, such as the hiring of temporary and casual employees.

⁴ This is based on a demographic census of existing staff. No net hiring is assumed up 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 rate in excess of 3%.

⁵ Zero net hiring is advocated here as a rule of thumb. For each state, the required analysis would need to be done to work out hiring requirements in more detail.

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

2.16 The above salary and pension reforms are admittedly partial, and “second-best” relative to a reform package focused on active downsizing, and wage de-compression (Das, 2001). Nevertheless, the reforms being pursued are proving quite effective in freeing up resources, and certainly deserve to be continued with. Andhra Pradesh (AP) provides an example of this. Its core civil service is estimated to have declined by an annual average of 2.4% in the past three years. As a percentage of GSDP, salaries are estimated to have fallen in AP from 5.5% in 2000/01 to 5.2% in 2001/02 and 5.0% in 2002/03, and are projected to continue to fall to 4.0% in 2006/07. Taking all states together since 1997, state employee strength shows an overall, marginal reduction of 0.7% (EPW, 2002). If the policy of zero 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% of GDP in 2001/02 to 3.4% after 5 years, and to 2.3% after 10 years.⁶

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 (DC) 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 The Government of India has announced the introduction of a 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, Tamil Nadu and Himachal Pradesh). While it is important that the scheme be designed prudently to protect the employee from investment risk, the proposed new scheme, though it will have transitional fiscal costs, nevertheless 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 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 (and thus fiscally neutral if existing staff are rational). Governments could also take advantage of the fact that no pension entitlement accrues to an employee 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 most highly-publicized being Tamil Nadu whose employees went on strike over the issue. Attempted and possible reforms include the following (see also RBI, 2003b):

- *Use of longer averaging periods for the calculation of benefits:* Some state governments use the last month's or even the last day's basic pay to determine pension levels. Others have followed

⁶ We assume 10 percent nominal growth in GDP, and 4 percent inflation.

GoI's lead in using the average of last 10 months 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, 2003b), 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% in some states, and as high as 40% 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% 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, 2003b).

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 in probability 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, Andhra Pradesh, 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 numbers

Tamil Nadu recently undertook a major data collection exercise looking into all types of pensioners. This showed the large number of employees outside the regular civil service (almost 1/3 of the total) who would be eligible for pensions to be paid by the state government.

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

Source: World Bank (2004f)

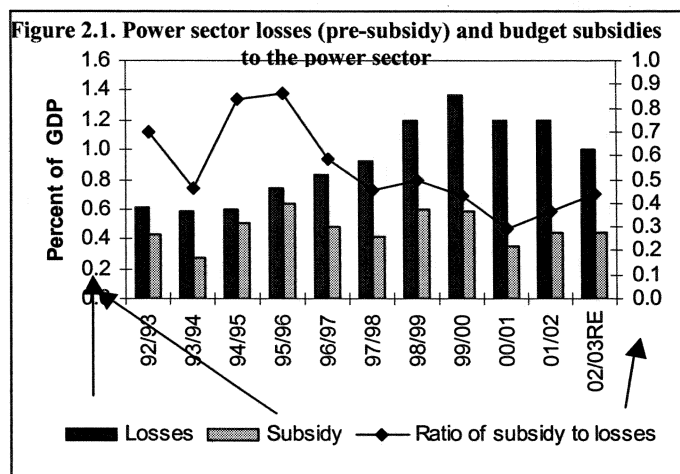
III SUBSIDIES

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 explicit state subsidy is for the power sector. Large implicit subsidies are provided for the irrigation and higher education sectors, while smaller explicit subsidies are provided by many states for public transport, housing and food. We do not have space here to provide a comprehensive analysis of state subsidies: see Srivastava and Sen (1997) for a national study and Rao (2003) for a case-study of Karnataka. Since the power sector subsidy is the largest and the most intractable of all the state explicit subsidies, we focus on it here to illustrate many of the broader points about subsidy reforms.

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 increased from 0.6% of GDP in 1992/93 to almost 1.4% in 1999/00. The ratio of subsidy paid to losses made has fallen from about 0.8 in the mid-nineties to less than half. With a declining portion of losses funded by the budget, losses have been increasingly financed by borrowing, including accumulation of arrears.



Source: See Figure 1.3

2.25 Figure 2.1 does suggest that power sector losses have come down as a percentage of GDP in recent years, though in the absence of actuals post 1999/00 it is difficult to be definitive. Moreover, even

if losses have come down slightly, these are still well above their level of the early nineties. There are various causes for the high level of financial losses in the power sector, including inefficient operations (reflecting under-investment) leading to a high level of technical losses, theft of power, and a rapid increase in generation unit-costs. 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 grew four-fold from 1992/93 to Rs 305 billion in 2001/02 (1.3% of GDP), while that to households grew six-fold to just over Rs 100 billion (0.4% of GDP). Much of this below-cost provision 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 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, 2002) ranked satisfaction with money-lenders – commonly regarded as exploitative – far in excess of satisfaction with electricity services (or irrigation). Indeed, Indian agriculture is stuck in a low-price, low-quality electricity-supply trap. To the extent that the electricity subsidy benefits any farmers, it is the better-off ones (Box 2.3).

Box 2.3 Does free power help poor farmers?

On average, India's states charge farmers just 10% of the cost of the electricity they supply to them; some states charge nothing. But do low or zero power tariffs for agriculture actually benefit poor farmers?

The evidence in fact suggests that free power may harm all farmers. The lower the agricultural tariff, the greater the financial stress on the power utility, and the lower the incentive to actually supply farmers with quality power. Evidence from the one survey (World Bank, 2001) undertaken so far to examine this price-quality trade-off suggests that farmers in Haryana, the site of the survey, pay heavily for current policies in terms of burnt-out motors and low reliability. The study found that improvements in quality of supply could more than compensate farmers for a quadrupling of tariffs: smaller farmers would especially benefit.

If we abstract from the quality issue, then one can certainly see cheap power benefiting farmers, but the benefits flow overwhelmingly to rich farmers, because: (i) a farmer with irrigation is much less likely to be poor than one without; and (ii) only relatively well-off farmers can afford the significant private costs incurred in buying a pump and sinking a borewell.

A study of Karnataka (Howes and Murgai, 2003) based on the 54th and 55th NSS surveys from the late nineties illustrates these points. Table 1 below shows that a farmer with irrigated land (just 28% of all farmers) is only half as likely to be poor as the farmer without irrigated land, a much larger group which makes up 83% of the poor.

Table 1: Irrigation status and poverty in Karnataka

Irrigation status	Landholding status (ha)	% of pop'n	Poverty incidence	
			(% in each group below poverty line)	Distribution of poor across groups
Not cultivating irrigated land	All categories	72.4	20.9	83.1
	Landless	14.2	16.9	13.2
	Landowners	58.2	21.9	69.9
Cultivating irrigated land	All categories	27.6	11.1	16.9
Total (Avg.)		100	(18.2)	100

Table 2 illustrates the second point. Even within the generally wealthy minority of pumpset owners, the subsidy is concentrated among the larger farmers, since only they are likely to be able to afford a pump. To take two extremes, only 22% of farmers with less than one hectare own a pump, whereas 70% of farmers with 4 hectares or more own a pump. Table 2 also estimates the distribution of subsidy across farmers based on data on the extent of irrigation. The majority of farmers of course get no subsidy. Marginal, irrigated farmers get an average of Rs 3,300 per year per pump-owning farmer. Irrigated farmers with 4 hectares or more get almost ten times this amount: Rs 29, 700.

Table 2: Ownership and use of electric pumpsets for irrigation

Irrigation status	Landholding status (ha)	Pumpset ownership (%)	Average Subsidy received per pumpset owner (Rs per year)
Cultivating irrigated land	All categories	42.3	15,444
Of which	<1	22.3	3,296
	1-2	37.5	9,303
	2-4	57.1	15,853
	>4	69.9	29,710

Results from Karnataka are replicated in other states. Acharya and Jogi (2004) do a nationwide study of input subsidies for farmers and estimate that farmers with irrigation get on average 15 times more subsidies than farmers without irrigation.

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

2.27 That agricultural supply to farmers is unmetered and often free (or close to it) has led to the introduction of a rationing regime for the supply of electricity to agriculture. Even if payments are required for electricity they are lump-sum, and so the marginal cost to the consumer of an additional unit of consumption is zero. As a result, consumption has to be restricted by the producer to affordable limits, which often means just a few hours a day. This aspect of the electricity regime in India is not only clearly damaging for agriculture, and more generally rural development, but also does great harm to the fiscal position of the states. Governments frequently yield to the constant pressure to supply more and more electricity to farmers, and so typically end up supplying whatever is available, whether or not it is affordable or optimal. Whatever progress states might make in improving their budgetary position or in reducing power sector losses outside of agriculture, or even in increasing agricultural tariffs, stands undone by the provision of additional supply to agriculture.⁷ Decisions on the quantity of electricity to be supplied are never made by the Finance Department but at the political level or by the utility itself. This is despite the fact that Finance Department is the effective purchaser of power for 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 labyrinthine prior-approval procedures for most expenditure areas, such as staff-hiring, but are simply presented with a bill at the end of the month or year for power sector losses. It is not surprising that one often sees a stand-off between finance and the utility, with the former often refusing to honour the ex-post subsidy claim of the latter. 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 in three key areas: first, in the utility-customer relationship – non-paying customers are frequently not disconnected, and bills are often not paid; 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; and third, in the utility-supplier relationship – utilities, lacking cash in part as a result of the payment defaults described above, in turn do not pay their suppliers, yet the latter, typically central government enterprises, do not disconnect them. Recent reforms have been made to reinforce payment discipline to suppliers (see para. 1.30), and some governments have started to meet their subsidy obligations, despite these beginnings, the lack of commercial discipline remains pervasive in the sector.

There has been some recent progress in reducing power losses, but not in agriculture.

⁷ In some states, additional supply to subsidized households has the same effect.

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 the 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 very impressive results from such a strategy (Andhra Pradesh for example), and, as mentioned, there are some signs at the aggregate level that the pattern of rising losses has been reversed. However, whether this reversal will be sustained remains to be seen. The new emphasis on rural household electrification, while welcome from a developmental perspective, will surely increase the subsidies flowing to the household sector. Attempts to reform the power sector in agriculture have not been successful, as Box 2.4 illustrates. In such a scenario, 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 2.4. Repeated attempts to increase the agricultural power tariff

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. This was when average cost of supply was estimated at close to Rs 1.50 per unit. This minimum tariff is still regarded as a benchmark today, which very few states achieve, even though the average cost of generation alone 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 gradually be 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:

- Karnataka moved away from free power in 1997. Though tariffs have been increased, collections from farmers are so low that power might as well be free.
- In Tamil Nadu, free power for farmers was ended in 2003, but resumed in May 2004.
- Madhya Pradesh has significantly increased agricultural 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 the state to free power.
- Andhra Pradesh had a low, non-zero tariff for farmers, but this was not increased in the entire period of the state's power sector reform program starting in the late nineties. The first decision of the newly-elected Andhra Pradesh government in May 2004 was to make power free to farmers.
- 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 also had little 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. Nor can the quality of service provision be expected to improve if commercial discipline remains lax. 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 strategy is no panacea. Orissa privatized its distribution sector in 2000, but the benefits from this have been 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 ways in which distribution can be taken out of government control, 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 that would help the power sector beside privatization, including the reduction of theft and losses, reduction in industrial tariffs, increases in household and agricultural tariffs, and improvements in the quality of electricity supply. The Electricity Act 2003 opens new vistas for reform by mandating unbundling and corporatization, and enabling competition in generation, and entry into distribution. 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 to an actual 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. Recent trends of growing input subsidies and increasing guaranteed output prices are suggestive of India 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.
- 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 increasing as rapidly as the power-sector subsidy is. The irrigation subsidy increased from 0.3% of GDP in 1980/81 to 0.4% in 1990/91 and by 1999/00 had fallen back to 0.3%,⁸ likely because of the slowdown in irrigation investments. Several states have had some success in cutting food subsidies (Andhra Pradesh, Tamil Nadu), and agricultural produce subsidies (Maharashtra) though progress has been mixed. There is no data on housing subsidies, but the increasing popularity of free rural housing schemes suggests they are growing rapidly, despite a lack of economic rationale.

2.33 Given the similarities, the same prescriptions will also 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. Adoption of a purchaser-provider model whereby the government compensates the utility for the net cost of the services rendered by the utility, as used in several other countries, would help bring the subsidy-recipient sectors more under the ambit of the Finance Department and the budgetary process. 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 irrigation 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. Andhra Pradesh, a reform leader in this area, 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%. Moreover, the water-user associations were suspended for the most part of 2003 owing to a delay in elections for Water User Association (WUA) office-holders, an indication that these associations, rather than commercializing the irrigation sector, have in fact themselves become politicized.

One important lesson from the power sector is that subsidies are here to stay. This suggests more attention be given to subsidy management.

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, controlling or reducing rather than eliminating subsidies will be a more viable strategy. 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.

IV PUBLIC ENTERPRISE REFORMS

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

2.35 The budgetary burden of public enterprises 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 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

⁸ Calculated from Gulati and Narayanan (2003), Table 5.2, using the Vaidyanathan Committee method.

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 Andhra Pradesh and Orissa.

2.36 According to recent GoI data, 14 states have identified 367 state-level PEs (about 1/3 of the total) for (Table 2.3). Of these, the process has been initiated in 289 state-level PEs. Andhra Pradesh, 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 because it is less political, and partly because states have few viable privatization candidates. Box 2.5 discusses the successful experience with public enterprise reform in Andhra Pradesh.

Table 2.3: Public enterprise reforms by state

Name of state	Approx. no. of state-level PE	PEs identified for reform	PEs in which reform 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
Maharashtra	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: www.divest.nic.in (2004).

Note : 'Reform' here refers to privatization, closure, or restructuring.

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

2.37 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 Andhra Pradesh – have both benefited from extensive consultancy support in this area.

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, Andhra Pradesh 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 Voluntary Retirement Scheme (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.

Table 2.4: redundancy compensation in a few states and GoI (in Rs)

	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)

2.38 The failure of retrenchment strategies in the core civil service stands in contrast to the widespread use of severance payments or VRS for public enterprise employees: the difference being perhaps that enterprises, unlike governments, 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 2.4), though there is no evidence that states with lower severance payments have found it more difficult to attract VRS candidates.

V REFORMS TO IMPROVE THE QUALITY OF SPENDING

The quality of spending must and can be improved

2.39 The strength of the case for increasing spending levels in health, education and infrastructure depends on the extent to which quality can be improved. 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.⁹

2.40 Perhaps the most important message of this section is that the quality of state government expenditure can be improved. While there is a lot of cynicism on this subject and 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 Annex 2, which consists of a series of 8 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 Annex 2 provides some examples of this. One can find plenty of other examples where reforms have been introduced, but have

⁹ See the 2004 World Development Report on service delivery for a theoretical framework. This topic is also being explored in more detail in a World Bank report under preparation which highlights and seeks to explain recent improvements in service delivery in India.

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 complex setting where success is not assured, 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; public expenditure management reforms; and capacity building.

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

2.41 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 re-engineer 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/or inter-governmental fiscal and accountability frameworks have to be given careful attention (World Bank, 1999, 2003e). Experience indicates that both approaches – reforms with or without transfer of responsibility – 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 fully 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

2.42 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:

- *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 service delivery in Bangalore 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, Tamil Nadu) 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 that simple passage of legislation would either 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 (Andhra Pradesh, Karnataka, Tamil Nadu). Reducing managerial transfers seems much more difficult, but there is no reason why the same approach of introducing minimum tenures and a rule-based system could not be introduced provided the requisite political commitment to improving service delivery is in place.
- *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 putting the spotlight of publicity on incidents of corruption, and thereby placing pressure on government and its agencies to reform.

Table 2.5 Average tenure of MDs 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
Madhya Pradesh	4	6
Uttar Pradesh	5	4.8

Source: Seshadri (2003)

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.

2.43 The World 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 and post-budget approvals follow automatically. 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 five years ending 2002/03, budgeted revenue estimates exceeded actuals by an average of 8%. 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. 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 are consumed in persuading Finance to release funds. The most important public expenditure management 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 controls on spending.¹⁰ 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 and ownership of the budget.

Table 2.6: Deviation of actuals from budget estimates, 1998/99 to 2002/03

	1998/99	1999/00	2000/01	2001/02	2002/03	Average
Total Revenue	-12.9	-4.3	-2.9	-11.0	-8.6	-8.0
State's own tax revenue	-9.4	-5.0	-4.2	-8.9	-4.8	-6.5
State's own non-tax revenue	-17.9	3.4	-8.3	-15.2	-8.7	-9.3
Central transfers	-15.6	-6.1	0.9	-12.5	-13.5	-9.4

- *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 the Finance Department 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.
- *Tighten accounting and audit arrangements:* India's accounting and audit arrangements are largely 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

¹⁰ 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 budgeted, or, overly-conservative budget estimates can be used for central government revenues.

even produce accounts, let alone audits. The challenge is to re-activate the system to reduce the gap between theory and practice.

2.44 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. Andhra Pradesh 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 Annex 2. There needs to be much more cross-state learning, with the support of key central agencies – not only GoI, but RBI and CAG – to replicate and further develop these promising beginnings.

Capacity building will be critical for reforms and performance.

2.45 Given their heavy expenditure responsibilities, policy-making and managerial capacity at the state government level is surprisingly limited. This is a problem which cuts across government. In an illuminating article, Mavalankar (2003) shows the almost complete lack of managerial capacity in the large maternal health programs which central and state governments run, and concludes that:

...very limited capacity of the top technical officers in the area of maternal health is a major constraint ... and unless this constraint is removed more investment in maternal health will not result in faster progress ...

