Volume VI

USAID/INDIA
REFORM PROJECT
COMPENDIUM WITH PRACTITIONERS' GUIDE

To State Fiscal Management Reform

Invited Papers

REFORM
Rationale, Objective & Terms of Reference

The REFORM Vision ……

"State governments have the necessary organizational structures, analytical tools and decision-making processes, information sources and trained staff that enable them to make better informed choices on a transparent and accountable basis with respect to state public finances. Subsequently, this capacity is institutionalized into the mainstream of state government practices to ensure the sustainability of the effort."

The Rationale:

The starting point of the USAID/India Fiscal Management Reform Project (REFORM) is that the fiscal distress seen at the state level in early 2000 was, to a large extent, a result of the systemic weaknesses in state fiscal management (Box 1), including within the key departments of finance and planning. This prevented forward-looking fiscal decision-making grounded in careful analysis and leading to good governance. In short, the majority of Indian states needed better analytical capacity backed by appropriate institutional infrastructure to formulate and implement good fiscal policy.

Box 1: Systemic Weaknesses in Fiscal Management

The systemic weaknesses found in fiscal management at the state level may be described as "inadequate":

- Technical know-how in modern fiscal management practices.
- Comprehensive, current information databases.
- Robust analytical tools and techniques that correspond to internationally accepted standards.
- Integrated management information systems and systematic approaches to the fiscal decision-making processes.
- Transparent, consistent and institutionalized fiscal practices, reporting systems, and structures that promote the desired accountability for the effective and efficient mobilization, allocation and utilization of public funds.

Currently, therefore, many Indian states do not have the *appropriate capacity*[1] and the *necessary practices*[2] to perform relevant, economic and statistical analyses (Box 2).

Box 2: Consequence of Systemic Weaknesses

As a consequence of the systemic weaknesses, most Indian states, for example, have inadequate fiscal management expertise and institutional infrastructure to perform revenue and expenditure projections and distributional analysis, assess multiplier and elasticity effects, and run policy simulation and develop alternative policy scenarios. This includes their inability to establish strong links between budgetary outlays and program outcomes for efficient and effective delivery of results, establish debt and investment frameworks to improve their quality and profile, and conduct rigorous project appraisals to ensure selection of socio-economically viable projects.

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[1] i.e., fiscal management skill-sets, tools and techniques and organizational structures.

[2] i.e., consistent, transparent and accountable processes.

Given increasing decentralization and the continued significance of public finance in India, many state governments will be required to assume greater responsibility for the design and implementation of their own development strategies. As a result, their ability to strike the *right balance between fiscal policy, broad-based growth, and financial sustainability* will be fundamental to promoting and sustaining development across every sector of the state economy and, consequently, the nation as a whole, especially in light of the new challenges posed by the opening-up of the Indian economy and state finances getting substantially linked with market forces.

The Objective:

As a response, USAID/India's REFORM project (September 2003 - 2008) was designed to provide practical hands-on "how to" skills transferal, based on international best practices, to strengthen fiscal analytical expertise, structures and systems of selected Indian states. The objective was to help these states to better plan and manage their public finances, especially in the light of the challenges they faced following the 2000-01 fiscal crisis. Jharkhand, Karnataka, and Uttarakhand were identified as the three REFORM partner states.

The specific objectives of REFORM were:

1) To improve "informed" decision-making within state (sub-national) governments;
2) To ensure that decision-making processes followed consistent and transparent principles, leading to greater accountability; and,
3) To sustain the efforts by institutionalizing and mainstreaming the capacity built.

> *REFORM, therefore, was not designed to advise or guide Indian state governments on specific policy decisions but rather to enhance their ability to evaluate and to address crucial policy choices and implementation options, based on an understanding of the environment - i.e., its potentials, its limits and its perceived needs.*[3]

Terms of Reference:

Based on discussions with the respective partner states, the REFORM terms of reference were to help enhance their fiscal management capacity in the following four (4) areas:

- *Revenue Management Capacity* – To help states undertake detailed analysis of revenue projections and the implications of alternative tax policies and revenue choices. Interventions included: Introduction of improved revenue forecasting methodologies, an Input-Output (I-O) framework and macro-economic database. A practitioners' guide was also developed along with hands-on training to build state capacity in the above areas.

[3] Capacity-building as defined by the United Nations Center for Education and Development, (Agenda 21's definition, Chapter 37, UNCED, 1992).

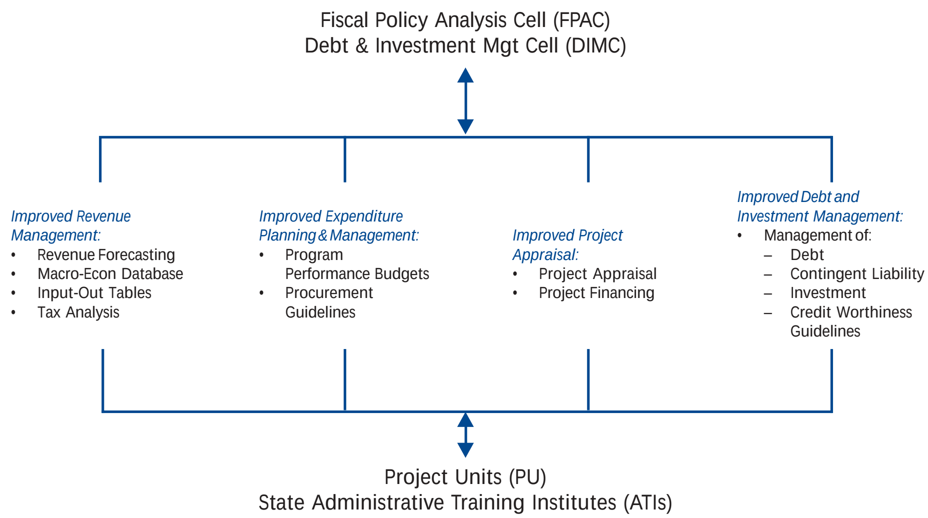
- *Expenditure Planning and Management Capacity* – To help states improve quality and accountability of expenditures. Interventions included: Introduction of an outlays to outcomes budgeting methodology (*i.e.*, program performance budgeting (PPB)) to help states' prioritise the allocation of public funds, improve program planning, monitoring and evaluation, increase transparency, accountability, and consequently, the quality of public services delivery. A practitioners' guide with related software was developed and delivered. Structured/hands-on training was provided across all levels and in almost all departments. Detailed public procurement guidelines were also developed for two out of the three states.
- *Debt and Investment Management Capacity* – To help states to better document, track, analyze, and manage debt, contingent liabilities and investments, in the medium to long term. Interventions included structured and hands-on training as well as introduction of practical guides (with reporting templates). Comprehensive debt datasets were developed and migrated into a database using the *Commonwealth Secretariat-Debt Recording and Management System (CS-DRMS)* software.
- *Project Appraisal Capacity* – To help states improve appraisal and selection of socio-economically viable capital projects. Interventions included: Training in the Harberger project appraisal technique which involves financial, economic, social and stakeholders' risks analysis. A Project Appraisal practitioners' guide with sector-specific guidelines was also developed and introduced to serve as a desk reference.

To sustain and mainstream the above fiscal management reform efforts, four (4) institutional structures were designed and supported:

- The Fiscal Policy Analysis Cell (FPAC) – To help states institutionalize continuous analysis of the implications of policies, procedures and regulatory decisions on the fiscal health of the states. An analytic unit supported by a team of dedicated and trained staff, with access to relevant and quality data, tools and techniques was established.
- The Debt and Investment Management Cell (DMIC) –To help states identify, generate, and analyze data and support more effective and prudent debt/investment decision-making. Similar to the FPAC, an analytic unit supported by a team of dedicated and trained staff, with access to relevant and quality data, tools and techniques was established.
- Project Unit (PU) – To help states offer a comprehensive range of services from project appraisal and monitoring, to final end-of-project evaluation, a project unit was designed that would also help promote public-private partnerships (PPPs).
- Administrative Training Institutes (ATIs) and State Institutes for Rural Development (SIRDs) – To help state civil service training institutes (ATIs and SIRDs) train entry level and mid-career state civil servants in fiscal planning and management, training courses; training materials and reference guides were developed and provided.

The REFORM project may therefore be considered as four-by-four (4x4), consisting of four intervention areas (expenditure, revenue, project appraisal, and debt and investment management) supported by four institutional structures (FPAC, DMIC, PUs, and ATIs/SIRDs).

REFORM: Four-by-Four



The Final Products:

A project *Compendium with Practitioners' Guides* was developed under REFORM to assist state governments to implement necessary fiscal management practices in the areas of forecasting, budgeting, tracking of debt and investment, and improving project appraisal techniques. Specifically, these Guides were developed to function both as desk references for government officers earlier trained under REFORM as well as training tools for strengthening capacity of new officers. For officers not earlier exposed to the new fiscal practices, the Guides will need to be supplemented with additional technical support or guidance.

The Compendium also includes a variety of case studies including the experiences of the three REFORM partner states – Jharkhand, Karnataka, and Uttarakhand – with respect to the implementing the new practices under REFORM.

"Fiscal Watch", a virtual resource center, has also been designed and launched to provide a dedicated site to promote greater thinking, collaboration, discussions, best practices and, exchange information and post current data on the fiscal health (and related issues) of Indian states and India. The key feature of "Fiscal Watch" is the dedicated discussion forums to facilitate interaction between fiscal practitioners, both Indian and international (*e.g.*, to provide a platform for finance secretaries, budget officers, revenue officials, and researchers). In addition, there are numerous hyperlinks to related online resources such

as government websites, professional societies, consultancy opportunities, and training and education providers.

To Conclude:

Despite spending large sums of money, governments and donors in many countries have been limited in their ability to develop successful, sustainable programs due to the inadequacy of fiscal management expertise and infrastructure. Such inadequacies prevent the productive absorption of funds. They also prevent states from equipping themselves with the necessary fiscal shock absorbers to cushion them against unexpected fiscal challenges - some arising out of discretionary, unplanned decision-making and others as a result of increased globalization. More often than not, these unexpected challenges can and have served as the tipping points, seriously affecting the fiscal condition of even fiscally healthy states, as seen in India especially post 1995-96.

However, given the increasing recognition by state governments of the role of and need for improved fiscal management capacity in Indian states' development process, and indeed for India as a nation, we are confident that endeavors such REFORM will be sustained and further strengthened.

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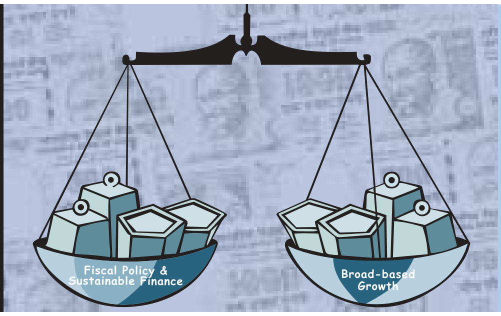

Centrally-sponsored Schemes and Funds Flow from Centre to States

March 2006

Authors' Name:

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Mr. S. C. Garg paper:

This paper was prepared for USAID/India REFORM Project in March 2006. It arose out of a concern that substantial levels of funds were largely bypassing the consolidated fund of state governments, especially under centrally-sponsored schemes. Therefore, the question was, how will state governments be responsible for the growth and development of sectors where substantial funds are not under their control? In light of this impairment of accountability of public funds at the state level, the challenge for fiscal managers will be to identify appropriate management structures and systems to address this issue. The objective of Mr. Garg's paper was to document the magnitude and modality of funds flow through centrally-sponsored schemes and the nature of the challenge.