2.46 State-level Finance Departments also enjoy much less policy-making capability than they need. Few if any benefit from the advice of a Chief Economist, have tax-analysis and forecasting capability, or the capacity to engage with line departments over what their performance targets should be. Many of the reforms state governments are seeking to carry out, whether to improve procurement policy, or to adopt fiscal responsibility legislation, simply will not be achievable without expanding analytical and policy-making capacity, including through the injection of fresh staff or consultants. A promising example of what can be done is given by the USAID-financed fiscal reform project (Case 8), currently active in three states. All states would benefit from the sort of capacity building this project is attempting to inculcate.

India's states are currently stuck in a low-quality, low-quantity expenditure trap. 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.

2.47 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. 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 (Box 2.6). Increased expenditure in priority areas can, in theory, compensate for cuts elsewhere, e.g. on unproductive 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 meal 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, Uttar Pradesh and Orissa.

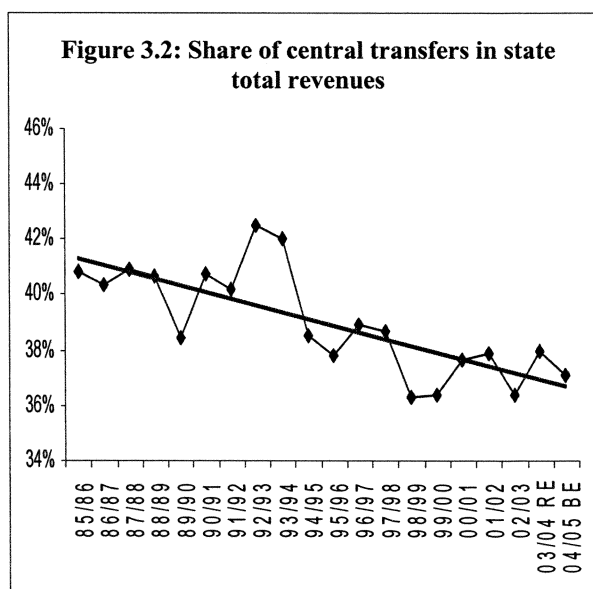
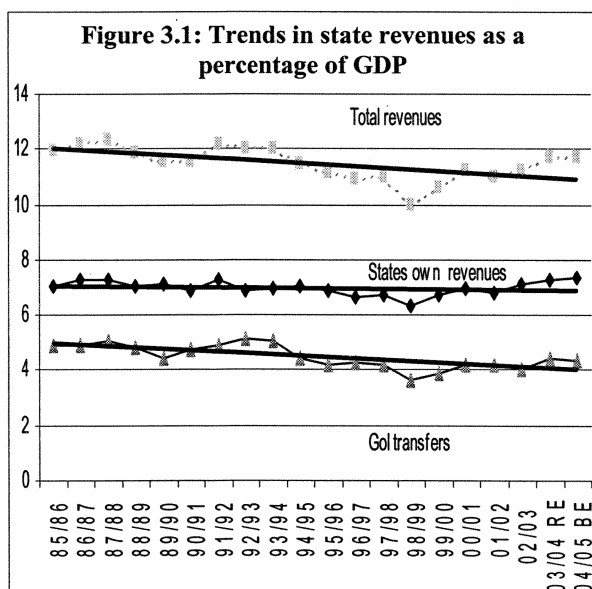
Source: Dreze and Goyal, 2003

CHAPTER 3 REVENUE POLICY AND ADMINISTRATION

I. INTRODUCTION

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% of GDP in the late eighties and early nineties to just over 10% by 1998/99 (Figure 3.1).

3.2 States in India derive revenues from own sources and central transfers (shared taxes and grants). States collect about 65% of their revenue themselves; the remaining 35% 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 under 4% at the end of the nineties, though there has been a partial recovery since. Figure 3.2 confirms the decline in the share of central transfers in total state 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.



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

3.3 The record of state governments in holding revenue constant as a percentage of GDP is creditable compared to the record at the central government level, where there has been a decline in the revenue/GDP ratio since the early nineties (see Figure 4.4). Nevertheless, 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; as we argue below, it is also feasible.

3.4 India's tax rates are high. 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). These high rates are combined with a narrow base, reflective in particular of the current 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.

3.5 Another challenge is to simplify the tax system, and reduce corruption levels. India's indirect tax system, administered independently by the centre and states, is, according to a 1994 report "archaic, irrational" and "the most complex in the world."¹ 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, 2002b). Reforms to simplify and reduce corruption are thus critical. This chapter considers first policy and administrative reforms for the more important individual revenue sources, and, then some cross-cutting administrative reforms.

II. STATES' OWN-REVENUE: STRUCTURE AND REFORMS

3.6 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 lie with the central government. 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 but shows low reliance on direct taxes at the sub-national level (Box 3.1).

Box 3.1: Tax structures in major federations

Fiscal imbalances are common in federations, for most of whom central transfers are an important source of provincial government finance. But 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 for the former, and the low end for the latter, as the table below shows.

Percentage of domestic indirect taxes and income taxes collected by states in the total tax take						
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)

Concerning specific taxes, motor vehicles taxes and, to a lesser extent, stamp duties appear to be widely assigned and collected by provinces. Major sub-national government revenue sources in some federations are as follows (Bird and Vaillancourt, 1998): Argentina - taxes on turnover, property, motor vehicles, gambling and social security and stamp duties; Colombia - taxes on liquor and tobacco; Indonesia - motor vehicles taxes and fees; Pakistan - stamp duties, motor vehicles tax and 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.

3.7 There are several federal constraints which shape 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 the specific levies mentioned in the previous paragraph, the states are severely restricted in their powers to levy a broad-based tax on goods and services, including a value-

¹ NIPFP (1994) quoted in Rao (2003b).

added tax (VAT). Other federal constraints which restrict the 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. Also important is that, although the right to tax agriculture has been reserved for the states, they have not exercised it, and the agricultural sector's tax burden is close to zero.²

3.8 Finally, India has taken the approach that the central and state taxes should in general be separate. Though both centre and states impose direct taxes (income and professions tax, respectively) and indirect taxes (on production and sales, respectively), these taxes are independent of each other and uncoordinated. This approach, in contrast to a "piggyback strategy" of sharing tax bases and administrative resources, increases the burden of tax compliance for the public and the costs of tax administration for the states. Shifting to a more co-ordinated approach between the centre and states is a long-term but important challenge for India.

The major tax sources for India's states 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.

3.9 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 from almost 2% to almost 1% of GDP (Figure 3.3). Tax receipts now make up 80% of total own revenues.³ 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.

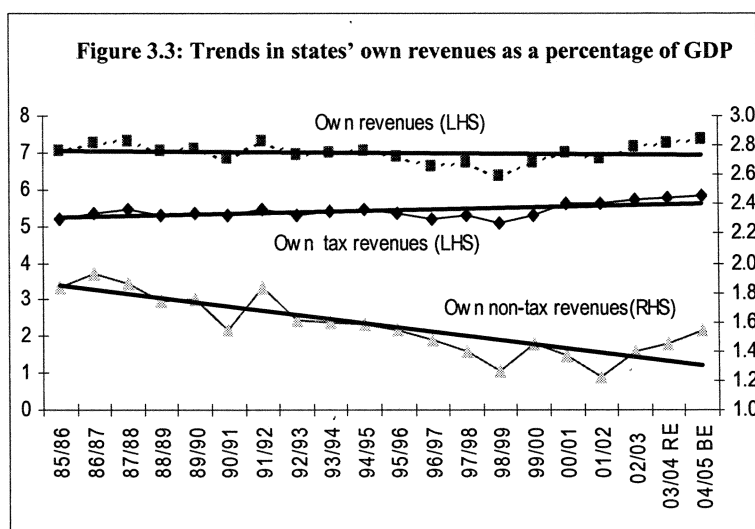


Table 3.1: Structure of state's own tax revenue: 1985/86 to 2000/01

	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

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

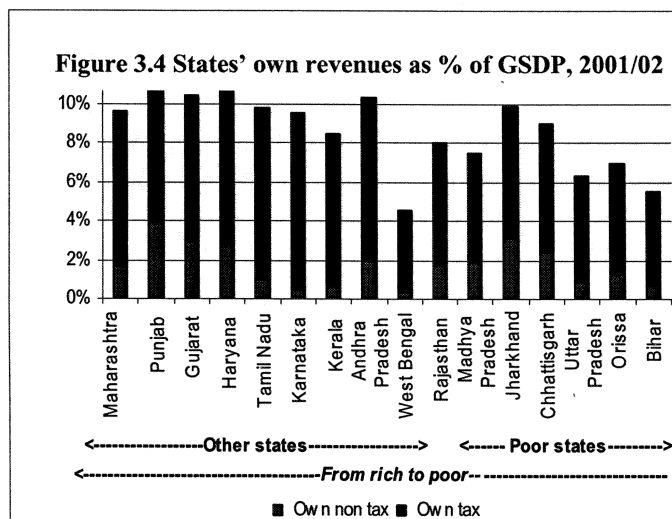
² Various suggestions to tax agriculture exist with Rajaraman and Bhende (1998) and recent proposals by the (Kelkar) Direct Tax Task Force (GoI, 2002c) being the most recent.

³ 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 other adjustments which should be made but for which data is not available – see Box 1.5.

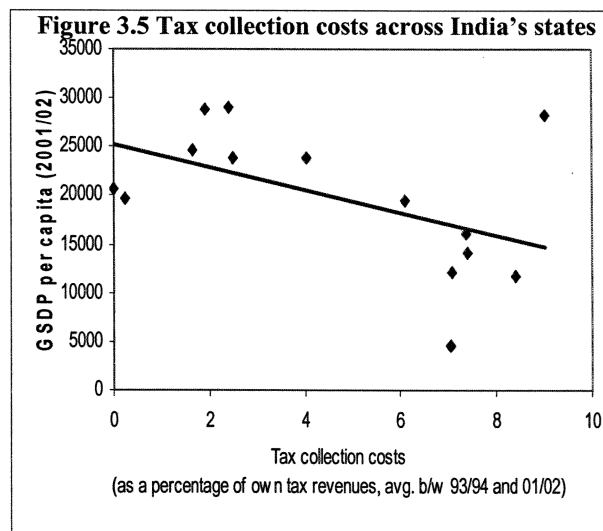
3.10 Are state taxes progressive? Aggarwal (1995) concludes that the state sales tax is progressive, though less so than central indirect taxes. Given the bases of motor vehicles tax and stamp duties, these taxes are also likely to be progressive. Whether or not excise duties on liquor are progressive, there are good public policy reasons for high taxes on alcohol.

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

3.11 As Figure 3.4 shows, the highest own-revenue/GSDP ratio (Haryana) is more than twice as high as that of the lowest (West Bengal). These ratios tend to be on the low side in the poorer states, around 8% for Rajasthan and MP, 7% for UP and Orissa, and 5% for Bihar. Chhattisgarh and Jharkhand do better due to large non-tax revenues. The middle- and high-income states all have ratios in excess of 9% except for Kerala which is just above 8% and West Bengal, which has a surprisingly low ratio, below that of Bihar. A key cause of low tax/GSDP ratios in the poorer states is the higher share of agriculture in the GSDP of the poorer states. Part of the lower tax/GSDP ratio of the poorer states may also be explicable in terms of lower tax effort resulting from poorer tax administration and from the negative incentive effects of being in receipt of a large volume of central grants (see Box 4.2).



3.12 Revenue net of collection costs⁴ 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% of tax revenues. This is high by international standards, the norm being 2-3%. 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.⁵

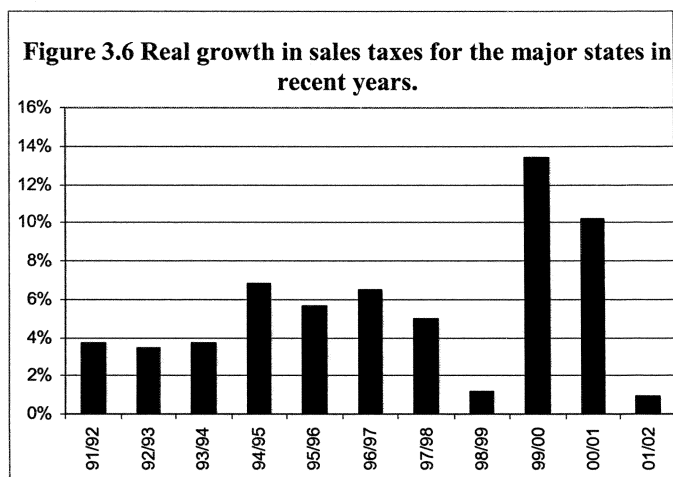


⁴ Data on collection costs are from the sub-head "Collection of taxes and duties" under the budget head "Expenditure on fiscal services". Data errors were identified and corrected for Gujarat (1985/86), Karnataka and Rajasthan (1987/88) and Maharashtra (1992/93 onwards).

⁵ 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 the VAT introduction.

3.13 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 the General Sales Tax (GST), levied on intrastate 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, and entertainment) and additional tax surcharges.



3.14 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 1999/00 and 2000/01 (Figure 3.6). It also suggested 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 being in early 2003.

The case for a comprehensive sales tax reform, centered around VAT introduction, remains compelling.

3.15 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 consists 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 are 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 many sales tax rates. Data in the case of 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% and 33%.

3.16 The delay in the implementation of the VAT, despite several states having completed their preparations, is a key failure of sub-national revenue reform in India. VAT would eliminate the cascading of state tax on exports, and would allow for the value-added in India’s increasingly organized retail sector to be taxed. To maximize its benefits, it should replace as many existing state-level indirect taxes as possible, such as the turnover tax, entry tax, etc. The introduction of VAT is also attractive as a vehicle for administrative reforms of the sales tax regime, such as computerization. In principle these reforms could be introduced on their own, and without waiting for VAT. In practice, however, most 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 it is about to be overhauled.

3.17 There is widespread agreement that India’s states should shift to a VAT. A fairly detailed design has been worked out. Although it does not appear to have been formally and publicly documented, it is

reasonably well known, and is summarized in Box 3.2. There are, however, still several outstanding issues concerning VAT introduction in India, and the paragraphs following are devoted to these. The discussion in the main text is supplemented by Annex 3 which covers, in more detail, three VAT-related issues: (i) the recent experience of Haryana, India's only state currently to have a VAT; (ii) international experience with VAT in federations; and (iii) different models for taxing inter-state trade in a state VAT regime.

Box 3.2 Design of the VAT for India's states

It is difficult to find a written account of the detailed design of the VAT that was intended for introduction on April 1, 2003, but then postponed. However, available sources (in particular, Aggrawal, 2003) suggest that the design had the following features:

- Two main rates of 4% and 12.5%. The 4% rate would cover basic goods (some basic and many unprocessed agricultural products would be exempt) inputs and capital goods (the argument being that this would minimize locking up of working capital by state governments), and declared goods (since under central legislation the rate of tax on these goods cannot exceed 4%, though they can now be taxed at more than one point). Special rates of 1% would apply on bullion and jewellery, and a floor rate of 20% for liquor. A 20% non-rebateable rate would apply for petroleum products.
- Small dealers: registration threshold of Rs 5 lakh, and then a further level (could vary across states) up to which a turnover tax would be payable in lieu of VAT.
- Rebates on capital goods were proposed to be spread out over 36 months.
- Exemptions: sales tax exemptions are no longer allowed, but already granted exemptions were proposed to be transformed into tax deferrals.
- Tax rental agreements on textile, tobacco and sugar would continue with the centre, so these would be excluded from the VAT.
- The VAT would cover only goods (as the sales tax does) but there were separate proposals for the taxation of services.
- Inter-state trade would continue to be taxed under the Central Sales Tax (CST), though there were separate proposals to reduce and/or phase CST out. Rebates for taxes paid on inputs used to produce outputs sold inter-state would be provided, but rebates on inputs only in excess of 4% if the output was sent to another state on consignment, as many outputs are to avoid the CST.
- Exports as of now would be zero-rated.
- Customs on imports would continue to be collected by the centre; like the sales tax now, the VAT chain would commence with the first sale post-import.
- Other taxes: States were advised, though it does not appear directed, to subsume other indirect taxes into VAT. This would include the entry tax, octroi and turnover taxes. Existing taxes on services, such as the luxury tax (on hotel stays) and the entertainment tax, would be consolidated once services were taxed.
- Compensation: VAT incurred losses would be measured by comparing actuals with expected revenue under the existing tax system. 100% of losses would be compensated in the first year, 75% in the second and 50% in the third.

The introduction of VAT should be on the basis of floor rather than uniform rates to avoid loss of revenue and preserve tax autonomy, and minimize the need for compensation.

3.18 One of the issues which complicated VAT introduction in 2003 was harmonization. Although the aim earlier was to agree between states on floor rates, this goal was later shifted to rate harmonization. Tax rates vary greatly across India's states. A main rate of 12.5% was proposed for all states, but southern and western states calculated their revenue neutral VAT rate to be 15-16%. Hence the call for compensation. However, once compensation is introduced, issues of moral hazard and game-playing are raised.⁶ Moreover, a strategy of rate harmonization will promote simplicity in the tax regime but may not be worth the cost in terms of loss of state tax autonomy and tax revenue (at a time when the tax/GDP ratio needs to be increased). Thus reversion to the earlier strategy of establishing floor rather than harmonized rates for VATs appears warranted. (The European Union has successfully introduced VAT across all its

⁶ 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.

member states with floor rates, but is still, after several decades, pursuing the much more difficult goal of harmonization rather across member states – see Annex 3.B.)

It would be better if a large number of states introduced VAT at the same time, but allowing those states that want to go ahead to do so is also an option.

3.19 Though a new inception date for VAT of April 2005 has now been agreed on, if a consensus cannot be established to guide the introduction of VAT across all states, individual states could be encouraged or at least allowed to graduate individually into VAT, provided that they follow a common, agreed framework. Several states would likely go ahead on such a basis, and others would then probably follow. Haryana is the one state which has not been deterred by GoI's postponement of VAT (Annex 3A). 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. Unfortunately, in some respects, the Haryana VAT deviates from the VAT model agreed by all states (e.g. there are three main rates, not two). If states do go ahead with VAT individually, it would be much better if they do so under a common framework; otherwise, there is a risk of making things worse.

Eliminating tax on inter-state exports is also critical, and should proceed with or without VAT. There are various models available to achieve this goal.

3.20 The Central Sales Tax (CST) is a tax on inter-state sales, set by GoI (typically at 4%) and collected and retained by the exporting state. CST collections are 13% of total sales tax collections (about 0.4% of GDP), and are concentrated among the better-off states (Rao, 2003). 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 of manufactured products. The result is a considerable concentration of CST revenues among a few states. Origin-based taxation of inter-state 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. There is widespread agreement that inter-state trade should not be taxed.⁷ The most commonly advocated approach is to reduce CST over time to zero and to allow input credits to be given regardless of where the output is sold (Rao, 2003). While this a reasonable approach, four points can be noted:

- CST rate-setting is purely within the prerogative of the central government. The phase-out of the CST should not be held hostage to the introduction of state-level VATs. GoI proposed a phase-out of CST in the 2003/04 budget, but this was put on hold when the VAT itself went off-track.
- When CST phase-out was proposed last year, transitional compensation was offered to the states by GoI. An alternative approach would be to offer the states compensation through other tax reforms, such as the ability to tax services (para 3.21), an increase in the professions tax rate (para 3.24), and, if possible, through VAT introduction itself.
- The problem with CST phase-out is that it will increase the already-existing incentive to evade the state sales taxes by claiming goods are being exported to another state, and thus escaping the need to pay tax. Evidence from the European Union, where such a zero-rating system is in place, points to the severity of this risk (see Annex 3.C and para. 3.23). Thus, if this path is pursued, it could perhaps be done in two steps (first to 2% and then to zero) and should be accompanied by increased surveillance over, and inter-state information sharing in relation to, interstate trade. Border controls (check posts) would need to be strengthened, but also modernized and streamlined

⁷ Though it is sometimes argued that rather than ending the tax on inter-state sales, a tax on inter-state consignments should be introduced to level the playing field. This would be a retrograde step, which would take India further away from being a common market. On the broader need for reforms to bring India closer to being a common market, see Bagchi (2002)

- There are alternative models within a VAT regime to eliminate the distortions of the CST system without eliminating the CST itself, and thus inducing widespread evasion. These are detailed in Annex 3.C. Broadly speaking, they aim to tax inter-state exports at the same rate as intrastate sales, but then allow such taxation to be refunded if the good is sold on. Revenue thus collected is then re-allocated across states to ensure that the destination, not origin, state benefits. These models have not received much attention in India, but could be considered as alternatives to CST phase-out.

Transfer to states of the right to tax services is a very positive initiative. Taxation of services by states should be integrated with the VAT, at least over time.

3.21 Until recently, neither the central nor the state governments taxed services (with a few constitutionally-mandated exceptions, such as hotel stays). The central government has now started to tax them, and the constitution has been amended to authorize the transfer from the central to state governments of the authority to tax services.⁸ This will give states access to the largest and fastest growing sector of the economy, and reduce India's high level of vertical imbalance. Central legislation is now required to operationalize service taxation at the state level. It will be useful if the legislation sets out a standard administrative approach to the taxation of services across states, but again an approach of setting floor rather than uniform rates might be superior. Concerning which services should be transferred, there are two competing proposals: one would transfer to states the right to tax specified services (Rao, 2001); the other would confer on both central and state governments the right to tax concurrently all but a specified list of services (Rao, 2001). The approach taken needs to be consistent with the states being allowed to integrate the taxation of services and goods outweigh under a broad-based VAT (Bagchi, 2004).

Even after VAT introduction at the state level, India's indirect tax system will still be very complex. The ultimate goal for the indirect tax regime should be a unified centre-state VAT.

3.22 The proposed state VATs are fairly complex because, apart from proposing multiple main rates – instead of the internationally-accepted practice of one main rate – they have to deal with centrally-imposed restrictions on tax rates on “declared goods” and with long-standing tax-rental agreements with the central government on textiles, sugar, and tobacco (Box 3.2). It would be useful to revisit such features– for the sake of a simpler tax design, and to ensure that VAT calculations, rebating and other procedures are as simple as possible. But even if the design of the state VATs can be simplified, the overall indirect tax regime will remain complex. Once India's states introduce a VAT, the country will be characterized by an uncoordinated, dual centre-state VAT: the GoI indirect tax is also a VAT, called CENVAT. Like the states' sales tax, it only applies to goods, not services; unlike the sales tax, it is only applicable at the manufacturing stage. International experience, summarized in Annex 3C, has a number of lessons to teach India in its pursuit of a dual centre-state VAT. Brazil's experience is particularly salutary, and suggests that a dual VAT system should only be viewed as a staging post towards a simpler, more integrated, national VAT, shared by the centre and states. Under such a model, each taxed good in each state could, for example, be subject to a tax rate made up of two components, one national and one state-specific. This sort of integrated VAT model has recently been advocated by the Kelkar report (GoI 2004), and would indeed be a logical conclusion to the current VAT plans – if it can be made to work. It would require a common taxation base, and, more fundamentally, a completely different approach to co-ordination and co-operation between the centre and states.

Whatever happens to VAT, administrative reforms to states' indirect taxes are urgently needed.

3.23 Key reforms, such as the introduction of a functional administration system to break the dealer-trader nexus, computerization, and rate simplification have been delayed awaiting VAT introduction. These are certainly reforms which are needed for VAT introduction. Indeed, recent research suggests that,

⁸ The 95th Amendment to the Constitution.

the good revenue performance of VAT around the world notwithstanding, VAT does not by itself eliminate evasion. The European Union estimates evasion of VAT within the Union at 80-100 billion Euros, about the amount of VAT actually collected by France!⁹ At the same time, these are also reforms sorely needed under the current regime. Those states which do not want to opt for VAT could pursue other reforms (computerization, functional organization, etc) within the sales tax framework, rather than continuing with a waiting game. Box 3.3 highlights the various commercial tax administrative reforms undertaken in Rajasthan in recent years. gives some recent proposals for administrative reform made in relation to Tamil Nadu, but which are applicable to most states.

Box 3.3: Administrative reforms in Rajasthan's Commercial Tax Department

Rajasthan has increased its commercial (sales) tax revenue by 1.5% of GSDP over the past five years. A large part of this growth has come from administrative reforms. Some of the measures adopted include:

Use of checkposts: The purpose of border check-posts is only to collect documents and information. This data gets centralized at headquarters to be used by the revenue assessing authorities. This not only reduces opportunities for corruption at the check-posts but also promotes dealer compliance.

Streamlining systems: Rajasthan is the first state to give all registered dealers nationally-compatible Tax Identification Numbers (TIN). Tax revenue is monitored on a daily basis at headquarters. This is possible because the department has established computer connectivity down till the circle level. New dealers are provisionally registered and given TINs within 24 hours after which they are authorized to collect tax on their sales, as registered dealers do. The provisional status is converted to regular status within 45 days after the required verification is complete. Rajasthan has endeavored to improve the accessibility of tax-related information for the dealers. The complete list of taxable commodities along with their sales tax rates is available on the official website (www.rajtax.org) of the Commercial Tax Department (CTD). The formats of sales tax forms have been simplified and all these forms regarding registration, exemptions, returns, appeals etc along with government notifications have also been put up on the net. Efforts have been made to improve the appellate structure for dispute resolution. Four new Deputy Commissioners (DC) have been appointed for settling appeals (there are 7 such DCs in all) filed in consequence of the orders passed by the assessing authorities. Departmental appeals have to be disposed of by these officials within a period of 2 years.

100% self-assessment: All dealers have to file their returns within a stipulated time period (depending upon the tax to be paid), which is acknowledged with a receipt from the Assessing authority. Currently 20% of these returns are audited by the tax authorities. The CTD aims to introduce IT-based risk audit of only up to 5% dealers in the next year. A risk assessment model and audit manual have already been developed after detailed and sustained interaction with the Canadian Revenue Agency.

Cell for large tax payers: A special structure has been created for the 90 big tax payers responsible for over 50% of the revenues of the CTD, with an Additional Commissioner over-seeing its work. The department also tracks 1200 other dealers, who pay tax above Rs.10 lakh a year, on a special basis.

Reducing corruption, improving tax-payer services and rewarding compliance: The department has moved in the direction of reducing the interaction between the tax official and the tax payer. No official of the CTD can visit (even in the case of tax evasion) or inspect the place of business of a dealer without the written permission of the Deputy Commissioner of the zone (A recently started 'Gold card' scheme gives further privileges to compliant taxpayers). Physical presence of the dealer is not required in the filing of returns. Taxes can be deposited in the authorized banks. Grievance redress cells have been set up at the zonal level headed by DCs to address the complaints of the district-level trade and industry associations.

While Rajasthan has made commendable progress on tax reform, and has the results to show for it, there are two further steps it could take. First, to further reduce corruption, a special vigilance unit could be established to investigate taxpayer allegations against tax officials and detect corrupt practices and officials in the department. Second, the single most important outstanding reform in Rajasthan is the shift to a functional organization, under which the administrative functions of registration, audit, collection, and taxpayer services would be allocated to separate staff to help break the taxpayer-official nexus.

⁹ <http://www.financialdirector.co.uk/News/1137084>.

There is a rich agenda for reforms in other taxes, requiring wide-ranging actions by the center and the states. The professions tax should be retained, and greatly increased.

3.24 The professions tax is a type of income tax collected by the states. It is a very small tax, which only raises 0.1% of GDP. Currently, the profession tax is not levied at all in five major states. Where it is levied, enforcement is weak, and the focus is often exclusively on the formal sector, where the tax is collected by deduction at source, and hardly, or not at all, on the informal sector. As Box 3.1 shows, states in several federations enjoy a direct tax base, and there are good arguments for greatly increasing professions tax collection. In particular, expansion of the indirect tax base to include services and expansion of the professions tax to increase the states' direct tax take should be seen as complements not substitutes.

3.25 The main problem with the professions tax is that the constitutionally-imposed ceiling is very low (Rs 2,500 per person): this greatly reduces the incentives for the states to take this tax seriously. There is a strong case for a, say, quadrupling of the floor rate, or, alternatively, a shift to a more flexible formula-based approach which would remove the current, nominally-defined limit from the constitution.¹⁰ Raising the ceiling on the professions tax would in turn give the states more incentive to utilize this tax, especially for self-employed professional and higher-income individuals in the unorganized sector.¹¹ We estimate that the potential collection from the professions tax to be about 10 times the current level of Rs 22 billion (that is 0.9% of GDP rather than 0.1% as currently) with ceiling revision and improved collection. 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.

Enforcement of state excise duties can be much improved.

3.26 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 one), 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.

3.27 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 and 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, it did not improve revenue buoyancy, almost surely due to weak enforcement.

¹⁰ A tripling was announced in 2001, but has not been implemented.

¹¹ 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.

3.28 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 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.

3.29 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" 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, 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 steps should be taken only if they are felt to be in consonance with health concerns of individual states.

Stamp duties – mainly taxes on property sales – should be reduced, and revenue increased by better valuation and a crackdown on corruption.

3.30 Stamp duties and registration fees are, along with transport tax, equal the 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. There are central, state and concurrent powers for rate-setting for different classes of documents. Property transfers are the major base, for which rates are set by the states. Stamp duties and registration fees have had the best 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.

3.31 Fees on the transfer of immovable property are very high by international standards. 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.¹² 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.

3.32 Other reforms in this area will also boost revenue. 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 such 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 with the prevalence of middlemen like real estate agents and even local revenue officials (Caseley, 2004). Reform of stamp duties and

¹² Stamp duty in Rajasthan was lowered from 12% to 7% in 1996-97. There was a 36% increase in stamp revenues between 1996-97 and 1998-99. However, the rate was subsequently raised to 10%. See Alm, Annez and Modi (2004) for further evidence on the revenue-enhancing impact on the lowering of stamp-duties.

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.¹³

The transport tax has shown low buoyancy. This can be tackled by increasing the tax on cars relative to buses, and by deregulating state monopoly bus services to improve service and grow the tax base.

3.33 Like 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. It sets uniform fees for transport department services like issuance of licenses and permits. The major revenue raising power lies 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 comes as a surprise.¹⁴ 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.

3.34 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".¹⁵ Consequently, to increase revenue from motor vehicle taxes as well as improve economic efficiency, state governments will need to "denationalize" most routes currently reserved for STUs. This should also result in lower administration costs, reduced corruption and better services.

3.35 Rate reform can lead to major revenue gains and is also desirable on efficiency and equity grounds: the motor vehicles tax 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. As Table 3.2 shows, tax revenue from buses is 83 times the maintenance required to repair the road damage they cause; the corresponding ratio for 2-wheelers is 0.4. Therefore, economic efficiency and equity suggest raising of taxes on other vehicle classes relative to buses, and perhaps reducing bus rates. 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

Category	2-wheelers	Cars	Jeep/Taxi	Bus	LCV	HCV	MAV
Revenue (2-wheeler rev.=1)	1.0	9.4	10.1	322.3	12.2	32.6	59.0
Ratio of revenue to road capital and maintenance cost	0.4	1.1	0.5	19.4	0.8	0.4	0.4
Ratio of revenue to road maintenance cost	1.8	4.9	2.0	82.5	3.3	1.5	1.9

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 (2003h) covering all states.

¹³ 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.

¹⁴ Though the all-state buoyancy for 1993/94 to 2000/01 was 0.83, buoyancies were above 1 in 8 of the 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 major states.

¹⁵ World Bank (1998a) estimates the tax gap in Uttar Pradesh in 1996-97 at around 24% of potential.

3.36 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.

3.37 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.

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

3.38 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. 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.

3.39 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 central government, 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.

3.40 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.¹⁶ 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.¹⁷ 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.

3.41 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, noted in the discussion in Chapter 2 on subsidies, namely a lack of commercial discipline, manifested in an unwillingness to withdraw services from non-paying customers. Restoring commercial discipline and improving cost recovery can be difficult in the public sector, especially when beneficiaries are politically powerful. Where external benefits or merit good characteristics are unimportant, the government should ideally withdraw rather than attempting recovery of user charges.

¹⁶ 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% of the work plans even by 2000. See D. K. Srivastava et. al. (1999).

¹⁷ 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.

Where the government stays involved, some basic principles for improved cost recovery and commercial discipline need to be applied. These are summarized in Box 3.4. 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 3.4: 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)

3.42 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 not give details of amounts, 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 state shows impressive growth in these sources of revenue. In many cases, loans to public undertakings and cooperatives are often really grants, not intended to be recovered. The poor performance of public enterprises is of course well documented (Chapter 2.IV).

III. REFORMS TO TAX INSTITUTIONS

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

3.43 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 via annual reports that stress effectiveness in achieving goals and (cost) efficiency is 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 make accountability for performance difficult.

3.44 the last section of Chapter 2 listed some general principles for improving government effectiveness. Some specific recommendations applicable to the functioning of tax departments are summarized below.

3.45 *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 3.5 for the example of Andhra Pradesh). 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.

Box 3.5 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 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, Government of Andhra Pradesh.

3.46 *Non-tax revenue retention.* Some states, notably Andhra Pradesh, 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 invest 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.

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

3.48 *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 some cases, these steps have been taken by involving the private sector and even outsourcing.¹⁸ As noted in Chapter 2, encouraging consumer voice can be a powerful way to improve government service standards. Measures required are the use of data on compliance with the citizen's charter and other forms of citizen's feedback in management information systems, performance indicators and reports, and the determination of incentives (positive and negative) for improved service delivery to citizens.

3.49 *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. This structure is close to that in states which have commercial tax departments. A permanent, secretary level, revenue committee would ensure coordination. 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.

3.50 *Modernizing field enforcement and checkpoints.* While mobile squads and particularly border checkpoints constitute an impediment to internal trade and a common market, their removal at the current stage of development, given large-scale evasion will lead to reduced state capacity to collect revenue.¹⁹ However, current checkpoints 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 checkpoints 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 checkpoints and mobile squads across different departments, and eliminating most internal checkpoints, these costs can be reduced.²⁰ Furthermore, by adoption of modern technology and institutional reforms, their effectiveness and cost efficiency can simultaneously be increased, while reducing avenues for corruption.²¹

3.51 *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, such as mobile squads and checkpoints, 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 collections, except for unpaid land revenue, and maintenance of overall taxpayer master files and current accounts.

3.52 *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

¹⁸ In a number of Stamps and Registration Departments, such as Andhra Pradesh, Maharashtra and Karnataka.

¹⁹ Das-Gupta (2003) presents evidence that the removal of border checkpoints 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 checkpoints, has a poorly performing sales tax.

²⁰ Integrated checkpoints are being established in Andhra Pradesh and Karnataka and possibly Maharashtra. Das-Gupta (2003b) reviews desirable ingredients of integration and modernization packages.

²¹ The importance of institutional reform to accompany induction of modern technology is illustrated by the experience of Gujarat. Computerization of Gujarat's border checkpoints in 1999 led to a threefold growth of check post revenues in 2 years. However, staff resistance and lack of maintenance led to checkpoint equipment becoming unusable thereafter. See Case 1 in Annex 2.

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.²² 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. That the Empowered Committee has now been broadened to include all Finance Ministers, and that it is now establishing itself as a permanent Society are encouraging indicators of a desire to institutionalize cross-state coordination on tax issues. 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 Annex 4.

3.53 *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 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 (Table 2.6).

3.54 *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 clean-up of tax laws is overdue in many states.

3.55 *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.

3.56 *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

²² 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 without improved cross-state data.

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.

3.57 *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 taxpayer's 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. Due to the great similarities across states in the nature of these dispute problems, establishment of an all-state commission or committee could be considered. This would have a mandate to undertake a detailed review of state dispute resolution procedure for all taxes, but for sales tax in particular, with the intention of reducing disputes, achieving speedy resolution of disputes, reducing opportunities for corruption, and exploring the introduction of modern self-assessment with post-assessment audit coverage.