Compendium Disclaimer:

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Executive Summary

This Study essentially encompasses three analytical exercises, as listed below, and then suggesting a strategic course of action to USAID/India for contemplating programs for strengthening capacity of states' finance departments for handling Centrally-sponsored Schemes (CSS) flows, both through their budgets and those by-passing budgets. These three analytical exercises are:

1. Determining outlays and objectives of CSSs (absolute and as a proportion of Centre's Gross Budgetary Support for Plan) and estimating CSS funds bypassing state budgets from outcome budget 2005-06 of GoI;
2. Estimating total and state-wise CSS receipts for 1990-2005 from RBI Study of States Finances and determining its' proportion to total grants from centre and total revenue receipts of states; and
3. Documenting critical parameters like objectives, size, funding route and allocation basis for four new major Central Schemes (Bharat Nirman, Rural Employment Guarantee, Urban Renewal Mission and Rural Health Mission).

Primary reference document for the first analysis are the Outcome Budget of GoI issued in August 2005 and the Expenditure Budget Volume II of the GoI. Outcome Budget document provides schematic details for 61 Ministries and Departments of GoI with an aggregate outlay of INR 110987.48 crores (USD 24.66 billion)[3], out of budgeted plan expenditure of INR 143496.78 crores (USD 31.89 billion). The remaining outlay of INR 32509.30 crores (USD 7.22 billion) for three central Ministries and state plan assistance to UTs through Finance Ministry and Home Ministry has not been dealt with in the Outcome Budget. Expenditure Budget provides line item budget outlays for each Ministry/Department. For working out the CSS receipts from states side, reference documents are the Hand Book of State Finances, published by RBI, for data on grants to states for the year 1990-2002, Study of State Finances 2004-05 for actuals of 2002-03 and Study of State Finances 2005-06 for actuals of 2003-04 and RE of 2004-05.

Centre's plan outlay in the outcome budget of GoI 2005-06 is classified, for determining what goes to states, in four categories as under:

1. Plan Outlay of Centrally-sponsored Schemes budgeted to go through state budgets explicitly- INR 17551.74 crores (USD 3.90 billion) (15.81 percent);
2. Plan Outlay of Centrally-sponsored Schemes functionally budgeted as CSS but not explicitly budgeted to go through state budgets INR 42787.97 crores (USD 9.51 billion) (38.55 percent);
3. State Plan Scheme Outlay in Ministries/ Departments Budgets- INR 2053.51 crores (USD 46 billion) (1.85 percent); and
4. Central Sector or Central Organizations Outlays- INR 48594.26 crores (USD 10.80 billion) (43.78 percent).

[3] At Rupee: Dollar conversion rate of 45 rupees to a dollar.

Amount budgeted for going through the state governments for CSS in Class I above and functionally budgeted for CSS in Class II above was INR 15637.23 crores (USD 3.47 billion) and INR 38942.43 crores (USD 8.65 billion) respectively. Central government's plan expenditure on state sector subjects in various facets is captured in the Table 1 and also compared to centre's gross budgetary support for plan and other relevant indicators.

In terms of key concern of this study, our estimates suggest that a total amount of INR 20254.99 crores of CSS would go through state budgets in 2005-06. Inclusive of schematic grants given to states as central assistance to state plans, total schematic flows to budgets are estimated at INR 33322.55 crores (USD 7.40 billion). CSSs aggregating to INR 34324.67 crores (USD 7.63 billion) by-pass the state budgets. Thus if we view only in terms of CSS, only 37.11 percent of CSS pass through the state budgets. In terms of entire schematic transfers, 49.26 percent of central outlays go through the state budgets, central transfers for CSS exceeding 50 percent by-pass the state budgets. When

Table 1: Central Government's Plan Expenditure on States Sector Subjects in Various Formats

(Amounts in Crores: bn stands for billion)

State Sector Outlays in Central GBS in Different Dimensions		As a Proportion of				
		Total GBS for Plan 143496.78 (31.89 bn)	Total GBS for Central Plan 110385.00 (24.53 bn)	Total GBS for State Plan 33111.78 (7.36 bn)	Total Revenue Receipts of States 421324 (93.63 bn)	Total Plan Expenditure of States 160081 (35.57 bn)
CSS Budgeted to go through State Budgets	15637.23 (3.47 bn)	10.90	14.17	47.23	3.71	9.77
Functional CSS going through State Budgets	4617.76 (1.03 bn)	3.22	4.18	13.95	1.10	2.88
Total CSS through the State Budgets	20254.99 (4.50 bn)	14.12	18.35	61.17	4.81	12.65
CSS bypassing State Budgets	34324.67 (7.63 bn)	23.92	31.10	103.66	8.15	21.44
Total CSS	54579.66 (12.13 bn)	38.04	49.44	164.83	12.95	34.10
State Plan — Other Ministries	2018.51 (0.45 bn)	1.41	1.83	6.10	0.48	1.26
Schematic State Plan — Finance Ministry	11049.05 (2.46 bn)	7.70	10.01	33.37	2.62	6.90
Total Schematic State Plans	13067.56 (2.90 bn)	9.11	11.84	39.46	3.10	8.16
Total Schematic State Sector Outlays	67647.22 (15.03 bn)	47.14	61.28	204.30	16.06	42.26
Normal Central Assistance	15450.95 (3.43 bn)	10.77	14.00	46.66	3.67	9.65
Total State Sector Outlay in GBS	83098.17 (18.47 bn)	57.91	75.28	250.96	19.72	51.91

we include general purpose plan transfers, central government plan expenditure on state subjects increases to INR 83098.17 crores (USD 18.47 billion) with INR 46863.83 crores (USD 10.41) (58.69 percent) going through the state budgets and INR 34324.67 crores (USD 7.63 billion) (41.31 percent) by-passes the state budgets.

CSS/CP grants to states from Centre received by States, as per states data, increased from INR 4577.18 crores (USD 1.02 billion) in 1990-91 to INR 18294.83 crores (USD 4.07 billion) in 2004-05. Jharkhand (10.23 percent) was the only state for which CSS grants made up for more than 10 percent of entire revenues. Quite a few states received CSS grants which were less than three percent of their entire revenues. Goa received only 1.26 percent, Punjab 1.75 percent, Gujarat 1.90 percent, Maharashtra 2.27 percent and Haryana 2.33 percent.

Present United Progressive Alliance (UPA) government came to power in the elections held in May 2004. UPA released its National Common Minimum Programme (NCMP) on 27th May 2004. Four major programs subject of this study have their roots in the NCMP. UPA government's first full budget was for financial year 2005-06 presented on February 2005. Programmatic commitments of NCMP were announced as major flagship programs of the UPA government in this budget. Table 2 summarizes the objectives, allocation basis, outlays for 2005-06 and fund routing arrangements for these four major programs.

States face two kinds of principal questions concerning special purpose transfers from Centre. First, states in general, believe that these special purpose schemes, have grown too big and too many to take away their fiscal independence in much of the expenditure field and therefore, as a policy and general approach, these should be wound down and central funds should either be transferred to them as additional share in taxes or in the form of block grants. Second, not having been able to stop growth of CSS leave alone curtailing these despite several attempts, states want to take as much share of CSS funds, as is possible for them as CSS funds are grant funds.

CSS going through the state budgets and by-passing state budgets both affect state finances tremendously. State Agencies are also organs of state. In most cases of CSS, the states have to provide counter-part funds. It is, therefore, very necessary for the Finance Departments of the states to monitor funds flow under all CSS. However, there is tremendous inadequacy of database on special purpose transfers both at central and state levels. Both Centre and States are facing problems in tracking funds released under these schemes which at central levels are released by several Ministries/Departments and at state level go to various recipients — state governments, state and district level agencies of state governments attached to several departments and local bodies. Keeping these factors in consideration, USAID can contemplate programs in following work areas:

- Assist Planning Commission and the Ministry of Finance in developing a comprehensive data base on all the special purpose schemes (irrespective of their multiple nomenclatures currently);

Table 2: Summary Position for Four Major Schemes Reviewed

Scheme	Objectives	Allocation Basis	Outlays 2005-06 BE	Fund Routing Arrangement
National Employment Guarantee Scheme	Conferring a statutory entitlement for at least 100 days of employment in one financial year on every rural household at statutory minimum wage rate in 200 notified districts of the country (to be extended to all districts of the country in five years) failing which state governments to pay an unemployment allowance	GoI to bear cost of wages and 75% cost of material, skilled and semiskilled workers. State governments to bear unemployment cost and 25% of the cost of material, skilled and semiskilled workers. No normative fund allocation basis. Requirement assessed on the basis of annual State Annual Work and Budget Proposals (AWBP) of states	Budget 2005-06 did not provide any specific outlay for NREGA as such. Outlays of National Food for Work Programme (INR 5400 crores or USD 1.2 billion) for FY 2005-06 to be utilized for this purpose.	The central funds under NREGA are to be transferred from the NREGF to the state/ district level "receptacle" designated by the state governments in their Rural Employment Guarantee Schemes. There is no transfer to the budget of the state government.
Bharat Nirman				
A. Accelerated Irrigation Benefit Programme (AIBP)	Completion of ongoing irrigation/multipurpose projects in advance stage of construction in a time-bound manner with a view to creating additional irrigation potential	Allocation depends upon the number of projects approved under the AIBP and expected expenditure on such projects during the year.	0	State Plan Schemes. From Ministry of Finance to State Governments on the basis of recommendations from Ministry of Water Resources
B. Accelerated Rural Water Supply Programme (AWRSP)	Provision of safe drinking water to rural habitations without or partial coverage of drinking water supply and to promote sustainability of safe drinking water systems	Allocated on the basis of a five point formula with weights: Rural Population (40); States with inaccessible areas (35); Not Covered / Partly Covered Villages in the ratio of 2:1 (10); Quality affected villages (5); and Overall water resources availability (10)	INR 4050 crores (USD 90 billion)	CSS. Department of Drinking Water releases funds directly to state governments as well as to state water missions societies (composite routing)
C. Pradhan Mantri Gram Sarak Yojana (PMGSY)	Provision of rural connectivity, through all weather roads, to all rural habitations with population of more than 1000 (500 in case of hilly and desert villages and 250 in case of tribal villages)	Funds allocated on the basis of requirements of rural roads to complete all eligible rural roads in four years	INR 4235 crores (USD 94 billion)	Department of Rural Development to State Rural Roads Development Agencies (SRRDAs) on the basis of recommendations of NRRDA (by-passes state budgets)

Table 2: Summary Position for Four Major Schemes Reviewed (Contd.)