CHAPTER 4

FISCAL FEDERALISM AND THE INCENTIVE FRAMEWORK FOR STATE REFORMS

I INTRODUCTION

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

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 the architecture of India's fiscal federalism, the subject of this chapter.

4.2 Box 4.1 provides a summary of India's fiscal federal arrangements from an international perspective. We have already noted that India gives expenditure responsibilities to its state governments to an extent 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.

Box 4.1: International perspective on India's fiscal federal arrangements

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 states 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 other countries. This reflects a high degree of dependence on central transfers as well as borrowing.

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 their constitution. India's constitution mandates an institutional framework for fiscal transfers, while leaving the onus of determining the size and distribution of such transfers on the Finance Commission. 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.

Borrowing rules. India's rules for sub-national borrowing, especially as they are put into practice, are relatively liberal. 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: see Box 4.4 for other examples. Two restrictive features of India's borrowing arrangements, which have not always been present in some other federations, and which 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 having the central government 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. 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% and Pakistan around 100%. In Argentina the ratio was 69%, and the US 44%.

	Sub-national as a percentage of total ...		<u>(1)/(2)</u>
	<u>Expenditure</u>	<u>Revenue</u>	
	(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

4.3 Nevertheless, the center plays a dominant role in the Indian federation in several ways. First, it transfers revenue resources to the states in the form of tax sharing and grants. Relative to their heavy 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 about 50% of their revenue from this source. Second, GoI plays a leadership role with respect to many national policies. For example, central pay commissions in theory set salaries only for central government employees, but in practice influence salaries paid in the public sector throughout the country. Third, GoI lends to the states and, under the Constitution, sets the borrowing framework within which states operate. Fourth, there are central pools of senior civil servants which operate at both the central-and state-government levels.

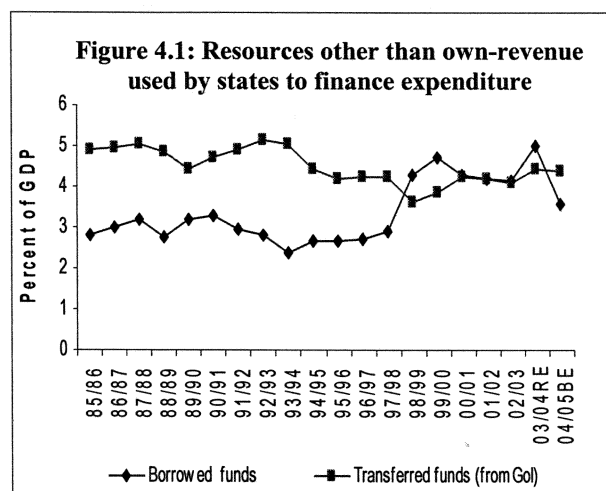
4.4 India has developed elaborate and complex institutional structures in the area of fiscal federalism. The two most important institutions influencing center-state financial relations are the constitutionally mandated Finance Commission, which convenes every five years to determine the sharing of revenues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

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.

4.5 The nature of resource flows to states changed greatly in the nineties with a fall in grants, and rise in loans (Figure 4.1). From 1998/99 onwards, borrowed resources supplement a state's own revenues at least as much as central revenue transfers do.¹ Not surprisingly, this development has generated considerable fiscal stress.

4.6 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 the 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.²

4.7 In part because we advocate the need for a sharp distinction to be made between transfers and loans, we approach this chapter by considering separately the state-level borrowing regime and the transfer system. We conclude with some cross-cutting institutional issues. 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: econometric work on fiscal federalism in India is summarized in Box 4.2



¹ This is budgeted to change in 2004/05. Whether it does remains to be seen.

² 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. 2 : Econometric studies of the determinants and impact of India's fiscal federal transfers.

Determinants of grants and loans. There is 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 being financed almost entirely by additional loans from the central government. Studies of 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 Arindam Das-Gupta) also finds that dependence on central transfers reduces tax collection efficiency. Findings from other countries are similar. 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. The 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 per capita own revenue among India's states can be explained by GSDP per capita, suggesting that the main determinant of tax performance is the level of economic development (Figure 4.7).

II BORROWING REGIME

4.8 While it is the states that determine the demand for debt, it is the center that controls the supply. As actual borrowing has been historically driven by the supply constraint (i.e. states typically borrow whatever is available), how the central government plays its role as the controller or regulator of state debt has an important bearing on fiscal sustainability at the state level.

States have six sources of deficit financing. These are subject to differing degrees of central control.

4.9 The Indian Constitution sets the basic rules of the country's sub-national borrowing regime. Section 293 forbids state governments from borrowing abroad and requires them, as long as they are in debt to the union government, to obtain central approval for domestic borrowing. The following sources of domestic borrowing are open to the states:

- (i) *Government of India (central plan) loans.* These are loans linked with grants in a fixed proportion, as “block plan assistance” to finance the state plan. Block plan loans and grants under the supervision of the Planning Commission consist of two parts: (a) an unconditional part, called “normal central assistance”, whose aggregate size is at the discretion of the central Ministry of Finance; and (b) a conditional part, called “additional central assistance”, consisting largely of the onward transmission of donor resources through the center to the states under various externally-aided projects. After earmarking 30% of the normal central assistance for the special category states,³ the remaining is distributed among the 17 general category states according to a Planning Commission formula.⁴ The block plan assistance to each state, including both the normal and

³ See Annex 1.

⁴ The revised Gadgil formula (1991) gives 60% weight to population, 25% to an inverse measure of percapita income, 2.5% to tax effort, 2.5% to fiscal management, 2.5% to national objectives and 7.5% to special problems.

additional components, takes place as a standard mix of loan and grant – 70/30 for the general category states and 10/90 for the special category states.

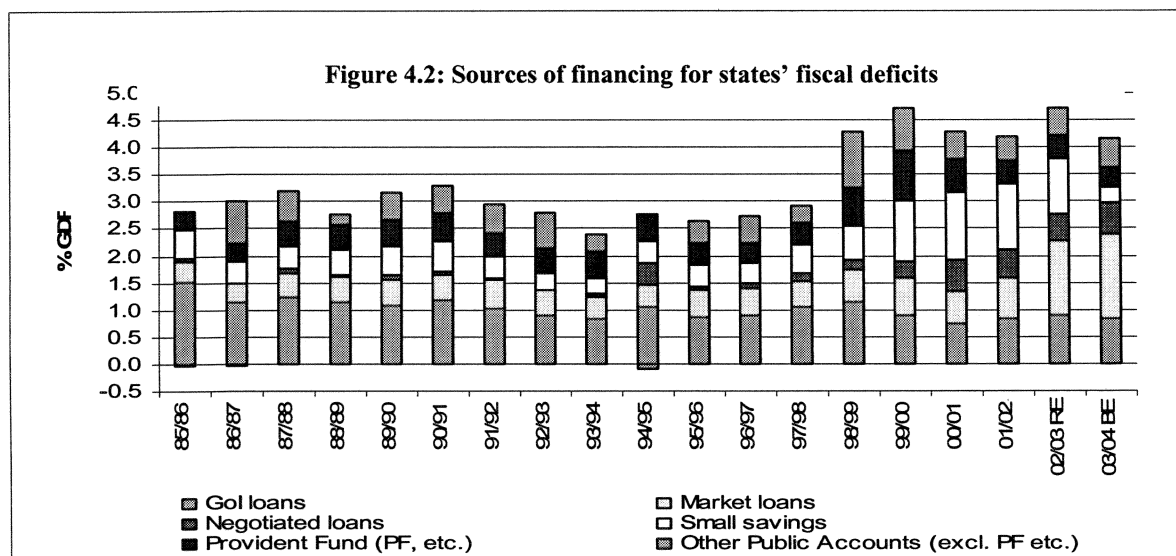
- (ii) *Market borrowing.* State bonds are issued to banks and financial institutions through a process managed by the Reserve Bank of India. Bonds from different states are sold at the same time and at the same price. RBI also manages debt-servicing for these bonds, and allocates for this purpose funds transferred from the central government, all of which pass through the central bank. Thus the bonds are supported by an implicit escrow arrangement though not by a central guarantee. The amount of borrowing per state is determined by GoI 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”, with room for central discretion and hence for lobbying.
- (iii) *Negotiated loans.* These are from public insurance companies and other GoI-owned financial institutions. The target for such borrowing is set at the time of Annual Plan finalization
- (iv) *Small savings:* Net public deposits from central post office savings schemes with administered interest rates that have been maintained above market rates, along with income tax incentives extended by the center, 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 under a scheme introduced by GoI in 2002. Small savings used to be merged with other GoI loans, but are now accounted for separately.
- (v) *Provident funds.* Flows into provident and insurance funds are involuntary savings of the state government employees at administered interest rates – the net inflow being the difference between the deposits of 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.
- (vi) *Other Public Accounts.* In addition to the five sources listed above, states also finance a portion of their accounted fiscal deficits through the “Public Accounts.” Besides the provident fund accounts considered in item (v) above, Public Accounts flows are best understood as accounting transfers, whereby expenditures are booked under a “deposit” account, but not actually incurred. The increase in the balance of the public account is then defined as having financed the booked expenditure. Expenditures booked in this way are by definition not incurred in the year in which they are booked, and experience shows that in fact they may not be incurred in subsequent years as well. The outstanding balance in Other Public Accounts is excluded from debt stock calculations, reflecting that they are largely non-debt creating.⁵

4.10 As Figure 4.2 shows (and as was also discussed in Chapter 1), deficit financing from all sources was constant at around 3% of GDP, but has been above 4% since 1998/99. Net small savings is estimated at about 30 per cent of total net deficit financing, prior to the recent debt-swap scheme under which fresh, cheap market borrowing has been used to retire old, expensive small savings loans. The debt swap scheme has pushed up market borrowings (bonds), but this was in any case a growing source, as have been negotiated loans. Loans from GoI, on the other hand, have shown a secular trend downwards in relative importance. Borrowing from provident funds has also declined to about 10 per cent of aggregate new borrowing. Net inflows from other Public Accounts fluctuate wildly, reflecting accounting adjustments rather than real debt accumulation.

4.11 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, especially on the part of the better-off states. Various orders have recently been issued by GoI and RBI, which would, if implemented, bring off-budget borrowing to an

⁵ See Ravishankar and Mathur (2003) for further discussion, and also Box 1.5. Note that in this categorization other Public Accounts is defined residually, and thus also includes changes in the cash balance.

end. 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, sell it at a loss, and not have to pay for it. Recent changes in the mechanism for paying central power utilities have, to a large extent, closed off this loophole (para. 1.31).



Note: All financing sources are shown on a net basis. The allocation between small savings loans and (other) GoI loans is an approximation, since, although fresh small savings loans are now shown separately from GoI loans, repayments on old small savings loans are still shown together with repayments of other GoI loans. The allocation of net lending between the two sources is done on the same ratio as that of gross lending. 2002/03 REs and 03/04 BEs are in addition adjusted for debt-swap proceeds between market and GoI loans as per RBI (2004c), on the assumption that the entire proceeds were used for retiring high-cost small savings loans, rather than any other GoI loans.

The strengths of the sub-national borrowing regime are its ban on offshore borrowing, and the limited history of bailouts. The weaknesses are the looseness of overall central control and absence of market-based discipline, leading to too much debt accumulation by states

4.12 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; the strong controlling role given to the central government under the constitution; and the limited history of bailouts. Although there have been some debt write-offs offered periodically by various Finance Commissions, these amount to about 7% of GDP over a 30-year period, and perhaps 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, and is partly a result of the other problems listed below. India's states were already heavily leveraged before the crisis of the late 1990s; Since then, the state-level debt burden has skyrocketed and Indian states now have the highest debt/revenue ratios of any sub-national entities world-wide (Box 4.1). The poorer states are particularly indebted with significantly higher deficit and debt ratios than the other states (see Table 1.3). In the last two years, GoI has wisely controlled the use of small savings for deficit financing by earmarking a significant and

increasing portion to retire old, high-cost debt to the center. However, this can only be a temporary solution.

- *Limited use of the center's 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. That borrowing by the states of India has grown to unsustainable levels even though it is formally under the control of the center shows that the actual effective control over sub-national borrowing is far below what the Constitution of India allows for. Of the borrowing sources outlined above, only two – loans from GoI itself, and market borrowing – are clearly under the effective, annual control of GoI.
- *Interest rates independent of 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 said 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 creditworthy: thus the better-managed states cross-subsidize the worse-managed ones. Such practices enormously weaken the incentives for prudent fiscal behavior. In 1999, the RBI did allow states to sell bonds on their own in state-specific auctions, up to 35% of their total market borrowing allocation; more recently some states have even raised up to 50% of their allocation in this way. But this remains only an option, not a requirement, and in fact reliance on state-specific auctions is declining, not increasing.
- *Complex system, with elements of discretion and arbitrariness.* The borrowing regime is complex with multiple borrowing channels, each with its own rules. There are elements of discretion and arbitrariness, especially relating to open-market borrowings, the allocation of which 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 financing public expenditures that is to be maximized rather than managed. India is also one of the few federations in which the central government acts as a direct creditor to the states. This again gives rise to lobbying opportunities. Several econometric studies have shown undesirable outcomes from this arrangement (see Box 4.2), including that politically powerful states get more access to central loans, and end up with higher deficits.
- *Soft budget constraints.* 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, are repeatedly bailed out, and states in stress are sometimes given additional loans by the central government. This sort of behavior clearly weakens the incentives for fiscal prudence (McCarten, 2003; Anand, Bagchi and Sen, 2003).
- *Plan financing out of step with pro-reform fiscal framework.* The emphasis on enlarging the aggregate size of State Plans and the system of financing such plans through a package of central grants and loans, plus loosely controlled domestic borrowing, has fed into a spiral of debt accumulation by the states, unrelated to the debt-bearing capacity of each state (see Box 4.3). The system has allowed states to substitute revenue transfers with borrowed funds during the 1990s, and so to persist with an expansionary and unsustainable fiscal stance. There are some welcome signs that the pursuit of enlarging the plan size each year has been moderated to some extent since 2000/01: the year-on-year growth of targeted state plan outlay is now below the rate of GDP growth.

4.13 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 state debt. We consider these in turn.

Box 4.3: Problems in the financing of state plans

The approach to, and mechanism of, financing the public sector plan of each state continues to encourage fiscal profligacy on the part of the states. Indeed, in the words of one analyst (Rao, 2004), India's planning process is the "most important reason for the deterioration in state finances." Since the size of the State Plan is finalized after the annual budget is presented, the borrowing agreed to for plan financing is taken as guaranteeing a floor rather than imposing a ceiling on a state's annual borrowing, and 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 maximizing the size of their annual plan; and
- seek additional borrowing to make up for any revenue shortfall during the year, in the name of meeting annual plan targets

A recent, 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.

Some suggestions for reform of the annual planning process and the role of the Planning Commission are explored in para. 4.42.

The most important reform to the borrowing regime would be to introduce an aggregate borrowing cap and allow for greater flexibility over the choice of borrowing instruments within the cap.

4.14 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."⁶

4.15 There is thus a strong case, in the short to medium term, for Government of India to impose an aggregate cap on each state, i.e., place an upper bound on that state's annual net borrowing. Within that cap, however, states could be provided with 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 bargaining by the states for additional loans, and for the center to use its discretion to approve additional loans.

GoI has in fact already begun to move in this direction. Various steps could be taken to move this reform further forward.

4.16 The Ministry of Finance has started to use the borrowing levels specified in the Medium Term

⁶ Anand, Bagchi and Sen (2003, p. 95)

Fiscal Restructuring Plans of the various states (submitted under the Fiscal Reform Facility – see Annex 5) as caps on aggregate state borrowing. It has also started to allow states greater flexibility with regard to some sources provided it stays within the overall cap. The 2004/05 Union budget gave states the option to borrow from the market instead of from the central government. That said, there is clearly a long way to go. There is no formula for defining the caps, and no mechanism for ensuring their enforcement. We outline below some of the steps which could be taken to move further in the reform journey on which GoI has already embarked on.

- The first step would be to shift to a formula-based approach for defining the aggregate cap for each state. Many countries have such caps: see Box 4.4 for examples. The cap should be based on observables, and not subject to negotiation: It could be defined in terms of debt servicing or debt stock or annual net borrowing, as a percentage of GSDP or total revenue receipts in an earlier year. Given that states are now adopting fiscal responsibility acts, the central government could simply adopt, and enforce the borrowing targets already legislated by the states. The targets, however derived, 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.
- 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 central law (e.g. Brazil's 2001 Fiscal Responsibility Law) or simply by administrative order. *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 administer the recommended hard borrowing ceilings.
- Borrowing arrangements within the cap should be simplified to the extent possible. Just as GoI is, so should the states 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 higher interest rates. If necessary, GoI could also offer a guarantee facility, at a price, to backstop poorer states. This facility could either be as a guarantee on market borrowing by state governments, or through direct intermediation by the central governments (i.e. state governments that wanted to could borrow from the central government rather than the markets but at a higher rate).
- 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 could be phased out. This would not only be consistent with international practice, but also with the principle of reducing complexity and discretion, while 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 4.43.

- 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 market-determined interest rates on sub-national debt that reflect risk premia, is not immediately feasible for India, 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 4.4 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. It is important that projections used for these ceilings be realistic, preferably conservative. It is equally important that a comprehensive debt definition be used.

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

Petersen and Valadez (2004) also provide 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 sub-national debt instrument contains a statement that there is no express or implied central government guarantee.
- Brazil: As part of the Fiscal Responsibility Act (FRA), a debt limit equivalent to two times the states net current revenue was set. States that were above this ratio were given a 15-year period to adjust to the limit. Each year, they had to reduce by 1/15th the difference. The FRA also authorizes new debt only when debt service does not exceed 11.5% of current revenue. It forbids lending between levels of governments.