Scheme	Objectives	Allocation Basis	Outlays 2005-06 BE	Fund Routing Arrangement
D. Indira Awas Yojana (AWY)	Provision of shelter to the rural poor by providing assistance for construction of dwelling units and upgradation of existing unserviceable nonpermanent houses for Scheduled Castes/ Scheduled Tribes and nonSC/ST rural families living below the poverty line	Funded in the ratio of 75:25 i.e., central government bears 75% of the cost of subsidy payable under the scheme, central funds are allocated on the basis of the poverty ratio and housing shortage with equal weightage to both the factors.	INR 2775 crores (USD 62 billion)	Department of Rural Development to District Rural Development Agencies/Zila Parishads by-passing state budgets)
E. Rajiv Gandhi Grameen Vidyutikarann Yojana (RGGVY)	Creation of rural electricity infrastructure and household electrification for providing access to electricity to all rural households	On the basis of the backlog of targeted rural electricity infrastructure	INR 1100 crores (USD 24 billion)	State Plan Scheme initially in BE 2005-06 converted in CSS later. Ministry of Power transfers funds to Rural Electrification Corporation (REC) which in turn releases to state-level implementing agencies
F. Village Public Telephone Scheme	Provision of a public telephone booth in villages	No budgetary outlay is allocated	No Budgetary Outlay	From Universal Obligation Fund in the Public Account to Public Sector Telecom Companies
National Rural Health Mission	NHRM aims at providing effective rural healthcare services, more specifically, in 18 states of India with relatively poorer health indicators and services. An umbrella program for all health care programs of combined Department of Health and Family Welfare in GoI, excluding only AIDS control program and the National Cancer Control Program.	A resource envelope to support the implementation of an agreed State NRHM Sector Programme Implementation Plan (PIP) as indicated in the Memorandum of Understanding being signed with each of the states	INR 6508.05 Crores (USD 1.45 billion) (not indicated as NHRM outlay in 2005-06 budget as such. From 2006-07 to be indicated as NHRM outlay	Ministry of Health and Family Welfare to state-level societies. Part funds are released to the state governments directly

Table 2: Summary Position for Four Major Schemes Reviewed (Contd.)

Scheme	Objectives	Allocation Basis	Outlays 2005-06 BE	Fund Routing Arrangement
National Urban Renewal Mission	JNNRUM aims at reforms driven, fast track, planned development of identified cities with focus on efficiency in urban infrastructure/ services delivery mechanism, community participation and accountability of Urban Local Bodies (ULBs)/ Parastatals toward citizens	GoI bears a part of the approved cost of projects as grants (percentage varies from 35% to 90% depending upon parameters of scheme). Aggregate requirement for each state estimated on the basis of projects approved and their expenditure requirement	INR 1027.55 (USD 23 billion) crore for submission on Urban Infrastructure and Transport and INR 589.62 (USD 13 billion) crores for submission on Slum Development	State Plan Scheme. Funds released by Ministry of Finance to State Governments on the basis of recommendations of Ministry of Urban Development and Ministry for Urban Employment and Poverty for two respective submissions

- Assist Ministry of Finance (primarily Chief Controller of Government Accounts) to develop a good system to capture releases, receipts, utilization and certification of funds transferred by various Ministries/ Departments to states, states/district agencies of state governments and local bodies;
- Assist States in building up their case better for streamlining and drastic reduction of special purpose schemes; and
- Assist States in building up a good database on all special purpose schemes funded by the Centre, their allocation bases, share which any state can expect to get under these schemes, and current receipts against all these schemes. A serious review on the basis of such a review can assist the states in improving their share of funds in these schemes.

It is suggested, for addressing the primary concern of CSS funds by-passing the state budgets, that states under REFORM project are assisted to develop a comprehensive and centralized database in Finance Departments on all central schemes which have provision for direct transfers to state agencies or local bodies. The centralized data base in Finance Departments should be able to capture all releases from the centre, releases from the state governments, funds in various bank and other accounts held by state agencies implementing these programs, progress of the use of funds and balances at weekly/fortnightly intervals, utilizations furnished and other relevant parameters. State Finance Departments can also be assisted to create an investment arrangement to help these agencies manage their cash better to realize best treasury gains without compromising availability of required funds at all times for schematic objectives.

Part I: Introduction, Terms Of Reference (TOR) and Scheme of Report

Introduction

Indian system of budgeting and accounting divides expenditures in two broad classes of plan and nonplan, besides the usual internationally accepted classification in revenue and capital. Expenditures on public goods, maintenance of development works and schemes, interests and pensions are classified as nonplan. Expenditures on new schemes of development in social and economic spheres are classified as plan expenditures. Plan and nonplan distinction primarily tries to distinguish and new and continuing expenses in the development space. To quote from the Tenth Plan Document, "Plan expenditure arises out of schemes freshly introduced in an ongoing Five Year Plan (FYP) period. In the same period, nonplan expenditure arises out of schemes carried forward from previous FYP periods. Nonplan expenditure, therefore, supports the old schemes of governments and plan expenditure, the new schemes. Since new schemes add to the economy's productive capacity as the old schemes did in the past, plan expenditure reflects government's investment in enhancing the economy's productive capacity. Thus nonplan expenditure maintains the existing capacities and plan expenditure adds to it." Plan expenditure can be both revenue and capital. In fact, most of the social sector plan expenditure like the expenditure on education, health and social security is classified as revenue expenditure, whereas expenditures on assets creation in new developmental schemes are classified as capital expenditure. Obversely, capital expenditure is not necessary plan expenditure. Capital expenditure on non developmental sectors like defence is classified as nonplan expenditure. To encapsulate, new development expenditure, both revenue and capital, in current Five Year Plan is referred to as plan expenditure.

Central government's gross budgetary support (GBS) to plan is divided in two broad classes — Central Plan and Central Assistance to States and Union Territories (UTs)[4] Plan. This broad division is prevalent since 1969 when central assistance to states' plan was drastically restructured and it was decided to allow such assistance to flow to the states in a pool (usually called block in India) and unconditional (except that states have to ensure that actual total expenditure on plan is at least equal to approved plan) form. Over the years, a rule of thumb emerged that 60 percent of GBS would be central plan and 40 percent would be central assistance to states and UT's. This has however got diluted over the years. Central government's enterprises also finance their plan expenditures from their internal resources and by raising resources from the market directly. These resources are broadly categorized as Internal and Extra Budgetary Resources (IEBR). GBS for Central Plan (i.e., excluding GBS for central assistance for states and UTs plans) and IEBRs of the enterprises of central government together are referred to as Central Plan.

Specific purpose plan expenditures of Centre on the development schemes concerning subjects in states' domain, referred to as Centrally

[4] Union Territories are administered by the Union Government. UTs may have legislatures, empowered to legislate on specified subjects. Of the six UTs, currently two National Capital Territory of Delhi and Pondicherry have legislative assemblies, whereas remaining four are administered directly by the Union.

Sponsored Schemes (CSS) or Central Plan Schemes, form part of the Central Plan. Central government spending on CSS and other schemes in states domain is constantly increasing. Over the years, this has made the Central government alter the basis character of central assistance for states plans. Specific purpose schemes have been introduced as part of central assistance for states plan diluting the prime "block" character of it. These schemes, to distinguish them in budgets and accounts, are referred to as Additional Central Assistance (ACA) schemes. ACA schemes are usually routed through the state governments[5], but CSS are not necessarily. CSS and other schemes in the central plan are implemented through states, state government entities at state or district levels and also through local bodies. There is no real distinction between ACA schemes and CSS schemes in terms of scheme objectives, nature of operations, guidelines issued and implementation. If we distinguish CSS and other CP schemes in two broad categories of CSS implemented through state governments and those implemented through state agencies and local bodies (funds by-pass state budgets in such schemes), we can broadly divide the specific purpose conditional schemes of the central government in states' constitutional domain in three categories of CSS through state governments, CSS through state agencies and local bodies and ACA schemes.

Indian system of budgeting and accounting divides expenditures in two broad classes of plan and nonplan, besides the usual internationally accepted classification in revenue and capital. Expenditures on public goods, maintenance of development works and schemes, interests and pensions are classified as nonplan. Expenditures on new schemes of development in social and economic spheres are classified as plan expenditures.

Centrally Sponsored Schemes (CSS) have been major instruments of central government for influencing development policies and expenditures on the developmental subjects constitutionally allocated to the states in India. CSS are conditional schemes designed for and aimed at influencing states expenditures for objectives which the central government considers of priority and in national/regional/public interest. CSS funds approximate over 1.5 percent of India's GDP and over one fourth of plan budgets of the states. CSSs and Central Assistance to states plans are discretionary in the sense that there is no constitutional or statutory mandate for such transfers. Central Government, can theoretically, withdraw any such scheme and reduce/increase its outlays. Indian Constitution provides for an independent statutory mechanism for determination of vertical and horizontal imbalance by providing states a share in central taxes and grants in aid of their revenues. The share of central taxes and grants in aid for states are determined every five years by an independent Finance Commission. CSSs/ACAs are schematic funding with detailed guidelines as against non-conditional non-schematic nature of deficit grants recommended by the Finance Commission for states in need of grants in aid and central assistance for states plans (normal central assistance).

[5] Rural Electrification Scheme (an ACA scheme till 2003-04) was routed for many years through the Rural Electrification Corporation — a central government-owned enterprise.

Configuration and components of central plan and interrelationships amongst the components can be better understood from Figure 1.1.

CSS have been subject of major controversies. States have usually preferred to get unconditional block assistance, whereas central Ministries/Departments have favored schematic assistance. States have also protested against Central Government transferring big chunks of CSS funds to state agencies and local bodies (primarily rural) directly by-passing the state budgets and accounts. Recently, the central government announced few major initiatives like Rural Employment Guarantee Scheme, an Urban Renewal Mission and Rural Health Mission. The funding pattern of these schemes was also sought to be made by-passing the state budgets.

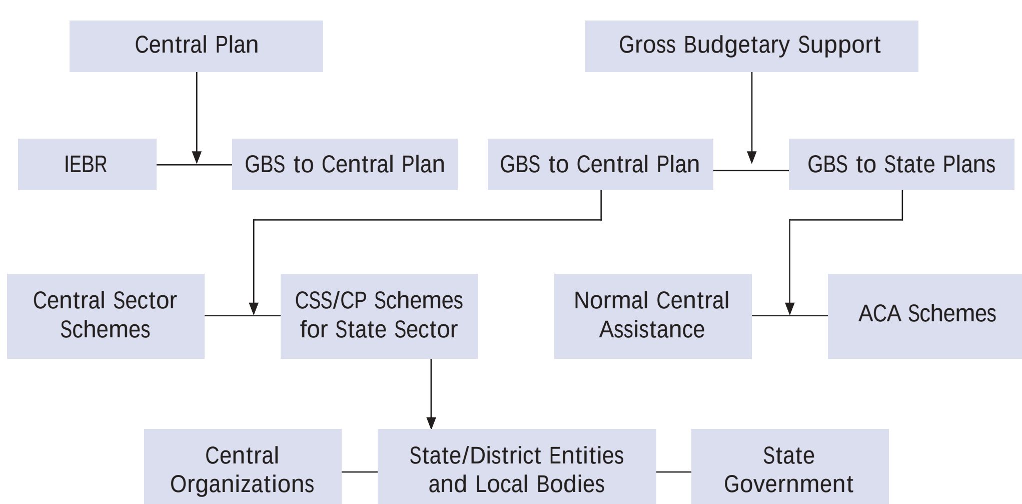
It is in this context that USAID wanted to comprehend the content, complexities and context of CSS and new schemes. This study attempts to explain and bring together CSS and CSS like ACA schemes and analytically classify the CSSs (including ACAs) in three broad classes based on the implementing agencies through which the funds are routed. The study tries to estimate the CSS funds by-passing the state budgets. The study also contextually assesses the significance of CSS funds for states finances. We finally suggest a course of action for consideration of USAID for designing their programs for strengthening capacity of state finance departments to better manage CSS funds flowing through and by-passing the state budgets.

Terms of Reference

Specific Terms of Reference (ToRs) of this study are:

- List, based on Consultant's assessment, objectives and outlays of Centrally-sponsored Schemes and their proportion of the Central Budgetary Outlay for the FY 2005-06, from Outcome Budget published by the Government of India;

Figure 1.1: Relationship and Components of Central Plan and Central Gross Budgetary Support to Plan



- Estimate, from Outcome Budget published by the Government of India for 2005-06, proportion of CSS funds, going through and by-passing the state budgets;
- Document, based on Study of state budgets by RBI, CSS receipts through their budgets, for all states in aggregate and each state individually for the period 1990-2005 and their proportion to total grants from the centre and total revenue receipts of states;
- Document objectives, size of GoI funding, decided/ likely funding route to states/local bodies and allocation basis for four major new initiatives of GoI i.e. Urban Renewal Mission, Bharat Nirman, National Rural Health Mission and Rural Employment Guarantee Scheme; and
- Suggest a strategic course of action for USAID for contemplating programs for strengthening capacity of state finance departments to respond to CSS funds by-passing the state budgets.

Nonplan expenditure maintains the existing capacities and plan expenditure adds to it." Plan expenditure can be both revenue and capital. In fact, most of the social sector plan expenditure like the expenditure on education, health and social security is classified as revenue expenditure, whereas expenditures on assets creation in new developmental schemes are classified as capital expenditure. Obversely, capital expenditure is not necessary plan expenditure. Capital expenditure on non developmental sectors like defence is classified as nonplan expenditure.

The ToRs involve essentially three analytical exercises and suggesting a strategic course of action to USAID/India for contemplating programs for strengthening capacity of state finance departments. Three analytical exercises are:

1. Determining outlays and objectives of CSSs (absolute and as a proportion of Centre's Gross Budgetary Support for Plan) and estimating CSS funds bypassing state budgets from outcome budget 2005-06 of GoI;
2. Estimating total and state-wise CSS receipts for 1990-2005 from RBI Study of States Finances and determining its' proportion to total grants from centre and total revenue receipts of states; and
3. Documenting critical parameters like objectives, size, funding route and allocation basis for four new major Central Schemes (Bharat Nirman, Rural Employment Guarantee, Urban Renewal Mission and Rural Health Mission).

Approach of this Study and Methodology

Primary reference document for the first analysis is the Outcome Budget of GoI issued in August 2005. The document provides schematic details for 61 Ministries and Departments of GoI with an aggregate outlay of INR 110987.48 crores, out of plan expenditure of INR 143496.78 crores. The remaining outlay of INR 32509.30 for three central Ministries and state plan assistance to UTs through Finance Ministry and Home Ministry has not been dealt with in the Outcome Budget. **Annexure 1** places plan budget outlay, divided in two parts of outlays dealt with in the Outcome Budget and those not dealt with in this document, for each of the Ministry/Department which has a plan budget.

Centrally-sponsored Schemes in Outcome Budget 2005-06 (ToR I and II)

Outcome Budget plan outlays belong to both central subjects and state subjects. We first take out outlays of Ministries like Ocean Development which are concerned with only central subjects. **Annexure 2** lists outlays of such Ministries and Departments, which deals with only central subjects. After excluding such outlays (Annexure 2), we are left with Ministries/ Departments which deal with either exclusively state subjects like Ministry of Agriculture or both central and state subjects (Department of Industrial Policy and Promotion or Ministry of Mines). Plan outlays of these Ministries/ Departments may be of broadly any or all **four types**: central sector outlay, outlays on CSS through state governments, outlays on CSS through state agencies and local bodies and outlays on state plan schemes. We classify outlays of these Ministries/Departments in these four classes and deal with the entire ToR on CSS (ToR no 1 and 2) in **Section II**.

Centrally-sponsored Schemes Grants in State Budgets (ToR III)

Reserve Bank of India (RBI) compiles states budgets every year and publishes a Study of State Finances. Reserve Bank of India published a Hand Book of State Finances based on their study of budgets of states since 1980-81 in the year 2004, which included data from 1980-81 to 2001-02 (actuals). RBI has subsequently published their study of state finances for the year 2004-05 and 2005-06 which have actuals for 2002-03 and 2003-04, respectively. Thus, actuals from state budgets are available for the year 1990-2004 out of the years 1990-2005 required by Task 2. For 2004-05, only revised estimates (RE) are available. I would, therefore, use Hand Book of State Finances, published by RBI for data on grants to states for the year 1990-2002, Study of State Finances 2004-05 for actuals of 2002-03 and Study of State Finances 2005-06 for actuals of 2003-04 and RE of 2004-05.

Detailed revenue receipts estimates provided by the RBI provide central grants to states with following sub classifications:

Table 1.1: Grants from the Centre (1 to 5)

1	State Plan Schemes
	of which: Advance release of Plan Assistance for Natural Calamities
2	Central Plan Schemes
3	Centrally-sponsored Schemes
4	NEC/Special Plan Scheme
5	Nonplan Grants (a to c)
	a) Statutory Grants
	b) Grants for relief on account of Natural Calamities
	c) Others

States use three subclassifications for central plan/ centrally-sponsored schemes which are numbered 2, 3 and 4 in Table 1.1. NEC stands for North Eastern Council. NEC provides schematic support for schemes of regional character in the north-eastern region of India. Aggregate of receipts of states for central plan schemes, centrally-sponsored schemes and NEC/Special Plan Schemes can be taken to be equal to CSS/ CP funding support to states budgets by GoI. Once CSS/CP grants are determined in this manner, their proportion to total grants from the centre and total revenue receipts of states can be determined, as required by ToR (iii). This exercise is presented in Section III.

New Centrally-sponsored Schemes (ToR IV)

ToR requires examination of four major new schemes of GoI and documenting certain critical parameters like objectives, size of GoI funding, whether the funds would be routed through state governments or not and allocation basis of these schemes. Government of India has issued guidelines for both components of Urban Renewal Mission (now named Jawahar Lal National Urban Renewal Mission). Bharat Nirman has six components. Guidelines are in existence already for three components — rural roads, rural drinking water and rural housing — under implementation by Ministry of Rural Development. Guidelines are in existence for irrigation component as well, which is also an existing scheme. Power Ministry has issued broad outlines of rural household electrification scheme which is named Rajiv Gandhi Rural Electrification Scheme. No guidelines have been issued for rural connectivity and there is no budget support for it either. This component is being implemented by Department of Telecom through support from Universal Obligation Fund and also from the budgets of PSUs. Brief summary on all the four schemes, with details of the required parameters, based on above examination discussions with concerned officials on latest position, is presented in Section IV.

Scheme of Presentation

Section I provides introduction, ToRs and discusses the methodology of our study. Section II contains analysis of outlays and objectives of CSS and estimates CSS funds bypassing the state budgets. Section III analyses the role of CSS funds in state finances. Section IV examines the four new major (Bharat Nirman, Rural Employment Guarantee, Urban Renewal Mission and Rural Health Mission) and documents critical parameters of these schemes. Finally, Section V suggests a course of action for consideration of USAID for designing programs for strengthening capacity of state finance departments.

Part 2: CSS and Estimates of CSS Funds By-passing State Budgets

Gross Budgetary Support for Central Plan and Outcome Budget 2005

Central Government's Gross Budgetary Support (GBS) for plan was placed at INR 143496.78 crores (Expenditure Budget-Volume II of the GoI)[6] in 2005-06. GBS for Central Plan was budgeted at INR 110385.00 crores and central assistance for state and UTs plan was placed at INR 33111.78 crores. Finance Ministry released the Outcome Budget on August 25, 2005. The outcomes identified and targets set by the Ministries/Departments for themselves were compiled in this document by the Planning Commission and the Ministry of Finance, Department of Expenditure only for the Plan Expenditure. The Outcome Budget actually did not cover the entire plan expenditure. There are a total of 105 demands[7] for all the Ministries and Departments as per the expenditure budget. The document provides schematic details for 61 Ministries and Departments of GoI with an aggregate outlay of INR 110987.48 crores, out of plan expenditure of INR 143496.78 crores. The remaining outlay of INR 32509.30 for 10 demands (three central Ministries, central plan assistance to states through Finance Ministry and six demands for Union Territories) have not been dealt with in the Outcome Budget. Annexure 1 places plan budget outlay, divided in two parts of outlays dealt with in the Outcome Budget and those not dealt with in this document, for each of the Ministry/Department which has a plan budget. The remaining demands are either nonplan demands or have been dealt with another demand in the outcome budget.

CSS Evolution and Funds Routing

States in India face strong vertical gap, which is primarily to be bridged giving states a share in central taxes and grants in aid of their revenues. Centrally-sponsored Schemes (CSS) are not meant to bridge vertical gap, but to provide states additional resources for expenditures which the Government of India considers of national/regional priority although being within the states domain. That is the reason, why CSS forms part of central plan. Specific purpose grants and loans in the form of specific purpose scheme (though not termed CSS before 1969) were a bone of contention between the Centre and the states ever since independence. States preferred unlinked assistance, whereas Central government was more inclined to provide specific purpose assistance. The states would typically argue that if Centre had additional resources, the same should be given to the states as part of additional share of taxes through the Finance Commission, failing which these should be given to them as in block form.

To resolve this, GoI and States decided in National Development Council in 1969 that central assistance to the states for their Plans should be by and large in the form of block/ unconditional assistance (termed Normal

[6] Expenditure Budget of Union Government is published in two Volumes. Volume I is analytical and places key aspects of GoI expenditures in various analytical statements. This volume also provides reconciliation between expenditure as presented in the Demands for Grants, Annual Financial Statement and Expenditure Budget- Volume II. Volume II presents Ministry/Department wise plan and nonplan budget on line item basis. Detailed demands for grants do not form part of budget documents and are dealt with at Ministry/Department level.
[7] Government presents its expenditure proposals to the Parliament in the form of grants. Once grants are approved, Government moves appropriation bills for getting authorization to draw money approved for grants from the Consolidated Fund of India (CFI).

Central Assistance or NCA) so that states can make their plans according to their own priorities. To provide outlays for those few programs which are considered to be of national/regional priorities for subjects constitutionally in the domain of states, it was decided that Centre could provide schematic support (termed Centrally-sponsored Schemes or CSS) but such support should not be exceeding 1/6th of amount to be given as block assistance (NCA). Central Assistance for states plan was almost entirely in the form of NCA for some years after 1969. However, over the years, CSS grew enormously and at much faster rate than the block central assistance (NCA). Later, state plan assistance, intended to be almost exclusively in the form of NCA also begin to be partly in schematic form (ACA schemes). Consequently, NCA component has come down very sharply in total central assistance to states and schematic component (CSS & ACA) has gone up.

States in India face strong vertical gap, which is primarily to be bridged giving states a share in central taxes and grants in aid of their revenues. Centrally-sponsored Schemes (CSS) are not meant to bridge vertical gap, but to provide states additional resources for expenditures which the Government of India considers of national/regional priority although being within the states domain. That is the reason, why CSS forms part of central plan.

Central Assistance to States Plans, both NCA and schematic (ACA) are routed only through state budgets, with very few exceptions. CSS funds to states are routed in two forms. Some CSS are budgeted and accounted for being routed only through state budgets[8]. Many other CSSs are however not so structured and listed in the Union Budget[9]. The funds routing for such CSSs are approved as part of the scheme and may change from time to time. This class of CSS may route part or full funds through state governments, or may route entire or part funds to special state or district level agencies of the state governments or local bodies directly from the central government by-passing the state budgets. Mostly, such schemes by-pass state budgets. Such by-passing of the state budgets is not unconstitutional as Article 282 of the Constitution permits Centre, and also states, to give grants for any public purpose, notwithstanding that the purpose is not one with respect to which Parliament or the Legislature of the State, as the case may be, may make laws.