Burki, Perry and Dilinger (1999) note the mixed experience with borrowing controls on sub-nationals in Latin America. They argue for “neither a purely regulatory nor a purely laissez-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.”

4.17 The reform agenda sketched out above is ambitious. It could of course be picked up piecemeal. In principle, an aggregate cap could be introduced and enforced 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 clear benefits to both the center and the states. Moreover, without greater flexibility it will be much more difficult to enforce the caps.

4.18 While the introduction of aggregate borrowing caps is probably the reform with the greatest potential in terms of inducing fiscal adjustment at the state level, it is unlikely to 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 eventually do away with centrally-imposed borrowing caps.

Allowing states to borrow commercially to restructure debt is consistent with a shift to an “aggregate cap with flexibility” model. But debt relief raises a number of questions

4.19 The debt restructuring initiated by GoI over the last few years (para. 1.31) is a welcome development for the states. The practice of earmarking a significant ratio of small savings to retire high-cost debt has restricted the use of this source for deficit financing 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 the terms of small savings and their 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. Such mechanisms can be used to familiarize the states with 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. Debt restructuring would also be a good use of adjustment lending resources available from external funding agencies.

4.20 We have already seen that India’s poorer states are also the most heavily indebted. Even if these states are able to stabilize their debt stock, it will be at very high levels. Just as the international community has floated the HIPC (Highly Indebted Poor Countries”) initiative (summarized in Box 4.5), the suggestion has been made that GoI should float a Highly Indebted Poor States (HIPS) initiative, under which good fiscal performance would be rewarded by debt write-downs. There is certainly merit in this suggestion: a well-designed HIPS scheme could use indicators of state performance similar to or same as those suggested for the Fiscal Reforms Facility (discussed in Annex 5) with perhaps a greater emphasis on a track-record of several years’ 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”. He noted that, in a scenario in which sovereign states were defaulting on their debt, agreeing on a workout could be in the interest 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 grant assistance are equivalent. As noted, India already has the Fiscal Reforms Facility, which provides additional grants to reforming states. Rather than adding yet another scheme to a system of transfers that is already very complex, more resources can be made available under the FRF as part of its strengthening , with particular targeting if required to the poorer, highly-indebted states, subject of course to meeting the performance benchmarks.
- Second, since the set of highly-indebted and poor states largely overlap, any shift towards a more progressive distribution of resources (discussed in the next section) will at once ease the relative debt-burden of the HIPS.
- 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 much higher than even the most indebted state (Box 1.2). The rationale for a more-indebted creditor to extend debt relief to less-indebted debtors is questionable.

4.21 Thus, while the problem of excessive inherited debt of poor states certainly needs to be addressed, provision of conditional debt relief may not be the best way forward. The problem could also be addressed through the reforms discussed in the next section, namely more horizontal equalization and rewards for fiscal performance. Even a well-designed conditional debt relief 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 4.5: HIPC Initiative- what is it, and has it worked?

The Heavily Indebted Poor Countries (HIPC) Initiative was launched in 1996 by the World Bank and the International Monetary Fund (IMF) with the goal of reducing the constraint that the debt build-up in HIPCs imposed on economic growth and poverty reduction. The HIPC Initiative was enhanced in 1999 to bring about deeper, broader and faster debt relief, as well as a stronger link between debt relief and poverty reduction.

The key debt burden indicators used in the HIPC Initiative are the NPV of debt-to-exports (NPV/X) ratio, or alternatively – in countries classified as very open economies and making strong efforts to generate revenue – the NPV of debt-to-revenue (NPV/R) ratio. Debt relief to a country under the HIPC Initiative is provided such that the relevant indicator (NPV/X or NPV/R) is lowered to a established threshold (150 percent and 250 percent, respectively). Initially, a country was required to demonstrate 6 years of “good performance” to benefit from HIPC debt relief: a 3-year track record of macro stability and policy reform was required to reach the “decision point”, and then another 3-year track record period to reach the “completion point”. The enhancement of the Initiative in 1999 allowed to speed the delivery of assistance through the provision of interim debt relief between the decision and completion points, and the introduction of “floating” completion points that would allow strong performers to reach the completion point faster.

Twenty-seven countries -more than two thirds of the HIPCs- have reached their decision points and are receiving debt service relief that would amount to more than US\$54 billion over time. Of these twenty-seven countries, fifteen have already reached their completion points. As a result of a decision taken recently by the Boards of the International Development Association (IDA) and the IMF, the “sunset clause” of the HIPC Initiative has been extended from end-2004 to end-2006. Countries potentially eligible for HIPC assistance will be identified using HIPC income and indebtedness criteria based on end-2004 data. Future HIPC debt relief will be restricted to these countries provided they would have adopted reform programs prior to end-2006.

It is still too early to conclude if HIPC has worked or not. The Operations Evaluation Department of the World Bank has carried out an initial review of the HIPC Initiative (2003) and found that if the anticipated debt relief is delivered, the initiative is likely to succeed in substantially reducing HIPCs’ external debt and provide them with a “fresh start”. The report also highlights key challenges on the implementation of the Initiative, including the need to manage expectations of what HIPC can – and was designed to – achieve in terms of poverty reduction given current funding levels and policy and institutional constraints.

Evaluations of international debt relief efforts (not HIPC) 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, 2001) or with poor 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 (Government of Netherlands, 2004).

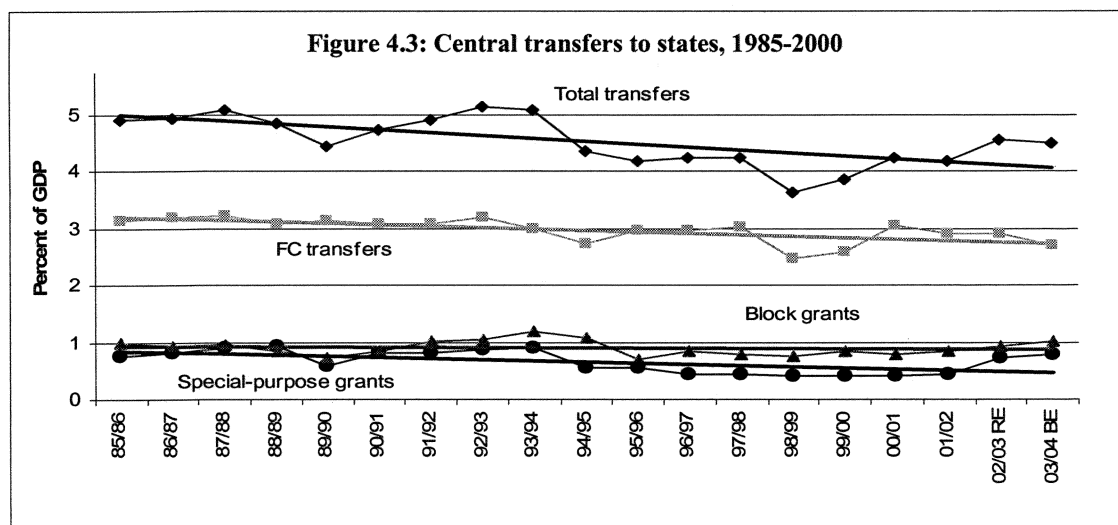
III REVENUE TRANSFERS (TAX SHARING AND GRANTS)

4.22 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 government and its expenditure responsibility. The center is resource rich relative to its expenditure responsibilities, while the states are revenue poor relative to their extensive mandate of expenditure responsibilities. This vertical imbalance, as measured by the share of

central transfers in total state revenues, is just under 40%, which is high by international standards Figure 3.2 and 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.

4.23 There are three principal ways in which the vertical gap is filled by transfers from the centre to states: Finance Commission (FC) transfers, block plan grants that are linked to plan loans, and specific-purpose grants for schemes designed or sponsored 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 in the late nineties. Some decline in all three sources of transfers is responsible for this. Some brief details on the three types of transfer channels are given below:



(i) *FC transfers* are largely untied, mandatory and formula-based transfers, consisting of tax-sharing and unconditional grants,⁷ which are distributed among the states for a 5-year period according to formulae recommended by the Finance Commission, a constitutional body.⁸ As Figure 4.3 shows, FC transfers account for the major 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,⁹ which weights both need and performance, and a small (about 10%) grant component that is determined (using the so-called “gap filling approach”) on the basis of the gaps between revenues and expenditures of states, projected over five years starting from estimated actual levels in a base year.

⁷ 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, the Fiscal Reform Facility (see Annex 5).

⁸ 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.

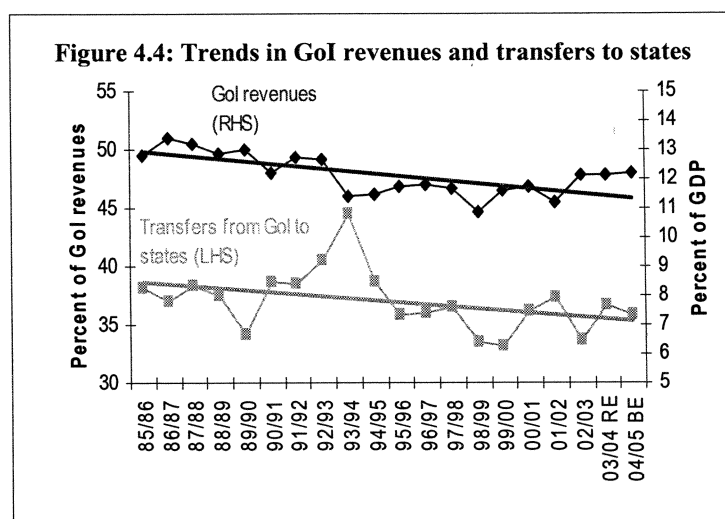
⁹ The formula varies from commission to commission: the Eleventh FC formula used weights of population (10%), income differential with the richest state (62.5%), area (7.5%), index of infrastructure (7.5%), tax effort (5%), fiscal discipline (7.5%). Note that this approach is similar to that used for the distribution of concessional aid that is distributed by the International Development Association, which also relies on a formula which weights both need (poverty) and performance (as measured by a country policy and institutional rating).

(ii) *Block plan grants* (called “Central Assistance to State Plans”), are the grant component of the mixed grant-loan transfer overseen by the Planning Commission. Block grant transfers make up about 20% of total transfers, and just less than 1% of GDP.

(iii) *Specific-purpose or conditional grants* (called “Central Assistance for Central and Centrally Sponsored Schemes”) finance centrally designed programs that are implemented by the states, either as 100% central financing or 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 poverty alleviation; 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. A rising share of 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 or executive agencies. 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, 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 are small relative to other transfers, but are a significant development in the Indian fiscal federal landscape.

Transfers from GoI have fallen due to fiscal stress at the centre, but there has been a partial recovery in recent years.

4.24 As Figure 4.4 shows, central transfers have fallen over the last two decades largely because GoI revenue has fallen as a percentage of GDP, and to a lesser extent because there has been a decline in grants to the states as a percentage of central (gross) revenue. In the last few years, stronger revenue growth, and an increased share going to the states have helped reverse the long-term decline in GoI transfers to states. However, transfers are yet to reach the 5% of GDP level last seen in the early nineties.



The formal transfer system is only modestly progressive, though the degree of progressivity has been improving over time.

4.25 Of the different transfer types, the FC transfers are the most progressive (negatively correlated with the income level of states), while other GoI transfers are 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, the per-capita transfer to the poorest state is a little less than double that of the richest. While the richest states clearly get less than the poorest, some middle-income states get more. For example, Tamil Nadu, Kerala, and Andhra Pradesh all received at least as much by way of central transfers per-capita as Uttar Pradesh during 1995-2000.

4.26 Although progressive, central transfers, separately or combined, do not come close to achieving anything like horizontal equalization. Figure 4.5 shows total per capita revenue for the 16 major states in 2001/02, normalized to the state with the highest revenue per capita that year, Haryana. 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. Bihar and Uttar Pradesh receive about the same volume of central transfers on a per capita basis as the middle-income states, and, with low own revenues, end up with less than half of the per capita revenue capacity of Haryana. The other poor states, with higher own-revenue, do slightly better, but nevertheless end up with no more than 60% of Haryana's revenue, except for Rajasthan which has 70%.

Table 4.1: Per capita transfers to India's states (average for 1995-2000)

	FC transfers	Special purpose grants	Block grants	Total
Poor states				
Bihar	166	13	22	200
Uttar Pradesh	118	13	21	152
Orissa	149	22	30	202
Madhya Pradesh	147	39	18	204
Rajasthan	116	32	19	168
Weighted average	135	20	21	176
Other states				
Andhra Pradesh	130	24	20	174
Karnataka	105	25	17	146
Kerala	123	20	15	159
West Bengal	101	12	22	135
Tamil Nadu	112	19	21	151
Gujarat	95	14	18	127
Haryana	71	25	19	115
Punjab	77	18	15	111
Maharashtra	73	16	16	104
Weighted average	100	18	19	137
Weighted average 14 states	116	19	20	155
Correlation with GSDPpc (major states)				
	-0.82	0.00	-0.67	-0.78

Note: Transfers in Rupees, adjusted for inflation.

Figure 4.5: P.C. revenues for the major states, 2001/02 (normalized)

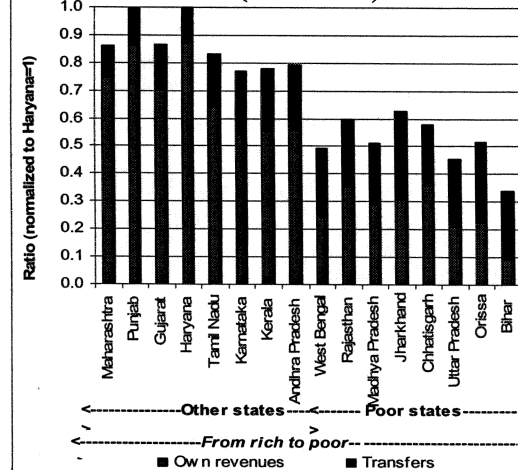
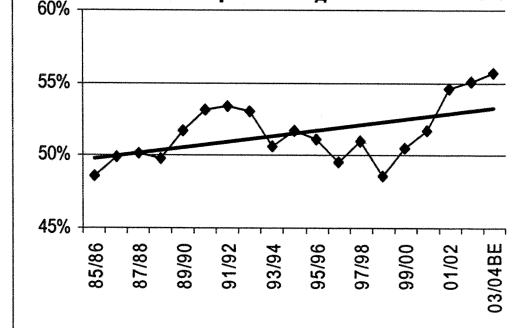


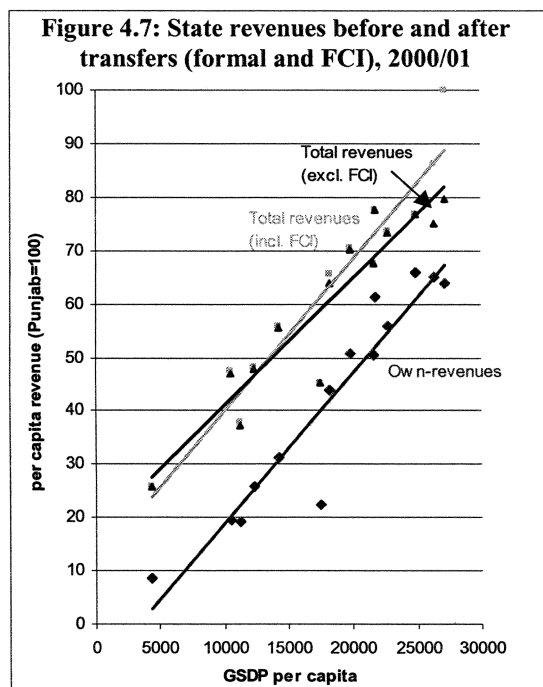
Figure 4.6: Transfers from GoI to the low-income states as a percentage of total transfers



4.27 Finally, Figure 4.6 shows the percentage of the total transfers that go to the seven poorest states, out of the amount which goes to the 16 major states. Amidst the volatility, there is a discernable trend upwards in the share of transfers going to the poorest states, suggesting an increase in progressivity over time.

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

4.28 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 (FCI) to procure at above market prices from particular states. 73% of the rice and 84% of the wheat purchased by the Food Corporation of India (FCI) is from the relatively well-off states of Haryana, Punjab, and Andhra Pradesh, even though these states produce only 26% of India's rice and 35% of its wheat. Farmers in these states enjoy assured sales at prices, which are much higher than where the FCI is not active.¹⁰ 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 transfer system: for example, in 2000/01, Punjab got Rs 814 per capita through the FCI subsidy, but only Rs 636 per capita through the formal transfer system.



Note: Per capita subsidy implicit in Food Corporation of India procurement of food produce (from World Bank, 2004e) added to formal transfers from GoI.

4.29 The informal transfers vitiate the modest progressivity of the formal transfer system. This can be seen from Figure 4.7 wherein the trend line plotting 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, including FCI transfers). The trend line showing per capita total revenues, but including formal revenues only, is less steeply sloped, indicating that there is at least some progressivity in the formal system, but that this is offset by FCI transfers which benefit better off states. Thus, on average, once FCI transfers are taken into account, all states gain the same amount per capita from the transfer system.¹¹

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

4.30 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, on the basis of FC transfers from individual central taxes to all taxes is also a welcome development. Another positive development over the nineties

¹⁰ 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."

¹¹ 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) provide estimates that, for example, Uttar Pradesh loss 0.8% of its revenue in taxes paid to other states. Of course, there are other implicit transfers, and one could also look at the geographical incidence of central government expenditure. The point here is simply that there are large, regressive implicit transfers.

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; Kannan *et al*, 2004).