Identifying and Classifying CSS

Centrally-sponsored Schemes have not been defined or separately identified in the Outcome Budget 2005-06 released by GoI. As explained in the methodology (Section I), we examined nature of all schemes from its title and objectives in the Outcome Budget for those Ministries/ Departments which deal with fully or partly with the subjects which are in states

[8] Statement 17 of the Expenditure Budget (Volume I) lists such outlays for each Ministry/Department in the aggregate, but not scheme wise. Expenditure Budget (Volume II) provides line item wise division of such CSS outlays.

[9] These schemes are listed as specific schemes in the outlays of Ministries/Departments. Budget documents do not distinguish them as CSS anywhere. Budget documents for FY 2006-07 have begun providing a schedule (statement 18) which lists outlays, for the first time, which are transferred through state/district agencies and local bodies. Statement 18, however, is not complete and seems to have left out outlays of some CSS by-passing the state budgets.

domain being part of either State List or Concurrent list. This was done after first excluding the plan outlay of the Ministries/ Departments which deal exclusively with central subjects. Of the Ministries/ Departments which deal with state sector/ or concurrent subject fully or partly, the schemes which were not meant for only central organizations and which had an element of going to states or their agencies or local bodies were sorted out. By comparing the nature of short-listed schemes with the line items in expenditure budget (volume II) with reference to inclusion in statement 17 of expenditure volume I and budget head 3601 in each such Ministry/ Department budget, we segregated those CSS which are routed through state budgets. The remaining CSS were divided in two classes of those by-passing state budgets and those going through state budgets, by examining their nature and also inclusion in statement 18 of similar CSS in budget 2006-07.

Annexure 2 lists plan outlay of all Ministries/ Departments, divided in four parts. These parts are for outlays of schemes which are going through the state budgets, schemes which are not explicitly budgeted to go through state budgets, state plan schemes in the outlays of such Ministries/ Departments and other outlays, which represent outlays for central organizations and such other expenditures which does not go through the state budgets or state agencies. Summarized division of total plan outlay of INR 110987.48 crores in the outcome budget of GoI 2005-06 is as under in Table 2. 1.

As Outcome Budget provides details of schemes for plan budget of INR 110987.48 crores, we estimate the plan outlay of central Ministries/ Departments for state sector subjects (total of 1-3 in above table) at INR 62393.22 crores (56.22 percent) with remaining outlay of INR and after excluding the outlay of INR 48594.26 crores (43.78 percent) for exclusively central subjects Ministries/Departments and expenditure on central organizations and other such expenditure on state sector subjects.

Entire outlay of CSSs classified above does not go to states. Some part of these outlays gets spent in Union Territories and by the Central Organizations as well. Actual amounts budgeted to go through the state budgets for type I schemes in above table is INR 15637.23 crores against schematic outlay of INR 17551.74 crores. Similarly, budgeted outlay of type II schemes is INR 38942.43 crores against the outcome budget outlays of INR 42787.97 crores.

We further classified budgeted expenditure of the CSSs not explicitly going through the state

Table 2.1: Classification of Plan Outlays in Outcome Budget 2005-06

S.No.	Type of Plan Allocation	Amount (INR)	Percentage of Total
1	Plan Outlay of Centrally-sponsored Schemes budgeted to go through state budgets explicitly	17551.74	15.81
2	Plan Outlay of Centrally-sponsored Schemes functionally budgeted as CSS but not explicitly budgeted to go through state budgets	42787.97	38.55
3	State Plan Scheme Outlay in Ministries/ Departments Budgets	2053.51	1.85
4	Central Sector or Central Organizations Outlays	48594.26	43.78
5	Total	110987.48	100.00

budgets given in the expenditure budget of GoI in two further subclasses — (i) CSS going through the state budgets; and (ii) CSS by passing the state budgets. Finally, we arrived at four classes of state sector schemes in the outlays of central Ministries/Departments. These four classes are as under:

A. Scheme Outlays in Outcome Budget and Budget Outlays in Expenditure Budget for CSS going to state governments directly i.e. CSS routed through state government budgets. These schemes with their outlays are listed in Annexure 3;

B. Scheme Outlays in Outcome Budget and Budget Outlays in Expenditure Budget for CSS not explicitly budgeted to be routed through the state governments' budgets, but are routed in practice through the state budgets i.e. the functionally budgeted CSS routed through the state budgets. These schemes with their outlays are listed in Annexure 4;

C. Scheme Outlays in Outcome Budget and Budget Outlays in Expenditure Budget for CSS routed through state/ district agencies and/or local bodies i.e. CSS by-passing the state budgets and routed directly to state/district agencies and local bodies. These schemes with their outlays are listed in Annexure 5; and

D. Scheme Outlays in Outcome Budget and Budget Outlays in Expenditure Budget which are classified as state plan schemes in the expenditure budget i.e. state plan schemes in Central Ministries/ Departments Plan Budgets (All state plan budgets other than these are budgeted in the budget of Department of Expenditure). These schemes with their outlays are listed in Annexure 6.

CSS through State Budgets (Annexure 3)

There are 112 CSS which are budgeted to be funded through states' budgets with estimated total outlay of INR 17551.74 crores and funds budgeted to go to states of INR 15637.23 crores. All these 112 CSSs are listed with their outlays and amounts to be given to the state governments at Annexure 3. Total outlay of CSS routed through state governments' budgets formed 10.90 percent of total GBS to plan, 14.09 percent of the total plan outlay captured in the Outcome Budget, 14.17 percent of the total GBS for central plan, 47.23 percent of the central assistance to state plans and 115.48 percent of the Normal Central Assistance.

Functionally Budgeted CSS going through the State Budgets (Annexure 4)

Our scrutiny of state sector schemes listed in the outcome budget and allocations made in the expenditure budget suggests that there were 43 CSSs with a total budget provision of INR 4617.76 crores which were budgeted functionally, but actually go to the states through their budgets. These schemes are listed at Annexure 4 with their outlays.

Total CSS Budget Allocation going through States Budgets

Aggregating two types of CSS (budgeted to go through state budgets — Annexure 3 — and functionally budgeted but going through state budgets- Annexure 4) gives us total central plan allocations of INR 20254.99 which is estimated to go through the state budgets. Thus, total budgeted outlay of CSS which is routed through state governments' budgets in 2005-06 formed 14.12 percent of total GBS to plan, 18.25 percent of the total plan outlay captured in the Outcome

Budget, 18.35 percent of the total GBS for central plan, 61.17 percent of the central assistance to state plans and 149.58 percent of the Normal Central Assistance.

CSS By-passing State Budgets (Annexure 5)

Total Outlay of CSS schemes which were not explicitly budgeted for being routed through the state budgets was INR 40422.54 crores of which INR 34324.67 crores is estimated to be by-passing the state budgets. There were 41 such schemes, which are listed at Annexure 5 which are routed through state/district agencies and local bodies. Thus, total budgeted outlay of CSS which would bypass state governments' budgets in 2005-06 formed 23.92 percent of total GBS to plan, 30.93 percent of the total plan outlay captured in the Outcome Budget, 31.10 percent of the total GBS for central plan, 103.66 percent of the central assistance to state plans and 253.48 percent of the Normal Central Assistance.

State Plan Outlays in Ministries Budgets (Annexure 6)

Three Ministries/Departments (Ministry of Tribal Affairs, Department of North Eastern Region and Department of Agriculture) have state plan allocations in their Ministry's/ Department's budgets. Ministry of Road Transport also has state plan scheme with an outlay of INR 1478.55 crores, but this outlay is funded from the Road Fund and hence does not form part of GBS for plan. These state plan schemes of three Ministries/Departments had an outlay of INR 2053.51 and budget provision for transferring to state governments of INR 2018.51 crores. Details of these schemes are at Annexure 6. Thus, total budgeted outlay of state plan schemes which go to the state budget but are budgeted in the Ministry/Departmental budget in 2005-06 formed 1.41 percent of total GBS to plan, 1.82 percent of the total plan outlay captured in the Outcome Budget, 1.83 percent of the total GBS for central plan, 6.10 percent of the central assistance to state plans and 14.91 percent of the Normal Central Assistance.

State Plan Outlays (Schematic) in Finance Ministry Budget

We place the budgeted outlays of schematic transfers to the states (Additional Central / Special Central Assistance Schemes) in Annexure 7. There are twelve schemes/ groups of schemes which are schematic in the state plan assistance outlays of the Department of Expenditure in BE 2005-06 with total outlay of INR 11049.05 crores. Thus, total budgeted outlay of state plan schemes which go to the state budget from the outlays budgeted in the Finance Ministry budget in 2005-06 formed 7.70 percent of total GBS to plan, 9.96 percent of the total plan outlay captured in the Outcome Budget, 10.01 percent of the total GBS for central plan, 33.37 percent of the central assistance to state plans and 81.90 percent of the Normal Central Assistance.

Total State Sector Schematic outlay

CSS through state budgets, CSS through state agencies/ local bodies and state plan schematic outlay together constitute specific purpose assistance from the central government for state sector subjects. This amount was INR 67647.22 crores in 2005-06 BE. Thus, total budgeted outlay of special purpose state sector schemes in 2005-06 BE formed 47.14 percent of total GBS to plan, 60.95 percent of the total plan outlay captured in the Outcome Budget, 61.28 percent of the total GBS for central plan, 204.30 percent of the central assistance to state plans and 499.56 percent of the Normal Central Assistance.

Total State Sector Outlay

Adding normal central assistance and special central assistance (non-schematic) in the Finance Ministry budget for state plan assistance gives the total GBS pertaining to state sector. This was INR 83098.17 crores in BE 2005-06 which constituted 57.91 percent of total GBS to plan, 74.87 percent of the total plan outlay captured in the Outcome Budget, 75.28 percent of the total GBS for central plan, 250.96 percent of the central assistance to state plans and 613.67 percent of the Normal Central Assistance.

State Sector Central Plan Expenditure summarized

We summarize the central expenditure on state sector subjects, budgeted and delivered to the states in multiformats, directly through their budgets or by-passing their budgets in the following Table 2.2.

Table 2.2: Central Government's Plan expenditure on States Sector Subjects in Various Formats

State Sector Outlays in Central GBS in Different Dimensions		As a Proportion of				
		Total GBS for Plan 143496.78	GBS dealt with in Outcome Budget 110987.48	Total GBS for Central Plan 110385.00	Total GBS for State Plan 33111.78	Normal Central Assistance 13541.28
CSS Budgeted to go through State Budgets	15637.23	10.90	14.09	14.17	47.23	115.48
Functional CSS going through State Budgets	4617.76	3.22	4.16	4.18	13.95	34.10
Total CSS going through the State Budgets	20254.99	14.12	18.25	18.35	61.17	149.58
CSS By-passing the State Budgets	34324.67	23.92	30.93	31.10	103.66	253.48
Total CSS	54579.66	38.04	49.18	49.44	164.83	403.06
State Plan Outlays in Ministries/ Departments Budgets	2018.51	1.41	1.82	1.83	6.10	14.91
Schematic State Plan Outlay of Finance Ministry	11049.05	7.70	9.96	10.01	33.37	81.60
Total Schematic Outlay of State Plans	13067.56	9.11	11.77	11.84	39.46	96.50
Total Schematic State Sector Outlays	67647.22	47.14	60.95	61.28	204.30	499.56
Normal Central Assistance	15450.95	10.77	13.92	14.00	46.66	114.10
Total State Sector Outlay in GBS	83098.17	57.91	74.87	75.28	250.96	613.67

State sector outlay in central plan finally reaches states and their agencies (including local bodies). It is interesting to measure role of central plan expenditures in what is essentially states' constitutional domain. We compare in the following Table 2.3 central plan expenditure in states' domain to states total revenues, states revenue expenditure and states' total plan expenditure.

State Sector Outlays of Centre going through and By-passing State Budgets

Key concern of this paper has been to estimate the central plan outlays by-passing the state budgets. It is important also to examine comparative position of central outlays which by-pass state budgets as compared to what goes through the budget. Table 2.4 places the comparative position. In terms of schematic transfers (special purpose schemes), of total central outlay of INR 67647.22 crores, INR 33322.55 crores (49.26 percent) goes through the budget, whereas INR 34324.67 crores (50.74 percent) was to by-pass the state budgets. Out of the total central expenditure of INR 83098.17 crores on state subjects through state governments, state agencies and local bodies, the outlay going through the state budget was INR 46863.83 crores (58.69 percent) and outlay bypassing the state budgets was INR 34324.67 crores (41.31 percent).

We compare Table 2.5 central plan expenditure in states' domain to states total revenues, states

Table 2.3: Central Government's Plan Expenditure on States Sector Subjects as a Proportion of States Revenues, Expenditures and Plan Expenditures

State Sector Outlays in Central GBS in Different Dimensions		As a Proportion of		
		Total Revenue Receipts of States (BE 2005-06)	Total Revenue Expenditure of States (BE 2005-06)	Total Plan Expenditure of States (BE 2005-06)
	INR Crores	421324	445818	160081
CSS Budgeted to go through State Budgets	15637	3.71	3.51	9.77
Functional CSS going through State Budgets	4618	1.10	1.04	2.88
Total CSS going through the State Budgets	20255	4.81	4.54	12.65
CSS by-passing the State Budgets	34325	8.15	7.70	21.44
Total CSS	54580	12.95	12.24	34.10
State Plan Outlays in Ministries/ Departments Budgets	2019	0.48	0.45	1.26
Schematic State Plan Outlay of Finance Ministry	11049	2.62	2.48	6.90
Total Schematic Outlay of State Plans	13068	3.10	2.93	8.16
Total Schematic State Sector Outlays	67647	16.06	15.17	42.26
Normal Central Assistance	15451	3.67	3.47	9.65
Total State Sector Outlay in GBS	83098	19.72	18.64	51.91
Total Schematic Outlays (State Plan and CSS) going through State Budgets	33323	7.91	7.47	20.82
Total Outlay going through State Budgets	46864	11.12	10.51	29.28

Table 2.4: Classification of Centre's Plan Expenditure on State Subjects through State Budgets and By-passing State Budgets

Particulars	Outlays	Total GBS for Plan	GBS in Outcome Budget	GBS for Central Plan	Total GBS for State Plan	Normal Central Assistance
Total Schematic Outlays (State Plan and CSS) going through State Budgets	33322.55	23.22	30.02	30.19	100.64	246.08
Total Outlay going through State Budgets (inclusive of NCA)	46863.83	32.66	42.22	42.45	141.53	346.08
CSS By-passing the State Budgets	34324.67	23.92	30.93	31.10	103.66	253.48

Table 2.5: Centre's Plan Expenditure on State Subjects through State Budgets and By-passing State Budgets as a Proportion of States Revenues, Expenditures and Plan Expenditures

Particulars	Outlays (INR Crores)	As a Proportion of		
		Total Revenue Receipts of States (BE 2005-06) 421324	Total Revenue Expenditure of States (BE 2005-06) 445818	Total Plan Expenditure of States (BE 2005-06) 160081
Total Schematic Outlays (State Plan and CSS) going through State Budgets	33323	7.91	7.47	20.82
Total Outlay going through State Budgets (inclusive of NCA)	46864	11.12	10.51	29.28
CSS By-passing the State Budgets	34325	8.15	7.70	21.44
Total State Sector Outlay in GBS	83098	19.72	18.64	51.91

revenue expenditure and states' total plan expenditure.

It would be quite reasonable to conclude that a highly significant amount of central plan expenditure on state subjects by-passes the state budgets. If we view this phenomenon only in terms of Centrally-sponsored Schemes, a very high percentage (62.89 percent) by-passes the state budgets.

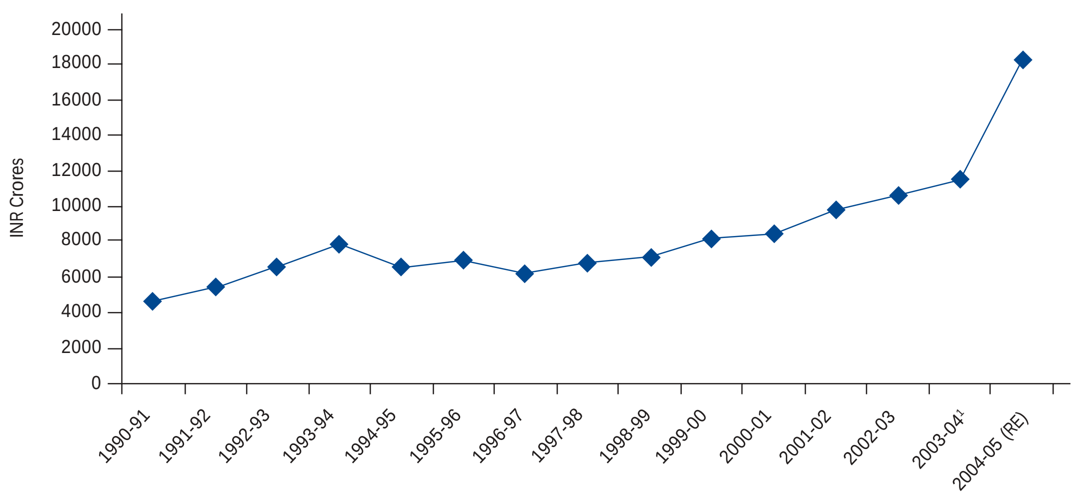
Part 3: CSS and States Finances

States' Aggregate Receipts from Centrally-sponsored Schemes/Central Plan Schemes over 1990-2005

Grants from centre received by the states are broadly classified in three categories in the states budgets and accounts. These are state plan grants, centrally-sponsored/ central plan (CSS/CP) schemes grants and nonplan grants. State plan grants correspond to the central assistance to the states from the centre for their plans and comprise both normal central assistance and additional central schemes (ACA) schemes. Nonplan grants are largely the grants which are recommended by the Finance Commissions and grants administered by the Ministry of Home Affairs, as the Ministry is the principal nonplan Ministry at the centre and has quite a few schemes for assisting states. All plan grants which are schematic are part of the CSS/ CP grants. There are many cases of mis-classification of grants in states accounts. However, we would go by the data as compiled and published by the Reserve Bank of India (RBI). RBI compiles data for CSS/CP schemes under three broad subclasses of Central Plan Schemes, Centrally-sponsored Schemes and North Eastern Council (NEC)[10]/ Special Plan Schemes. Central Government classifies all central plan schemes for which the funds are routed through states' budgets as CSS/CP schemes. CSS/CP grants to states from Centre, as per states data, increased from INR 4577.18 crores in 1990-91 to INR 18294.83 crores in 2004-05. See **Annexure 8** for annual details. Figure 3.1 graphically presents trends.

CSS receipts have exhibited volatility for states and have constantly declined as a proportion of states' total revenues over the years (direct transfers to state/district agencies and local bodies are not covered in these transfers through the budget). States' CSS/CP receipts, as a proportion to total central grants and their total revenues are placed at **Annexure 9** for the years 1990-2005. If we do not take into consideration the RE numbers of 2004-05, as these might turn

Figure 3.1: CSS/CP Grants to States Over the Years



[10] North Eastern Council comprises of eights states of India in the eastern part of India. NEC undertakes projects of regional importance funded by grants from the Union Budgets.

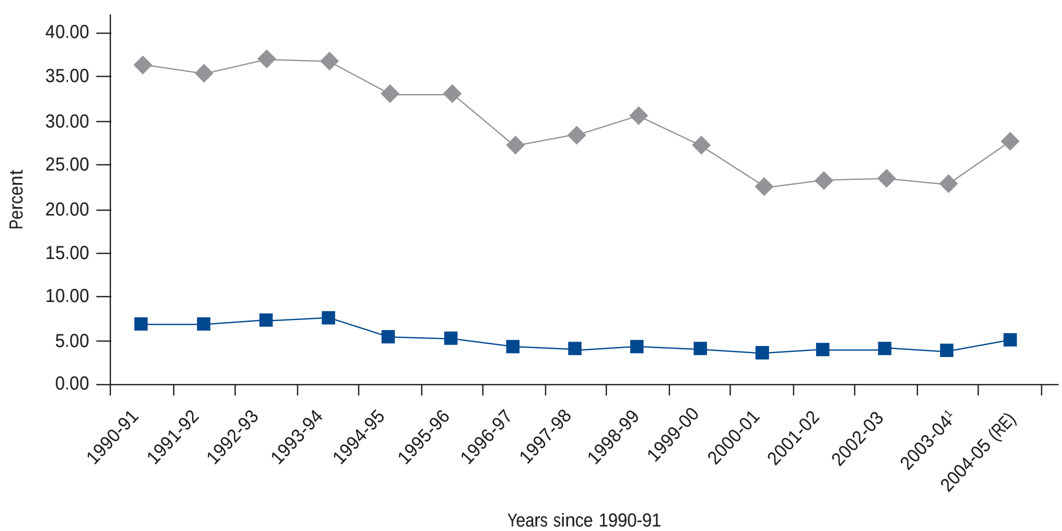
out to be quite different later when actuals are available, CSS/CP receipts declined from 36.13 percent of total central grants (average of 1990-93) to 23.03 percent (average during 2002-04). As a proportion of states' total revenue receipts also, receipts from CSS/CP declined from 6.92 percent to 3.84 percent during these two periods (1990-93 compared with 2001-04). See Figure 3.2 for trends of CSS/CP receipts as a proportion of total grants and states total revenues.

Individual States' receipts from Centrally-sponsored Schemes/Central Plan Schemes over 1990-2005

Annexure 10 lists CSS receipts for all 28 states between 1990-2005 and gives proportion of CSS receipts to total grants from the centre and their total revenues. Taking four years average of actuals (2000-04) and comparing across states in terms of absolute amounts of CSS grants received, its proportion to total grants from the Centre and share of CSS grants in their total revenues, key highlights of these transfers, are as under:

- Andhra Pradesh was the largest recipient of CSS/CP grants in terms of absolute amount during this period at INR 890.75 crores. AP was followed up by states of Rajasthan at INR 768.95 crores, Jharkhand at INR 739.91 crores and Maharashtra at INR 739.91 crores;
- Goa on the other hand received lowest amount of INR 21.24 crores on an average during this four year period, followed by Sikkim at INR 46.32 crores and Meghalaya at INR 80.90 crores;
- CSS/CP grants formed largest chunk of central grants for the state of Jharkhand at 45.09 percent, followed by states of Maharashtra at 41.74 percent, Kerala at 41.51 percent and Karnataka at 40.91 percent;
- As special category states receive proportionally much higher grants as state

Figure 3.2: CSS/CP Receipts (Proportion of Total Central Grants — Blue — and States' Revenue Receipts-pink)



plan assistance, most of them received 10 percent of central grants as CSS/CP grants, with Jammu and Kashmir receiving the lowest proportion at 4.51 percent;

- Jharkhand (10.23 percent) was the only state for which CSS grants made up for more than 10 percent of entire revenues. For Mizoram, CSS grants were 9.22 percent of its' entire revenues and for Arunachal Pradesh, CSS grants made up for 8.71 percent; and
- Quite a few states received CSS grants which were less than three percent of their entire revenues. Goa received only 1.26 percent, Punjab 1.75 percent, Gujarat 1.90 percent, Maharashtra 2.27 percent and Haryana 2.33 percent.