- *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 at each level of government. Econometric evidence (summarized in Box 4.2) 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, in fact all sources of transfers show a decline, including both mandated and discretionary transfers. 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 food grain procurement is also taken into account, all states receive roughly equal per capita transfers, regardless of income. It should be noted here that there are other federations which also show only partial equalization (Box 4.1).¹² However, given the vast disparities within India, it is unlikely that a per capita distribution of transfers is optimal. Indeed, there are strong efficiency and equity reasons for a more progressive distribution of resources.
- *Weak incentives for reform and good performance.* The practice of Finance Commission to award additional grants to states with large projected revenue deficits 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 data or forecasts. 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 transfers are determined in part by factors other than need and merit, in particular political affiliation (Box 4.2).
- *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.
- *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 over 130 such schemes.¹³ 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 Ministry of Finance are all key players, but

¹² The Brazil comparison is particularly interesting. World Bank (2002a) shows that the standard deviation of income per capita of the states is 50% of the mean and the same figure for state revenues is 36%, i.e. a proportional reduction of 28%. The same figures for the 14 major states of India are 35% and 28%, a proportional reduction of 20% (exercise done for 2000/01 for India, and new states clubbed with the states from which they were created).

¹³ The GoI Expenditure Budget, 2004-05. These programs are administered by 27 line ministries/departments.

each has responsibility for particular areas, and none can control the behavior of the others, and thus plan for reform of the transfer system in an integrated way.

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

India's system of revenue transfers is complex, and there are various reform options.

4.31 Given the complexity, India's system of revenue transfers is more amenable to a discussion in terms of options rather than clear-cut prescriptions. But from the summary diagnosis above, some recommendations are straightforward.

- *Block plan grants should be de-linked from loans.* Separating grants from loans is a requirement for the rationalization of debt management discussed in the previous section, including the imposition of aggregate borrowing caps. Once they are separated, grants and loans can be allocated using different criteria: loans on the basis of creditworthiness, grants on the basis of need and/or performance.
- *Hidden or informal transfers should be eliminated.* As discussed in Chapter 3, the Central Sales Tax, which results in a regressive hidden transfer of resources from poorer to richer states, needs to be phased out. Procurement of farm produce, though beyond the scope of this report, also needs a major overhaul (World Bank, 2004e).
- *Use of projected deficit levels, starting from an actual 'base year' level, to determine a portion of mandatory transfers, should be discontinued.* These "gap-filling grants" of the Finance Commission generate adverse incentives against expenditure saving measures and realistic revenue forecasting by the state governments. The mandatory transfers would then become entirely formula driven, using parameters that measure differences in revenue capacity and/or expenditure disadvantages, independent of actual figures pertaining to any "base year".

4.32 These three recommendations would find widespread support among Indian analysts, 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) can a larger share of transfers be made conditional on state level performance, without compromising on the equity objective?

4.33 It is generally argued in the fiscal federalism literature that (a) vertical imbalance should be reduced to promote state-level accountability, (b) horizontal imbalance should be reduced both for equity, efficiency and national standardization objectives; and (c) conditional grants should be used to increase spending in particular areas where there are cross-state externalities or where national and state priorities diverge. In the conditions of India, the application of these general principles poses some specific problems. First, because own-revenue is an increasing function of per capita income, reducing vertical imbalance (by increasing the state's tax base) would increase horizontal imbalance. Second, because the performance of governments of the poor states is seen as being particularly weak, there is an apparent conflict or trade-off between reducing horizontal imbalance and rewarding performance. Third, the Constitution gives no clear guidance on the degree to which the system of central transfers should attempt to fill the horizontal gap, and judgments vary on the trade-off between the degree of fiscal equalization and what is compatible with the fiscal sustainability objectives of the central government.

4.34 Bagchi and Chakraborty (2003) argue that "in the last analysis, the task of fiscal transfers is to provide a level playing field", and that transfers should be primarily equalizing and unconditional.¹⁴ On the other hand, Godbole (2001) argues that central transfers already give more weight to equity than is justified by good policy, and that "the golden rule must be not to release any funds unconditionally".

¹⁴ See also Bagchi (2003) and Chakraborty (2003).

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).

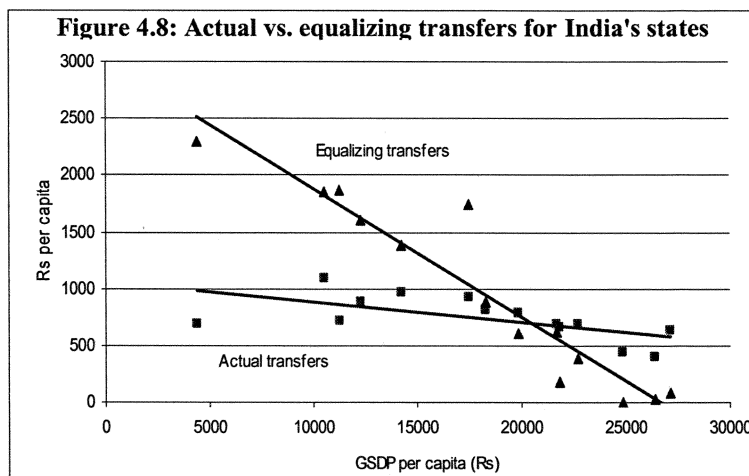
4.35 Recognizing the difficulty of the issues and variety of views involved, and the absence of any simple solution, we present below some analysis, options and suggestions for reform of the center-state transfer system.

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

4.36 Reduction of vertical imbalance would require increasing the taxing capacity of the states. This reinforces 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).

Adoption of a Representative Tax System would be a positive step forward towards horizontal equity.

4.37 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. How far central formal transfers are from achieving this goal is shown by Figure 4.9, which plots actual transfers against revenue 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.¹⁵



Note: Actual transfers are for 2000/01. Equalizing transfers are those which would equal post-transfer revenues at the level of the highest own-revenue state in 2000/01.

4.38 While full equalization may be ruled out as too radical an option, there are ways through which the current system can be made more progressive. One alternative would be to simply give greater weight to the need variables in the current FC allocation formula, which, as mentioned earlier, weights both need and performance. An alternative, which has the advantage of making the equalization objective more explicit, would be for the Finance Commission to dedicate part of its transfers to an equalization objective that 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 4.6),

¹⁵ 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 per capita 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.

allows the level of equalization to be set at less than 100 percent. For instance, a system that guarantees each state at least the average revenue capacity of all states would, rough calculations suggest, cost about 50% of FC transfers. 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 4.6: Representative Tax System (RTS) approach to fiscal equalization

The RTS approach has long been used by mature federations such as Canada (Hobson, 2002), and has recently been adopted by the Russian Federation. 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 (Shah, 1994). The equalization entitlement for a state can be negative or positive. For a federal program, as in India, negative entitlements are ignored and the federal government compensates the states for deficiencies in fiscal capacity, in effect by providing a revenue floor for states. (In Canada 8 out of 13 provinces receive transfers under the RTS.)

There are two ways in which the RTS system could be applied to India. The standard one, used in Canada, is one in which information on individual tax bases and rates is compiled and aggregated. Rangarajan and Srivastava (2004), in their recent review of the Canadian RTS point to the data difficulties this would involve on account of the lack of “comparable and reliable information required for this purpose.” The alternative pointed to by these authors is to use a “macro-indicators” approach in which tax capacity is estimated based on aggregate indicators such as per capita state product or income.

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 (Spahn and Shah, 1995; Rangarajan and Srivastava, 2004), 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.

In a fiscally-stressed system, a critical enabler for more progressivity in the transfer system, that is, more revenue for poorer states, is for GoI to increase its tax/GDP ratio.

4.39 Poor states need more revenue, but the better-off states are also fiscally stressed, and could not afford a reduction in transfers relative to GDP. And, as we have seen (Box 1.2), in many ways GoI is more fiscally stressed than any of the states. The only way to square this circle is for GoI to aggressively pursue its goal of increasing its tax/GDP take, and for this additional revenue to be distributed at the margin towards the poorer states. Recent statements indicate that GoI is aiming at an increase in the tax/GDP ratio of about 2 percentage points. As the scenarios in Chapter 5 show, this is crucial not only for central but also state government fiscal sustainability and equity.

To improve incentives for performance, it is important to rationalize the existing range of specific-purpose grants.

4.40 There is widespread agreement on the need to rationalize the large number of specific-purpose grants (Centrally Sponsored Schemes). The 2004 Union Budget speech referred to the “plethora” of Plan schemes, and their “mind-boggling” number and variety. The Planning Commission has been given the mandate to rationalize these schemes, in line with the commitment of the current central government to transfer most of them to the states. While a detailed analysis of this issue is beyond the scope of this report, one can note that international experience (summarized in Box 4.7) would support a shift towards a small number of non-discretionary grants 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. However, unlike in India, the expenses would not necessarily be 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 potentially available to the poor states could be increased, but with access still dependent on performance.

Box 4.7: 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. Conditional transfers to set national minimum standards can be used to encourage the attainment of economic union or a common internal market. By imposing conditions on attainment of service standards, and broader access to these services especially by the poor and disadvantaged, such transfers can foster national efficiency and equity objectives without undermining state and local autonomy.

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. The re-designed program is an example of a simple (per capita) program with conditions on standards and access of health care but not on the use of funds. Canada, USA and Indonesia used these transfers to create a national network of highways and link roads. Various developing countries have used them to widen the access of health (Brazil) and education (Chile and Colombia).

Sources: Boadway and Wildasin, 1984; Shah, 1998.

4.41 As noted earlier, an important response by the central government to the deterioration in state finances has been the creation of a number of reform incentive funds. The Fiscal Reforms Facility – analyzed in greater detail in Annex 5 – rewards fiscal adjustment, and there are now also funds to incentivize power and urban reforms, among others. These funds are controversial, and seen by some as too intrusive. However, they also counter-balance the incentives in the system for irresponsible behavior. While of course incentives against good performance should be removed where possible, some will likely be permanent features, such as a high degree of vertical imbalance. Thus there is a good case for strengthening rather than eliminating these reform facilities, at least at the current juncture. Options to strengthen the FRF in particular include: (i) increasing transparency by, for example, making all transactions and agreements under such funds public; (ii) setting the adjustment path according to the initial conditions of each state, so that targets are not unrealistic for some and inadequate for others; (iii) defining indicators in terms of targets the states themselves use (e.g. targets in their own Fiscal Responsibility Act) and/or can control (such as the salary bill to own-revenue ratio); (iv) strengthening reporting requirements, so as to restrict the scope for creative accounting practices, such as postponing payments and/or distorting expenditure through transfers to public accounts; and (v) using block plan grants, hitherto linked with loans, to enhance the total size of incentives under the FRF.

IV INSTITUTIONAL ISSUES AND EXTERNAL FUNDING AGENCIES

There are some important institutional reforms, which would help strengthen India's fiscal federal arrangements.

4.42 One major source of difficulty in implementing reforms in the system of center-state transfers is that different central actors determine different components of central transfers. Rationalization of the system requires a road map covering all three formal channels of transfers from the center to the states, as well as the five channels of loans. Coordination 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 aggregate 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 the functioning of fiscal federalism in India:

- The first would be if the Finance Commission was made a permanent body, as it is in Australia, for example. This would improve co-ordination and data collection.

- The second would be if the responsibility for compiling timely state-level fiscal data were entrusted to a single agency. The challenge is not just to improve the timeliness and accuracy of existing data reporting (though improvements in this regard would help greatly – see Box 1.5) 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; Anand, Bagchi and Sen, 2003).
- The third possible institutional reform would be an overhaul of the role of the Planning Commission with respect to state finances. As Box 4.3 indicates, the one fiscal indicator state chief ministers are most familiar with is the size of the state plan, and the target they have most internalized is to maximize the size of the plan, often by over-optimistic revenue targets or unaffordable borrowing levels. The elimination of the distinction between “non-plan” and “plan” expenditures is warranted, not only because the distinction lacks economic rationale, and complicates budgeting and accounting but because it would remove this incentive to fiscal imprudence, including the bias in favor of new investments at the expense of non-wage O&M. The practice of providing Planning Commission approval for a “plan size” for each state has little justification. Multi-year plans, if needed, should encompass the entirety of resources available for development in the state. The Planning Commission could then focus on the much more important role of being an overall strategy, monitoring, evaluation and reporting agency with respect to both fiscal and development outcomes.

External funding agencies are also participants in India’s fiscal federalism, and there are some implications of the above analysis for donors, and how government might treat them.

4.43 Donors contribute a mix of grants, concessional and commercial loans, and they pass their funds to states 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 (Srivastava, 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 into 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 at 9% interest, and 30% grant). 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 recent arrangements have profited the central government at the expense of the states, though this has varied over time (Srivastava, 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.¹⁶ 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 external funders. Much depends on the extent to which the central government wishes to use such agencies as levers for state reforms.
- As to where donors should concentrate their financing, this depends on whether the role of external financing is seen to be promoting horizontal equalization, or rewarding good

¹⁶ The 2004-05 Union Budget announced that the Government of India would “consider passing on external loans to the States on a back-to-back basis.”

performance and piloting new initiatives. These two forces may 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. Just as GoI has the Fiscal Reforms Facility to encourage better fiscal behavior, some external agencies offer to states structural adjustment loans (SALs), the performance of which is also evaluated in Annex 5. 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 external financing, since state governments are constitutionally forbidden from borrowing off-shore? 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 Six years on from the onset of the fiscal crisis, many states have embarked on the reform path, but none have yet fully recovered. While all state governments accept the necessity for reform, 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. There are pressures for a wage increase. Farmers are vocal in demanding government support and want more subsidized power. Industry complains of a heavy tax burden. We have already shown that, without a continuation of reforms, the fiscal situation will deteriorate, even with good growth (Chapter 1). If the states continue with reforms, will they be able to stabilize, and will this require sacrificing productive expenditures?

5.2 This chapter begins with a proposed states' reform package applicable for most states, culled from the analysis and suggestions of Chapters 2, 3 and 4. We then model the reform impact, and show that, with the reform package proposed in this report, states can emerge from the fiscal crisis, and emerge strengthened as developmental actors. However, this will only be possible if a sustained, cross-sectoral and cross-government reform effort is undertaken, at both the central and state levels. The scenarios outlined in this chapter are largely best-case scenarios and, we conclude by considering various risks.

II SUMMARY OF RECOMMENDATIONS

5.3 **Proposed expenditure and revenue reforms.** The key expenditure and revenue reforms proposed for the states from Chapters 2 and 3 are summarized below in Tables 5.1 and 5.2 respectively. Given the many responsibilities of the central government with respect to state taxes, reforms in Table 5.2 are marked as those which can be undertaken by the states only (S), by the centre only (C), and by joint action (C/S).

Table 5.1: Key expenditure reform recommendations

Area	Problem	Suggested reforms
Expenditure Restructuring		
Salaries	Salary bill is large and crowding out other forms of productive spending	<ul style="list-style-type: none"> • Maintain a policy of no real wage increases and no net hiring. • Offset required hiring in priority areas by downsizing in non-priority areas.
Pensions	Pension spending is a rapidly mounting liability. Short-run parametric reforms are needed as well as longer-term structural reforms	<ul style="list-style-type: none"> • Short-term parametric reforms including: (i) use of longer average periods for the calculation of benefits, (ii) use of higher discount rate; (iii) reduction in leave encashment limits, (iv) reduction in scope for commutation. • Shift from the current pay-as-you-go system to a defined contribution scheme. • Crack down on pension abuse.
Subsidies	Subsidies are fiscally costly and poorly targeted.	<ul style="list-style-type: none"> • Continue sectoral reforms (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. • Selective tariff increases to reduce cross-subsidies. • Strengthen subsidy management to define and limit government's liabilities.
Public	Limit the fiscal burden of public	<ul style="list-style-type: none"> • Continue privatization and restructuring.

enterprise reforms	enterprises on the budget and improve their performance	<ul style="list-style-type: none"> • Limit generosity of VRS schemes
Interest payments	Debt service accounts for a major share of recurrent spending	<ul style="list-style-type: none"> • In addition to fiscally responsible behavior to reduce debt burden, prepay high-interest loans where possible to reduce interest rates on outstanding debt.
Priority expenditures	Have been squeezed by the fiscal crisis	<ul style="list-style-type: none"> • Protect and enhance, subject to fiscal constraints, while paying due attention to improving expenditure efficiency.
Expenditure quality		
Service delivery	Poor expenditure quality undermines government effectiveness; causes include low accountability, and weak public expenditure management.	<ul style="list-style-type: none"> • Implement agency reforms including transfer of service responsibility to the private sector or local government • Strengthen the enabling environment for service delivery: promote cost recovery and commercial discipline; encourage citizen demand for better services; increase transparency; crack down on civil service transfers; establish strong and independent anti-corruption commissions. • Budget 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, and adhering to accounting and audit arrangements. • Strengthen managerial and policy-making capability.

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	<ul style="list-style-type: none"> • Implement VAT (C/S), with floor rather than harmonized rates. • Eliminate tax on inter-state trade (C). • Provide states with the authority to tax services (C). • Introduce functional organization, set up large tax-payer units (S).
Professions tax	Non-existent in many states, low ceiling.	<ul style="list-style-type: none"> • Introduce professions tax in all states and enforce more widely and vigorously (S). • Amend constitution to raise ceiling and allow further future increases (C).
Stamps and registration	High rates lead to low compliance.	<ul style="list-style-type: none"> • Lower tax rates on property transactions (S). • Increase rates on substitute transfer transactions (C/S). • Ban physical stamps (S). • Improve procedure for establishing guidance rates (S).
Transport tax	Buses overtaxed; private vehicles undertaxed.	<ul style="list-style-type: none"> • Raise tax rates on private two and four wheelers relative to buses (S).
Other taxes	Minor levies are distortionary and non-transparent.	<ul style="list-style-type: none"> • Remove entry tax, turnover tax, and surcharges as part of VAT introduction (S). • Merge entertainment tax, registration fees and luxury tax with tax on services (S). • Remove concessions (S).
Non-tax revenues	Significant deterioration in revenue performance.	<ul style="list-style-type: none"> • Reform system of mineral royalties and sale of forest produce (C/S). • Improve performance of user charges by close monitoring and

		more regular adjustments and better collection (S).
Cross-cutting administrative reforms	Weak accountability	<ul style="list-style-type: none"> • Strengthen and institutionalize Inter-state coordination and information sharing (C/S). • Improve enforcement technology and procedures coupled with computerization, better staff incentives, management flexibility and effective anti-corruption institutions (S). • Modernize, integrate and rationalize check-posts (S). • Improve taxpayer services through e-governance, citizen charters, etc (S).