Part 4: Analysis of New Major Central Schemes

(National Rural Employment Guarantee Programme, National Rural Health Mission, Bharat Nirman and National Urban Renewal Mission)

National Common Minimum Programme

Present United Progressive Alliance (UPA) government came to power in the elections held in May 2004. UPA released its National Common Minimum Programme (NCMP) on 27th May 2004. Four major programs subject of this study have their roots in the NCMP. To quote relevant extracts from NCMP:

- The UPA government will immediately enact a National Employment Guarantee Act. This will provide a legal guarantee for at least 100 days of employment to begin with on asset-creating public works programs every year at minimum wages for at least one able-bodied person in every rural, urban poor and lower middle-class household. In the interim, a massive food-for-work program will be started;
- The UPA government will ensure that public investment in agricultural research and extension, rural infrastructure and irrigation is stepped up in a significant manner at the very earliest. Irrigation will receive the highest investment priority and all ongoing projects will be completed according to a strict time schedule;
- The UPA government will raise public spending on health to at least two-three percent of GDP over the next five years with focus on primary health care. A national scheme for health insurance for poor families will be introduced. The UPA will step up public investment in programs to control all communicable diseases and also provide leadership to the national AIDS control effort;
- The UPA government commits itself to a comprehensive program of urban renewal and to a massive expansion of social housing in towns and cities, paying particular attention to the needs of slum dwellers. Housing for the weaker sections in rural areas will be expanded on a large scale. Forced eviction and demolition of slums will be stopped and while undertaking urban renewal, care will be taken to see that the urban and semiurban poor are provided housing near their place of occupation; and
- The UPA will pay special attention to augmenting and modernizing rural infrastructure consisting of roads, irrigation, electrification, cold-chain and marketing outlets. All existing irrigation projects will be completed with three to four years. Household electrification will be completed in five years.

Announcement of major schemes in Budget 2005-06

UPA government's first full budget was for financial year 2005-06 presented on February 2005. Programmatic commitments of NCMP were announced as major flagship programs of the UPA government in this budget. To quote from the budget speech 2005-06 of Finance Minister:

- National Rural Employment Guarantee Scheme: "National Food for Work Programme

was launched in November 2004.
….allocation will increase to INR 11000 crores. It is Government's intention to convert this program into the National Rural Employment Guarantee Scheme. When fully rolled out, the scheme will provide livelihood security for crores of poor families, and I promise to find money for the program;"

- National Rural Health Mission: "The National Rural Health Mission (NHRM) will be launched in the next fiscal. Its focus will be strengthening primary health care through grass root level public health interventions based on community ownership. The total allocation for he Department of Health and the Department of Family Welfare will increase from INR 8420 crores in the current year to INR 10280 crores in the next year. The increase will finance the NHRM and its components like training of health volunteers, providing more medicines and strengthening the primary and community health centre system;"
- Bharat Nirman: "Bharat Nirman has been conceived as a business plan, to be implemented over a period of four years, for building infrastructure, especially in rural India. It will have six components, namely, irrigation, roads, water supply, housing, rural electrification and rural telecom connectivity. In each of these areas, we must dare to be bold and set for ourselves high targets to be achieved by the year 2009. The UPA Government's goals are:

  a. To bring an additional one crore hectares under assured irrigation;

  b. To connect all villages that have a population of 1000 (or 500 in hilly/tribal areas) with a road;

  c. To construct 60 lakhs additional houses for the poor;

  d. To provide drinking water to the remaining 74000 habitations that are uncovered;

  e. To reach electricity to the remaining 125000 villages and offer electricity connection to
  2.3 crores households; and

  f. To give telephone connectivity to the remaining 66822 villages.
- National Urban Renewal Mission: "The demographic trends in the country indicate a rapid increase in urbanization. India needs urban facilities of satisfactory standards to cope with the challenge. If our cities are not renewed, they will die. The National Urban Renewal Mission is designed to meet this challenge. It will cover the seven mega cities, all cities with a population of over a million, and some other towns. I propose to make an outlay of INR 5500 crores in 2005-06, including a grant component of INR 1650 crores for the Mission."

National Rural Employment Guarantee Programme

Objectives

India has not used system of legal mandates for conferring entitlements on beneficiary groups, households or individuals for its development programs. India has long history of running large rural employment schemes. For the first time, the Parliament enacted National Rural Employment Guarantee Act (NREGA), 2005 (notified on 7th September 2005) for conferring a statutory entitlement or at least 100 days of employment in one financial year on every rural household whose adult member(s) volunteer to do unskilled manual work. This employment guarantee is at statutory minimum wage rate. This guarantee has been given in 200 notified districts of the country from February 2, 2006. The program is programmed to be extended to all districts of the country in five years. NREGA provides that state governments shall give this guarantee and in the event the state government does not provide employment to any such eligible rural household, the state government has to pay an unemployment allowance. Unemployment allowance is to be paid at the rate of 25 percent of the minimum wages for first thirty days and at 50 percent of the minimum wage for the remaining days of the financial year. The unemployment allowance, together with whatever wages is earned for days, if any, for which employment was provided to any household, cannot exceed more than 100 days of wages at minimum wage.

State governments are to issue Employment Guarantee Schemes as statutory schemes under the Act. Central government has framed operational guidelines for laying down important parameters and standards which can form part of the schemes to be notified by the state governments.

Budget Outlays (Size of GoI Funding Support)

Budget 2005-06 did not provide any specific outlay for NREGA as such. The outlays available under the head National Food for Work Programme were to be used for NREGA during the year, whenever the NREGA districts get notified. Budget provision for National Food for Work Programme was INR 5400 crores for FY 2005-06. Budget 2006-07 indicates that a National Rural Employment Guarantee Fund (NREGF) has been created, as required under the NREGA Act for transferring funds to state agencies for meeting cost of components which the Central Government is obliged to bear as per the provisions of NREGA. A total amount of INR 11300 crores is budgeted to be transferred from the Consolidated Fund of India to NREGF for further transfer to states.

Allocation Basis

NREGA provides that Central Government will bear the complete cost of wages of labor employed on NREGA works under the Act, 75 percent cost of material, skilled and semiskilled workers, complete administrative cost of the program, including the salaries of program officers and their staff and cost of central employment guarantee council. The state governments are to bear complete unemployment cost, 25 percent of the cost of material, skilled and semiskilled workers and other costs of the program.

There is no normative allocation basis for allocating funds to various states. Requirement of each state is to be furnished by state governments in the annual State Annual Work and Budget Proposal (AWBP). AWBPs would have detailed estimates of the cost to be borne by the centre and the states. Once central government approves AWBP of a state with the cost to be borne by the state and the centre, the approved cost becomes commitment of the centre to provide to the states, subject of-course to satisfaction of other conditions of the Act and guidelines.

Fund Routing Arrangement

The central funds under NREGA are to be transferred from the NREGF to the state/ district level 'receptacle' designated by the state governments in their Rural Employment Guarantee Schemes. There is no transfer to the budget of the state government. Ministry of Rural Development has been consistently following the policy of transferring funds to the District Rural Development Agencies (DRDAs)[11] and Zila Parishads (ZPs)[12] under all its programs. Most of the state governments have designated DRDAs/ZPs as the "receptacle" under the scheme.

Bharat Nirman

Bharat Nirman is an umbrella nomenclature for six major rural infrastructure programs. All the six programs were under implementation even before the UPA government came into power in 2004. UPA government has put them together in one coherent program and has sought to raise outlays for these programs.

Planning Commission estimates the cost of achieving specific targets at INR 176205 crores. Component wise cost estimates are as under (Table 4.1):

Central government spending on CSS and other schemes in states domain is constantly increasing. Over the years, this has made the Central government alter the basis character of central assistance for states plans. Specific purpose schemes have been introduced as part of central assistance for states plan diluting the prime 'block' character of it.

Objectives

Specific objectives for these six programs as part of the Bharat Nirman were stated in the budget speech of FM for 2005-06 Budget (see page 16 above). Objectives of these six programs are described more comprehensively in the **Annexure 11**.

Budget Outlays (Size of GoI Funding Support)

In the budget 2005-06, three of the six Bharat Nirman schemes viz. PMGSY, IAY and AWRSP were budgeted as CSS in the budget of the Ministry of Rural Development. While PMGSY and IAY are implemented by the Department of

Table 4.1: Program Components of Bharat Nirman

(INR crores)

Sector	Program	Cost
Irrigation	Accelerated Irrigation Benefit Programme (AIBP)	68,500
Drinking Water	Accelerated Rural Water Supply Programme (AWRSP	25,300
Rural Roads	Pradhan Mantri Gram Sarak Yojana (PMGSY)[13]	47,554
Rural Housing	Indira Awas Yojana[14] (AWY)	11,000
Rural Electrification	Rajiv Gandhi Grameen Vidyutikarann Yojana[15] (RGGVY)	23,300
Rural Telephone	Village Public Telephone Scheme for Rural Telephone Connectivity	451

[11] DRDAs are societies registered under the Societies Registration Acts with separate Bank account and budget to implement the rural development schemes of the central government. In some states, DRDAs have been merged with Zila Parishads.
[12] Zila Parishads are the top and the district level organization of the three (in some states two) tier system of panchayats which are representative local bodies in the rural areas elected by people directly.
[13] Prime Minister Rural Roads Programme.
[14] Named after former prime minister Indira Gandhi, Indira Housing Programme.
[15] Named after another former prime minister, Rajiv Gandhi Rural Electrification Scheme.

Rural Development, AWRSP is implemented by the Department of Drinking Water Supply. Two schemes viz. AIBP and Rural Household Electrification (later renamed as RGGVY) were budgeted as state plan schemes in the budget of the Ministry of Finance in 2005-06 budget. The last scheme (Rural Telephone Connectivity), funded from Universal Service Obligation Fund in the Public Account, is a non-budgetary scheme. Scheme wise budget outlays for 2005-06 were (Table 4.2):

AIBP was funded with 100 percent loans from the Centre to the states until 2003-04. Funding pattern was changed in 2004-05 for providing 30 percent grant on certain types of AIBP projects. Going by the past traditions, BE for 2005-06 did not provide any grant funds for AIBP and as it was decided not to provide loans to states for plan schemes (states were permitted to raise additional market loans in lieu thereof), there was no loan provision either. Therefore, there was no budget provision for AIBP in BE 2005-06. Budget provision has been raised to INR 1680.00 crores in RE 2005-06 as presented with BE 2006-07.