5.4 Role of the central government. The ultimate responsibility for fiscal adjustment at the state level lies with India's states, but, as we have argued throughout the report, the required reforms are too important and difficult to be carried out by the states alone. We have outlined in Chapter 4 some proposals to strengthen India's fiscal federal framework. Of these, we would highlight two here. The first is the challenge of hardening the budget constraint by introducing effective global borrowing caps, within which states would be given more flexibility to manage their debt. The second is the need to reverse the decline in central transfers to the states. Given GoI's own deficit-reduction requirements, we have argued that this can best be done by increasing the central tax/GDP ratio since this automatically results in greater revenues for both the centre and the states, especially the poor states.

5.5 In addition, the center also plays an important role in the areas of state-level expenditure and tax reforms. As highlighted in Table 5.2, there are a number of critical state-level tax reforms, which require central leadership, prime among them the shift to VAT. The transfer of services to the states should be accelerated. A constitutional amendment to lift the ceiling on the professions tax would revitalize that tax, and perhaps raise close to 1% of GDP. 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, and, more generally, help improve the quality and timeliness of state-level fiscal data.

5.6 On the expenditure side, the prime need is for GoI, given its leadership role, to lead by example. Central government wage policy is particularly important in this regard. 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).

III MODELLING THE IMPACT OF REFORM

5.7 We run illustrative reform scenarios which implement the reform package described above. A recurrent theme in this report has been the divergent performance of poor states and other states, and heavier fiscal burden of the former group. The projections below therefore present separate scenarios for the 7 poor states (Bihar, Chattisgarh, Jharkand, Madhya Pradesh, Orissa, Rajasthan, and Uttar Pradesh) and for the other states. Our aim is to see whether both groups of states can eliminate the revenue deficit by 2007/08,¹ without sacrificing, and if possible increasing capital and non-salary operations and maintenance expenditure. Expenditure and revenue reforms are assumed to be the same, and to have the same impact across the two sets of states, but the central government reforms have a divergent impact, as shown below.

¹ We take this as the target date for achievement of this target, since this is the year by which GoI has committed to eliminate its revenue deficit under the central Fiscal Responsibility Act (though Common Minimum Programme of the newly-elected central government has shifted this target to 2008/09). Several state governments have committed to achieve revenue balance by an earlier date under their respective FRAs. The goal of the Fiscal Reforms Facility is to eliminate revenue balance by 2004/05.

5.8 Modelling the 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 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:

- Restraint on hiring and pay scales leads to a fall in wage bill to fall by an additional 0.2 percentage point annually (see 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 (Chapter 2).
- The impact of subsidy reforms is difficult to quantify. There are problems in both estimating the existing level of subsidies and the likely impact of reforms. For the sake of analysis, we estimate explicit subsidies at 0.8%. 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 actual subsidy was only 40% 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.
- To support growth and development, capital spending is increased by 0.5 percentage points over the forecasting period; and recurrent expenditures, other than salaries, pensions, interest and subsidies, are protected as a percentage of GSDP, and as fiscal space allows, increased.

5.9 Modelling the impact of state revenue reforms. We assume that, if these reforms are implemented, the revenue/GDP ratio will rise. Of course, a fair amount of guesswork 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 points starting in 2006/07 and a further 0.2 percentage points in 2007/08.²
- Other tax reforms, some of which are already underway (reducing stamp duty rates on sales and raising rates on substitute transactions, strengthening professions tax, and reforming the 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 2005/06.³
- Taxation of services starting in 2006 will increase revenues by 0.2 percentage points starting 2007/08.²
- 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, states' own-revenues increase by 1.5 percentage point of GSDP between 2003/04 and 2007/08.

5.10 Modeling the impact of central government revenue reforms. Higher central government tax revenues would lead to higher central transfers to the states. As outlined in World Bank (2003g) and in Hausmann and Purfield (2004), tax reforms at the center (eliminating exemptions, bringing 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.⁴ Under such a scenario, it seems reasonable to

² VAT is assumed to be introduced without compensation with revenue-neutral rates, so no revenue loss is expected from VAT introduction *per se*. However, early revenue gains from VAT and service taxation are assumed to be offset by CST elimination.

³ As we have noted, the revenue potential from the professions tax is much greater than this. But, since a constitutional amendment is required, we take a conservative view.

⁴ See also the recommendations by the two Kelkar Committees, GoI (2002b, 2002c and 2004).

assume that transfers to the states would increase by 0.5 percentage points of GDP on average over the forecasting period (transfers to the states are more than 35% of central revenues). Assuming there is no change in the share of major states in total transfers, and assuming there is no change in the share within major states (i.e. poor states will continue to receive the same share of transfers), an increase in transfers of 0.5 percentage point of GDP will translate into a 1.0 percentage point increase in GSDP of poor states over the scenario period (i.e. up to 2007/08) and a 0.3 percentage point increase in GSDP of other states over the same period.

5.11 **Other assumptions.** Macroeconomic indicators are as per the “no-reform” scenario outlined in Box 1.7. The same rate of growth is assumed for poor states and other states.⁵ As in the no-reform scenario, base line fiscal indicators are largely based on 2003/04 budget estimates, adjusted as necessary when they look unrealistic.

All states can stabilize their debt and achieve the zero revenue deficit target, but only if a sustained cross-sectoral and cross-government reform effort takes place.

5.12 Table 5.3 shows the key fiscal indicators under the reform scenario for the “other” (high- and medium-income general category, major) states. It shows that the zero-revenue-balance objective can be achieved if the reform package outlined and estimated above is implemented at both the central and the state level. Capital spending increases, as targeted by 0.5 percentage points of GSDP, and other recurrent spending (our proxy for non-salary O&M) increases modestly by 0.2 percentage points over the scenario period.

**Table 5.3: Reform scenario fiscal indicators for the high-and medium-income (“other”) states
(% of GSDP)**

	2003/04	2004/05	2005/06	2006/07	2007/08
Revenue receipts	12.2	12.6	12.9	13.4	14
of which: additional transfers from center	0.0	0.1	0.1	0.2	0.3
additional own-revenue	0.0	0.3	0.6	1.0	1.5
Total spending	16.7	16.6	16.4	16.4	16.5
Interest	3.2	3.2	3.2	3.3	3.2
Wage bill	4.2	4.0	3.8	3.6	3.4
Pensions	1.7	1.7	1.7	1.7	1.7
Subsidies	0.8	0.8	0.8	0.7	0.7
Other recurrent spending	4.8	4.8	4.7	4.8	5.0
Capital spending	2.0	2.1	2.2	2.3	2.5
Primary deficit	1.3	0.8	0.3	-0.3	-0.7
Fiscal deficit	4.5	4.0	3.5	3.0	2.5
Revenue deficit	2.5	1.9	1.3	0.7	0.0
Debt stock	30.0	30.7	30.8	30.4	29.5
Interest / revenue	26.1	25.2	25.1	24.3	22.9
Revenue deficit / revenue receipts	20.5	15.1	10.1	5.2	0.0

Source: World Bank Staff Projections.

Note: These figures are for some states and a percentage of GSDP, and so base year figures may not align with those in Table 1.7 (no reform scenario), which is shown for *all* states and as a percentage of *GDP*, but the underlying figures are consistent.

⁵ For 2003/04, we also assume constant growth across states, with real growth equal to the GDP growth of 8.1% assumed in the “no reform” scenario of Chapter 1. For 2002/03, we use state-specific growth estimates where available, and our own estimates in other cases.

Fiscal stabilization depends critically on policy performance, but for the poorer states performance of central revenues is especially important. The poorer states can also achieve a zero-revenue - deficit target in spite of lower incomes and worse fiscal indicators today if they undertake the same set of reforms as the better-off states and if transfers from the center are increased.

5.13 Table 5.4 shows the key fiscal indicators under the reform scenario for the poor states. It shows that for the poor states the zero-revenue-balance objective can also be achieved. Once again, capital spending is increased as per the targeted 0.5 percentage points of GSDP; however, non-salary O&M cannot be expanded but only protected relative to output. Critical to the achievement of revenue deficit elimination for the poor states is the large increase in central revenues. As a percentage of GSDP, they receive three times as much as the better-off states from the same projected increase in central taxes.

**Table 5.4: Reform scenario fiscal indicators for the poor states
(% of GSDP)**

	2003/04	2004/05	2005/06	2006/07	2007/08
Revenue receipts	18.0	18.5	19.1	19.8	20.5
of which: additional transfers from center	0.0	0.2	0.5	0.8	1.0
additional own revenue	0.0	0.3	0.6	1.0	1.5
Total spending	24.0	23.9	23.9	23.7	23.5
Interest	4.8	4.9	5.0	4.9	4.8
Wage bill	5.7	5.5	5.3	5.1	4.9
Pensions	1.9	1.9	1.9	1.9	1.9
Subsidies	0.8	0.8	0.8	0.7	0.7
Other recurrent spending	8.3	8.2	8.2	8.3	8.2
Capital spending	2.5	2.6	2.7	2.8	3.0
Primary deficit	1.2	0.5	-0.2	-1.0	-1.8
Fiscal deficit	6.0	5.4	4.8	3.9	3.0
Revenue deficit	3.5	2.7	1.9	1.0	0.0
Debt stock	46.7	46.9	46.6	45.3	43.3
Interest / revenue	26.7	26.7	26.0	24.9	23.4
Revenue deficit / revenue receipts	19.4	14.6	9.9	5.1	0.0

Source and notes: See Table 5.3.

Achieving the zero-revenue-deficit target will leave little room for a much-needed increase in productive recurrent spending; alternative fiscal targets such as debt stabilization and fiscal deficit reduction could also be considered.

5.14 Pursuing revenue deficit elimination by 2007/08 will lead to a sharp fall in debt, but will also leave limited scope for an increase in productive expenditures. A significant primary surplus is required to achieve the adjustment.

5.15 In the above scenarios, other recurrent spending, which can be interpreted as non-salary operations and maintenance, stay constant in relative terms (for the poorer states) and increases mildly for the better-off ones. As outlined in Chapter 2, non-salary O&M has already been squeezed over the nineties. It is not clear why capital spending should be increased, but not operations and maintenance. This path is taken in the scenarios because of the compulsion to achieve current balance. Some state governments may prefer a less tight fiscal adjustment path, which would leave greater room for increases in productive spending at the expense of a delayed achievement of the zero-revenue-deficit target. For instance, instead of a zero-revenue-deficit target, some state governments could aim in the short-term for a debt stabilization target, or a 3-4% fiscal deficit target (corresponding to primary rather than revenue balance). This would leave room not only for capital spending but also for priority current expenditure to expand.

IV RISKS

5.16 The scenarios outlined above rest on several “best-case” assumptions, in particular for the poorer states. Perhaps the most important risk across states is that the comprehensive reforms needed could be delayed due to political concerns, including elections, and resultant unwillingness by the states to take tough measures. Political obstacles to the needed hardening of budget constraints between the center and the states could further erode state finances and discourage reforming states.

5.17 Other risks could threaten the states’ development prospects. Even though interest rates have declined over the past 18 months, the states’ debt stock has continued to rise, albeit more slowly. Continued low interest rates will certainly help the states to adjust, but, 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.

5.18 Improved revenue performance by the central government is a critical assumption of the reform scenarios. If reforms at the center are not sufficient to achieve an increase in transfers equivalent to 0.5 percentage point of GDP by 2007/08, the consequences might not be dire for the richer states, since their revenue would be lower only by 0.3 percentage points of GSDP. The fall-out would be much worse for the poorer states, whose revenue would be short by 1.0 percentage points of GSDP, and who would be unable to achieve their deficit targets without severely compressing developmental spending.

5.19 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. There would be no fiscal space to protect other recurrent spending, including operations and maintenance. It is therefore of great 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 (2003g, 2004c). Again, this is of particular importance for the poor states. Their achievement of the deficit targets in the scenario rests on their achieving the same growth rate as the other states: something they were not able to do in the nineties (Table 1.1)

5.20 The devolution of contingent liabilities can also become an obstacle in achieving the fiscal stabilization targets outlined above. If the impact 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 debt stabilization and would also free up more resources for priority programs.

5.21 This is not the first time that a fiscal stabilization scenario has been drawn up for the state governments. The Eleventh Finance Commission drew up a similar set of revenue-deficit-elimination projections about five years ago. Sadly, reality subsequently disappointed. What will happen in the next five years? Fiscal adjustment will not be easy. States are now burdened with higher levels of debt than they had five years ago, a solution to controlling power sector subsidies remains elusive, and, as mentioned, there are signs of “reform fatigue”. In other respects, however, the prospects for state-level fiscal reform look much more promising today than they did five years ago. Good economic growth, better revenue performance, and low interest rates – not to mention the progress in fiscal adjustment made to date and the much more widespread recognition of the need for reform – are all conducive for fiscal adjustment. So is the fact that the system today is not absorbing a fiscal shock, as it was five years when public sector wages were increased. Grasping these opportunities, and staying the reform course, will be critical to meeting one of India’s most important national challenges: to stabilize fiscal indicators at the state level and, at the same time, to increase the development effectiveness of state governments..

ANNEX 1 (CH. 1): INDIA'S SPECIAL CATEGORY STATES, SMALL STATES AND UNION TERRITORIES

This report conducts its fiscal analysis at the all-state level, but focuses its attention on the 16 major, "general category" states where 92% of India's population lives. This annex provides a brief overview of the fiscal situation outside of these states. India is made up of 28 states and 7 union territories (UTs). Other than the 16 states considered by the report, there are: 11 'special category' (SC) states (hilly, border states with limited income-generating capacity, namely Jammu and Kashmir, Himachal Pradesh, Uttarakhand, Sikkim and the 7 north-eastern states); the small, rich state of Goa; the National Capital Territory of Delhi; and 6 other union territories which are administered and financed as part of the Union Government. About 6% of the country's population lives in the special category states, and another 2% in Goa, Delhi and the other union territories.

The 11 SC states combined have a total income of 5% of GDP, only about 1 percentage point higher than the income of Delhi and Goa together. Unlike the latter, most of the SC states have a per capita income below the national average, but they also show wide differences in development outcomes. The incidence of poverty is very low in Himachal Pradesh and Jammu and Kashmir. Poverty remains high in the north-east, being above 30% in Sikkim, Assam, Arunachal Pradesh, Meghalaya and Nagaland. According to the 2001 *National Human Development Report* of the Planning Commission, most of the SC states show above-average performance on the human development index (HDI) with high literacy rates. The fiscal performance of Delhi and Goa is quite different from that of the SC states. Delhi and Goa have high incomes, low deficits, and high levels of capital spending. SC states, in contrast, are high-deficit states that are very dependent on the centre. In spite of making up only 6% of the population, they receive about 20% of total GoI transfers to the states, including 20-30% of the total central assistance for state plans, because of their special category status. Non-statutory assistance is given to them at a special rate: 90% grant and 10% loan, versus the 30-70 formula other states are subject to.

SC states have very bad fiscal indicators despite the favorable treatment in terms of central devolutions. They are exaggerated versions of the poor major states with even lower levels of own-revenue and higher levels of central revenues and expenditures. Overall, they have similar levels of deficits and debt, though many among them have very high debt stocks (e.g. Nagaland has an outstanding debt stock of more than 80% of GSDP in 2003-04 according to budget estimates). They exhibit a large degree of volatility in their fiscal outcomes due to their dependence on central devolution. Their revenue deficits tend to be lower than the primary deficits, mainly on account of the very high levels of capital expenditure being incurred by them (though they remain low in infrastructure penetration as brought out by the CII, 2002).

Fiscal indicators for the major states (poor and other), SC states, and Goa and Delhi, 2001/02						
<i>Per cent GSDP</i>	Poor major states	Other major states	Goa and Delhi	SC states	Major states as percent of All States (incl. Delhi)	
Revenue	14.9	12.1	10.1	25.6	86.5	
Own revenue	7.2	9.2	9.2	5.9	92.3	
GoI transfers	7.7	2.9	0.9	19.7	77.1	
Expenditure	20.7	17.0	13.0	31.5	87.8	
Capital expenditure	2.2	1.5	4.2	4.7	77.7	
Primary deficit	1.7	1.9	1.3	1.4	92.5	
Revenue deficit	3.6	3.4	-1.3	1.2	99.5	
Fiscal deficit	5.8	4.9	2.9	5.9	91.1	
Debt stock	40.2	27.9	15.4	39.4	90.4	

Notes: Numbers for poor states given in the table above may differ from the text tables, e.g., Table 1.3. because in this table Uttarakhand is treated as a SC state, as it is, whereas, in some of the text tables, Uttarakhand is included with UP for comparability over time.

The issues facing the small and special category states and UTs are quite different from those of major states, which is why they are not addressed in this study. Goa and Delhi have the happy combination of low deficits along with high levels of capital spending. Special category states face different fiscal challenges, in particular fiscal dependency. Their fiscal correction will have to be driven by the central government, much more so than for the major states.

ANNEX 2 (CH. 2): CASE 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 projects in order to improve delivery of public services. Some have been clear successes. For example, the e-Seva project in Andhra Pradesh 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 land records was seen as the solution. An ambitious state-wide project to computerize the entire Department of Registration and Stamps was completed in a record time of 15 months. Though widely heralded as a success, a user survey in 2000/01 (Caseley, 2004) showed that although the time to register a document has been reduced from eight to three days (not the 1 hour claimed by the 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. Caseley 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 checkpoints, the Government of Gujarat decided to computerize 10 border checkpoints. 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 increasing revenue from checkpoints threefold, and again was heralded as a success. But apart from experiencing 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 back-end 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 are critical for the verification of success.

Sources: Caseley (2004), Panneervel and Bhatnagar (2001), Bhatnagar and Vyas (2001); Bhatnagar and Chawla (2004); Pandey (2002).

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, larger 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 as well as monitor the 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 promote transparent governance.

Source: Bhardwaj (2004).

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 15,000-20,000. 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. 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% to 95%, and the number of children fully immunized has increased from a baseline of 31% to 85%. 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 who 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 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 who 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%, the number of deliveries by 36%, and the number of laboratory tests by 82%. Outsourcing sanitation has resulted in very clean hospitals, as confirmed by a recent patient satisfaction survey, which indicated that 71% of PHSC patients were satisfied with the cleanliness of the toilets compared to 42% in non-PHSC facilities. This program is an example of successful introduction of some private sector management techniques, such as measuring performance and instilling a results-oriented culture, into a public-sector bureaucracy.

Source: World Bank (2004d).

Case 4. The Bangalore service delivery turn-around

The Public Affairs Centre (PAC) 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?

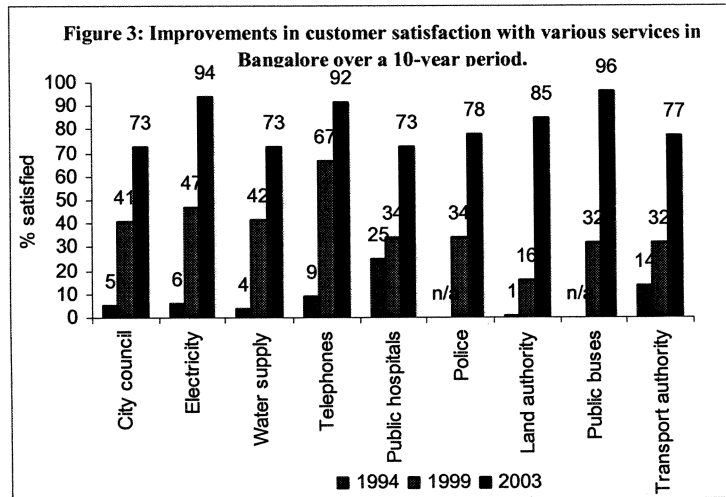
In several cases, the improvement in performance mainly comes post-1999, which was a period during which intense efforts were made to improve service delivery in Bangalore. The Bangalore Agenda Task Force (BATF) was established in 2000 by the government as a civil society watch-dog to interact with government 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 (see case 6).

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 PAC was itself one expression.

Whatever the reasons, these results augur well for the potential of service delivery improvements in India’s growing cities –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, 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, 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 (PHCs) 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 distribute 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.tnmisc.tn.nic.in).

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

- 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 the 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's grievances against any public servant, including the Chief Minister. He also has the right to initiate prosecutions 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 Governor, 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 redressal 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 (2003g).

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 2003-04), 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 billion of additional financing was required for their completion: far in excess of what was affordable. The ZBI Review required each department to place the projects under four categories: (i) full funding for fast track completion; (ii) funding on slower track for now, which could graduate to fast track in the 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 2002/03, 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 Public Works Department found resources within its budget to complete eight bridges which would 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 funds towards priority projects, rather than hide white elephants to protect budgetary resources.

Andhra Pradesh Budget management Reforms. In AP, the Medium-Term Fiscal Framework guides the preparation of the Annual Fiscal Framework, within which the detailed annual budget is developed. The fiscal framework enabled the Finance Department to make 6-month budget releases at the beginning of the 2002/03 fiscal year, and a credible commitment to quarterly releases in the second half of the year. This was further improved in 2003/04 when the release at the beginning of the year was for the first 9 months. 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 and Maharashtra have networked the entire state through satellite, and so also 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 delinquent 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 tenth 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

Case 8: The USAID-financed India REFORM Project: helping states develop fiscal reform capacity.

The starting point for this project is that the fiscal weaknesses seen at the state level are a result, at least in part, of an absence of analytical capacity and institutional structures and/or systems, especially within the key state departments of finance and planning that prevent forward-looking fiscal decision-making grounded in careful analysis and good governance. In short, Indian states currently lack the analytical capacity and the institutional infrastructure required to run a good fiscal policy.

The purpose of USAID/India's REFORM project is to provide technical assistance and training (currently targeted to three states - Karnataka, Uttaranchal and Jharkhand) to strengthen their fiscal analytical capacity and fiscal management structures and systems to enable states to make fiscal decisions and budget preparation based on more accurate data and sound analysis. The mandate of the REFORM project is to help:

- establish a fiscal planning and analysis cell (FPAC) in the Department of Finance of the respective states;
- establish or strengthen the states' debt/investment management cell (DIMC);
- strengthen the states' payment and receipt mechanism, including treasury operations;
- develop and/or improve relevant databases and management information systems (MIS), including the human resources database, procedural/ operational manuals.;
- improve state-level procurement policies and systems;
- strengthen the capacity of the states' project appraisal units, both in the department of finance and planning;
- improve socio-economic data collection and assessment, segregated where possible by socio-economic groups, including gender; and
- build capacity of states' training institutes to provide better training in fiscal management and public finance.

The 5-year \$US 20 million program is based on hands-on technical assistance and training by international experts and in-country specialists. Three local offices have been established in each of the three states to house consultants that will be based here for the duration of the program - to facilitate day-to-day work with the state governments. The ultimate aim is not only to upgrade the states' skill base in public resource management but also to improve transparency, integrate databases for smoother information flows and institutionalize the knowledge/skill base by involving other state-level administrative and technical departments.

As the REFORM project makes progress, it will try to create forums and platforms to share the lessons learned on the ground.

ANNEX 3 (CH. 3): SELECTED ISSUES IN VAT INTRODUCTION AT THE STATE LEVEL IN INDIA

A. Haryana's experience with VAT : going it alone.

Variants of VAT on manufactured goods, using the subtraction method, have been tried out in individual states on resellers of taxable commodities, e.g. Andhra Pradesh and Maharashtra in 1995. While VAT continues to exist in Andhra Pradesh 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 taxpayers has increased from 6417 to 8504. State sales tax revenue grew by 20% in 2003/04 as opposed to 17% in 2002/03. Overall sales tax revenue (including Central Sales Tax) grew by 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, the fact that VAT introduction has not resulted in tax losses and in fact seems to have improved compliance is apparent.

B. 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 (ICMS) which mainly falls on goods rather than 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 law (though they have to conform to an over-riding national law), and more than 40 rates, and different rules for assessing tax credits; (ii) evasion – associated with the complexity and also the system for taxation of interstate trade, on which see below; and (iii) fiscal wars, with states offering tax exemptions and refunds. The system of interstate trade is itself complex, with different rates allowed in different states (though set centrally) for interstate sales, and interstate rates lower than those prevailing for intrastate transactions.
- **Canada** tells a much happier tale. In the province of Quebec a *coordinated dual VAT* is in operation. The Quebec provincial 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 Quebec and central 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 provincial and the federal government (e.g. a joint approach to audit) are 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 (the 6th Directive establishes a common set of rules, exemptions, and definitions), and there is a main 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 interstate 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. India needs to work over time towards the goals of harmonization and information sharing across governments, and ultimately a shared central-state VAT.
- 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 interstate 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 intrastate sales as interstate. Various suggestions have been put forward for how to solve this problem (see Annex 3.c), but none has yet been implemented. The consensus in India is to adopt the Quebec and EU systems of zero-rating interstate 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).

C. Mechanisms for handling inter-state trade in a VAT regime.

It is well recognized that interstate trade poses a special problem for the introduction of VAT at the state level in a federation, particularly if one wants to, as one should, introduce the VAT on a destination basis (i.e. such that revenues accumulate to the state in which a good is consumed, not in which it is produced). The common practice, implemented in the EU and Canada, is to zero-rate interstate imports. This is also what is proposed for the state VAT in India, via reduction of the Central Sales Tax, currently at 4%, to zero. However, it is acknowledged that this solution is far from perfect. It breaks the VAT chain and thereby gives sellers an incentive to claim they are selling interstate when in fact they are not. It is reported that this form of evasion is a major problem in the European Union.

Various alternatives have been suggested, though not yet implemented. All of them are similar in that they require (a) that “tax levied on exports from one province be credited/refunded against tax due in another” (Keen, 2000), and (b) that a clearing-house mechanism be used to reallocate the revenues collected in conformity with the destination principle. Four options which have been presented in the literature are as follows (see Piffano, 2003 and Genser, 2003 for surveys):

- As proposed by the EU in the early nineties, the original *clearing house* proposal: a rebateable tax on interstate trade, set at the rate of and collected by the exporting state.
- The *compensating VAT (CVAT)*, developed by Varsano (1995) and McLure (2000): a rebateable tax on interstate trade, set centrally, perhaps at the average of the state VATs, and also collected by a central administration. (In India, this would essentially mean increasing the CST, introducing a rebate mechanism for it, and shifting its administration to a central outfit.)¹
- The *Viable Integrated VAT (VIVAT)*, proposed by Keen and Smith (1996): separate rebateable rates are applied to registered and non-registered traders regardless of residence. The former is common across states and would be collected by a central administration; the latter varies by states, and would be collected by states.
- The *prepaid destination VAT*, proposed by Vanistendaal (1995) and Poddar (1999): a rebateable tax on interstate trade, set at the rate of the importing state, but collected by the exporting state from the purchaser.

All of these mechanisms remove the evasion incentive present under zero-rating. But they also have their own drawbacks:

- The problem with the EU clearing house is that the state of origin will have no incentive to collect tax on interstate exports since the revenue thus collected will be re-distributed.
- The problem with the CVAT and VIVAT mechanisms in the Indian context is that a central collection mechanism will need to be created. If there is already a federal VAT administration, it would be a natural candidate for this job. But the federal VAT in India only goes up to the manufacturing stage, and so there is much interstate trade which does not fall under its net. So a new administrative set-up, reporting either to GoI and/or to the states, would be required to run the CVAT or VIVAT.²
- The prepaid destination VAT may be subject to its own evasion. Exporting firms may produce fake forms that their importer has paid tax.

It thus remains a matter of judgment whether India should go down the zero-rating route or the new alternatives proposed. Perhaps the most important point is that, whichever route is chosen, shifting to a destination allocation of revenue will require greater administrative effort and co-ordination across states than is currently in evidence (on which see Annex 4 more generally): the zero-rating option will require strengthening the existing administrative machinery and co-ordination efforts for tackling evasion through claimed interstate trade, while the CVAT and VIVAT alternatives will require setting up a new institution altogether for taxing interstate trade.

¹ Note that if a dual coordinated VAT was in place, CVAT revenues could simply be allocated to the federal government, in which case no clearing house would be needed.

² In principle, CVAT and VIVAT could be operated by state administrations, but, since a clearing house would be needed to achieve a destination allocation of revenue, one would then face the same incentive problems discussed in relation to the EU clearing house option. Thus, it is assumed that CVAT and VIVAT are operated by a central administration. However, as Keen (2000) notes, the central administration might be run by the central government, or by the states, in a co-operative effort.

ANNEX 4 (CH. 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 three problems. First, 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. Second, in some important cases, fiscal autonomy is constrained even when there are no discernable uniformity or coordination benefits. Third, there is no uniformity in revenue administration. There are 29 states (incl. Delhi) 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 interstate 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 interstate 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 in 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). These would include the Motor Vehicles Act,³ the Indian Stamp Act, the Indian Registration Act, The Forest Conservation Act, the Mines and Minerals (Development and Regulation) Act.

A central body, new or existing, 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. Such an institutional arrangement would help ensure that specific rates and thresholds 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. Some other measures that could be taken to improve interstate and centre-state coordination, whether implemented through a Central Administration law or otherwise, include the following:

(a) Information sharing is currently extremely limited, for example, 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 interstate sales via "C Forms" and "F Forms", as well as problems with fake documents, can be greatly reduced by increased computerization 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 Vehicle 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

³ 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).

Regional Transport Offices (RTOs); (b) to transfer registrations across states;⁴ (c) to verify genuineness of permits; etc. All of this requires systematic computerization and data networking both within states and across states.

- State Sales Tax Departments 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.⁵

(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) While checkpoints are needed to check evasion, states can reduce compliance and administrative costs by running joint checkpoints or having checkpoints on only one side of the border, with the other state's checkpoint examining compliance with laws of both states for goods vehicles travelling in the other direction.

(d) Administration associations can be used for sharing of "best practices" 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)⁶ and the Intra-European Organisation of Tax Administrations (IOTA).

(e) Joint – centre-state or cross-state – audits would help detect evasion, especially involving interstate trade.

⁴ To transfer a vehicle registration from one jurisdiction to another, whether intra- or inter-state, 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.

⁵ For a description of the VIES see Hutchison (1996) and European Union (2002).

⁶ See <http://http.ciat.org>. Links to IOTA are available through this site.

ANNEX 5 (TO CH. 4): SCHEMES TO PROMOTE GOOD FISCAL PERFORMANCE

This Annex reviews two schemes adopted in India to promote fiscal performance, namely the Government of India Fiscal Reforms Facility and the Sub-National Structural Adjustment Loans of the World Bank.

A. 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 Commission’s grants to progress under this programme. The result was the Fiscal Reforms Facility (FRF), 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). FRF is one of a number of reform schemes launched in recent years (others are for power sector reforms, urban sector reforms, etc) and it has also been argued 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, and the focus is mainly on strengthening the federal fiscal framework, rather than on deficit reduction. The Russian Fund is rather small (about 10% the size of the FRF), but 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, Clements, Pivovarsky and Tiongson, 2003) found a mixed impact of SALs on domestic revenue mobilization. SALs to Indian states are considered on the next page.

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. Opening up the various MOUs to the states 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.

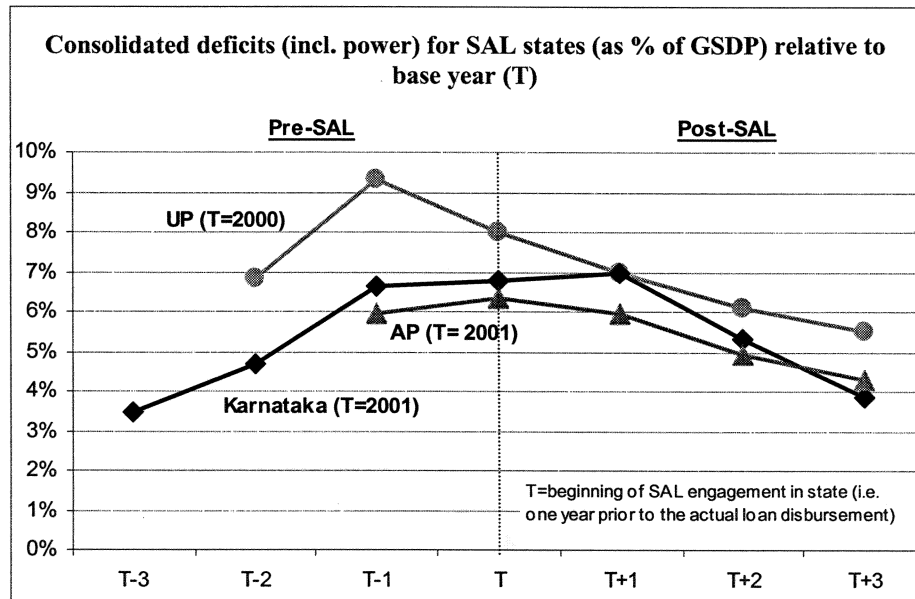
B. World Bank Sub-National Adjustment Lending

The Bank began sub-national adjustment lending in India in 2000 with a loan to Uttar Pradesh. To date, five structural adjustment loans (SALs) have been made, with two to Andhra Pradesh and two to Karnataka in addition to the first to Uttar Pradesh. The average loans size is \$190 million. The Asian Development Bank has also provided SALs to Gujarat, Kerala, and MP.

The World Bank SALs, following guidelines issued by the Government of India, are designed as a series of about four one-tranche operations. Each operation is released once agreed up-front actions (normally a dozen or so) have been achieved. SAL documents are now in the public domain so that all these agreements are public.

The focus of the SALs is fiscal stabilization, and the key target for the SALs is the consolidated fiscal deficit, which includes key off-budget liabilities such as power sector losses. SAL programs also incorporate governance reforms, deregulation, public enterprise reforms, and sectoral reforms, such as in the power sector and education sector. The rationale for SAL funding is to provide states with low-cost deficit financing: since they are intended to help reduce the deficit, they are intended to substitute for, rather than supplement, other, higher-cost forms of borrowing. States receive SALs on normal terms for central government lending, which currently amount to an effective interest rate of less than 4%.

As the figure on this page shows, the three SAL states have achieved a sustained reduction in the consolidated fiscal deficit. Overall their performance on revenue deficit reduction exceeds that of the non-SAL states. The SALs have also helped promote some key reforms in the recipient states, in a wide range of areas from public enterprise reform to industrial deregulation, to governance and sectoral reforms.



Note: T+3 are estimates for AP and Karnataka.

At the same time, SALs in India remain controversial. Some

argue that the provision of untied funding encourages profligacy; others that whatever reforms are achieved will not be sustainable. The future of SALs will largely depend on the pace of state reforms. SALs are undoubtedly a risky business: a SAL for Tamil Nadu had to be withdrawn at the last minute when the state government reversed in quick succession a number of its own policy reforms.

In this uncertain environment, it is likely that SALs will continue to evolve. When the first SAL was made, there was no Fiscal Reform Facility (FRF). Now good performance under the FRF is a pre-requisite for accessing SALs. One possibility for the future would be to fully integrate SALs with the FRF. This could be of mutual benefit: the FRF would benefit from the supervision and technical assistance provided to SAL states, while the SALs would benefit from closer coordination with GoI.

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