To quote from the Tenth Plan Document, "Plan expenditure arises out of schemes freshly introduced in an ongoing Five Year Plan (FYP) period. In the same period, nonplan expenditure arises out of schemes carried forward from previous FYP periods. Nonplan expenditure, therefore, supports the old schemes of governments and plan expenditure, the new schemes. Since new schemes add to the economy's productive capacity as the old schemes did in the past, plan expenditure reflects government's investment in enhancing the economy's productive capacity.

RGGVY was budgeted as Household Electrification Scheme in the BE 2005-06 as state plan scheme under demand no 36 of the Ministry of Finance. Later on, during the year, the scheme was shifted to budget of Ministry of Power as a CSS. Budget 2006-07 indicates that provision of RGGVY for 2005-06 RE was placed at INR 1100.00 crores.

Allocation Basis

INDIRA AWAS YOJANA (IAY)

Scheme is funded in the ratio of 75:25 i.e., central government bears 75 percent of the cost of subsidy payable under the scheme. Funds are allocated on the basis of the poverty ratio and housing shortage with equal weightage to both the factors. Poverty ratios are prepared by the

Table 4.2: Budgetary Outlays of Bharat Nirman Schemes

Program	Budget Outlay (2005-06) INR Crores
Accelerated Irrigation Benefit Programme (AIBP)	0 (4,500)
Accelerated Rural Water Supply Programme (AWRSP)	4,050
Pradhan Mantri Gram Sarak Yojana (PMGSY)	4,235
Indira Awas Yojana (AWY)	2,775
Rajiv Gandhi Grameen Vidyutikarann Yojana (RGGVY)	1,100
Village Public Telephone Scheme	No budgetary outlay

Planning Commission and housing shortage is based on decennial census.

PMGSY

There is no formula for allocating funds to the states. PMGSY is a time bound program to complete all eligible rural roads. States estimate their requirements based on District Rural Roads Plan prepared for providing rural roads connectivity to all eligible villages/habitations.

ARWSP

ARWSP funds are allocated amongst the states on the basis of a five point formula as under:

Rural Population	40
States with inaccessible Areas[16]	35
Not Covered/Partly Covered Villages (in the ratio of 2:1)	10
Quality Affected Villages	5
Overall Water Resources Availability (unirrigated over irrigated)	10

The states have to provide matching share.

ACCELERATED IRRIGATION BENEFIT PROGRAMME

AIBP, launched in 1996-97, intended to provide funds, albeit loans only, to state governments to accelerate completion of 171 major, 259 medium and 72 extension, renovation and modernization (ERM) irrigation projects, at various stages of construction, involving total public investments of INR 75,690 crores. The Program was intended to give top priority to last mile projects. However, over the years, its focus has got dilute. Presently, new minor surface irrigation projects in certain states are also eligible besides projects which are still incomplete. GoI works out its funding allocation to the states in a complicated way. First AIBP eligible cost is worked out, taking into several factors into consideration (type of the project, whether it fast track, whether the state has committed to undertake reforms, whether the project state is a special category state or general). AIBP cost varies from 66.67 percent of the cost to 100 percent of the cost of the project. GoI funds 30 percent of such AIBP cost in case of general category states and 90 percent for special category states and one backward area of Orissa in the form of grants. The states are to raise the remainder AIBP cost of the project from the market by loans.

There is no formula of dividing total grants available on any normative basis to the states. Allocation to the states depends upon the number of projects approved under the AIBP and expected expenditure on such projects during the year.

RGGVY

GoI provides 90 percent cost as grants of creating following rural electrification infrastructure:

- Rural Electricity Distribution Backbone (REDB) with at least one 33/11 (66/11) kv substation in each 'block';
- Village Electrification Infrastructure (VEI) with at least one distribution transformer in each village/habitation; and
- Decentralized Distribution Generation where grid supply is not feasible

[16] Four types of areas fall under this category (areas covered under Desert District Programme, Drought Prone Area Programme, Hill Area Development Programme and special category hill states).

The scheme provides for free of cost connection to each household below poverty line (this does not include free electricity supply, which can be subsidized by states, if they intend to do so).

Allocations are based on backlog of rural electrification infrastructure.

RURAL TELEPHONE CONNECTIVITY

No budget funds are involved. There is no allocation as such. The state agencies BSNL/NTNL are provided required funds.

Fund Routing Arrangement

INDIRA AWAS YOJANA (IAY)

Funds are released to DRDAs/Zila Parishads. Usually 60 percent of the annual allocation is released as first installment (modest cuts are applied in certain conditions based on balances with states from the previous year) and second installment depending upon the progress during the year.

PMGSY

Ministry of Rural Development releases the funds directly to State Rural Roads Development Agencies (SRRDAs) on the recommendations of National Rural Roads Development Agency.

AWRSP

Funds are routed from the Budget of Department of Drinking Water to budgets of the state governments and to state level water missions. AWRSP thus operate as a CSS with direct funding to state governments as well as to state level water missions societies by-passing the state budgets.

AIBP

GoI grant funds are released through the state government. AIBP funds thus get routed through the state governments.

RGGVY

GoI support is grant support and is routed through the Rural Electrification Corporation (REC), a central government undertaking. REC provides grants to electricity utilities, with or without any additional loans for the RE projects.

RURAL TELEPHONE CONNECTIVITY

Telecom operators subject to the universal obligations under their licenses contribute the USO Fund. Funds required for the rural connectivity under the Bharat Nirman Programme are released from the USO Fund, which is an account in the Public Account of GoI to the state agencies of BSNL/MTNL.

National Rural Health Mission

Objectives

NRHM aims at providing accessible, affordable, effective, accountable and reliable healthcare to all citizens and in particular to the poorer and vulnerable sections of the population; consistent with the outcomes envisioned in the Millennium Development Goals and general principles laid down in the National and State policies, including the National Health Policy, 2002 and National Population Policy, 2000. The "architectural correction" of the health sector is a key objective for the NRHM, to be carried out through integration of vertical programs and structures; delegation and decentralization of authority; involvement of Panchayati Raj Institutions and other supportive policy reform measures in the areas of medical education, public health management, incorporation of Indian Systems of Medicine, regulation of healthcare providers and new health financing mechanisms.

NHRM aims at providing effective rural healthcare services, more specifically, in eighteen states of India with relatively poorer health indicators and services. These states are Arunachal Pradesh, Assam, Bihar, Chhattisgarh, Himachal Pradesh, Jharkhand, Jammu and Kashmir, Manipur, Mizoram, Meghalaya, Madhya Pradesh, Nagaland, Orissa, Rajasthan, Sikkim, Tripura, Uttaranchal and Uttar Pradesh.

NRHM is again an umbrella program for all healthcare programs of combined Department of Health and Family Welfare in GoI, excluding only AIDS control program and the National Cancer Control Program. GoI contribution to NHRM covers, among others, implementation of RCH phase II, National Vector Borne Disease Control Program, National Leprosy Eradication Program, National Iodine Deficiency Disorder Program, Revised National Tuberculosis Program, National Blindness Control Program, AYUSH scheme on hospitals and dispensaries, Integrated Disease Surveillance Program and the thrust areas identified under the NRHM.

The NRHM would operate as an omnibus broadband program by integrating all vertical programs of the Departments of Health and Family Welfare. However, independent subbudget lines are being retained to provide independent "financial" identity till the expiry of existing bilateral agreements.

NHRM also introduce an additional female health activist in each village.

Allocation Basis

The MoHFW will provide a resource envelope to support the implementation of an agreed State NRHM Sector Programme Implementation Plan (PIP), also referred to as Sector PIP, reflecting all sources of funding for the health sector, including State's own contribution. The agreed outlay for the Sector PIP for financial year 2005-06 and 2006-07 and the sources for the funding of the same are being indicated in the Memorandum of Understanding being signed with each of the states.

Budgetary Outlays

NHRM is a Centrally-sponsored Scheme under MoHFW. Budget outlay for NHRM is INR 6508.05 crores, which has been slightly revised downwards to INR 6075.17 crores in RE for 2005-06. Budget outlay for 2006-07 has been kept at INR 8141 crores. The Budget outlay comprises of specific outlays for all erstwhile components of health intervention like disease control programs, RCH, family welfare etc. There is a provision of INR 1530.88 crores as Mission Flexible Pool and INR 1529.95 crores for RCH Flexible Pool under Flexible Pool of State Project Implementation Plans in the 2006-07 budget. There was no such provision in the budget 2005-06 for mission flexible pool. Provision for RCH flexible pool was for INR 614.48 crores in BE 2005-06 which has been revised to INR 1781.42 crores in RE 2005-06.

Funds Routing Arrangement

The State governments have been asked to merge existing State level vertical societies in the health sector into an integrated Society, usually referred to as SCOVA. This society receives the funds from the MoH&FW directly. State governments are also to transfer their shares to SCOVA. Part of the NHRM funds are routed through the state governments directly also as the entire establishment of family welfare services are funded by GoI.

National Urban Renewal Mission

National Urban Renewal Mission, renamed Jawaharlal Nehru National Urban Renewal Mission (JNNRUM) was launched on December 3, 2005. It has two sub-missions. JNNRUM aims at reforms driven, fast track, planned development of identified cities with focus on efficiency in urban infrastructure/ services delivery mechanism, community participation and accountability of Urban Local Bodies (ULBs)/ Parastatals[17] towards citizens.

First sub-mission on Urban Infrastructure and Governance, a city-based program, has been launched with the objective of paying focussed attention to integrated development of infrastructural services in the cities covered[18] under the Mission, secure effective linkages between asset creation and asset management so that the infrastructural services created in the cities are not only efficiently maintained, but become selfsustaining over a period of time, and to ensure adequate investment of funds to fulfil deficiencies in the urban infrastructure services. The sub-mission also targets planned development of identified cities including peri-urban areas, outgrowths, inner (old) areas of the cities and urban corridors so that urbanization takes place in a dispersed manner. The sub-mission also has the objective of scaling up delivery of urban services and utilities with universal access to all. Second sub-mission on basic urban services has similar objectives but is more focussed on providing basic services to urban poor including security of tenure at affordable prices, improved housing, water supply, sanitation and ensuring delivery through convergence of other already existing universal services of the Government for education, health and social security.

JNNURM seeks to build the capacity of Indian cities for management and provide them with financial muscle and the technical resources to rebuild themselves. Governance reform-related proposal in the Mission for a participation law and a disclosure law are seen as necessary to enable the cities to locate the needed human and financial resources for improving its services. Operational framework of the Mission seeks to create capacities in the Cities to develop a long-term planning framework.

JNNURM seeks to draw a governance reform agenda for urban sector policies and organizations. States have to enter into a memorandum of understanding with the Centre, with reforms being classified in two parts. Mandatory reforms have to be completed within the period of reforms, whereas voluntary reforms agenda can be drawn up with mutually agreed time schedule.

[17] Parastatals are nonrepresentative official instrumentalities of states created for specific purposes like Delhi Jal Board is for delivering water services to people of Delhi or Delhi Transport Corporation is for delivering bus services.

[18] There are in all 63 cities covered under the program. 35 cities have been selected on the basis of population as per 2001 census (with population of more than one million). Remaining 28 cities include all the state capitals not selected as per population criterion and certain other cities which are considered of religious/ historic or tourist importance.

Budgetary Outlay

Budget 2005-06 had provided for a grant outlay of INR 1027.55 crores for sub-mission on Urban Infrastructure and Transport and INR 589.62 crores for sub-mission on Slum Development. These outlays have been drastically reduced to INR 150.00 and INR 100.00 crores, respectively, in the revised estimates for 2005-06. Budget 2006-07 enumerates four components of Jawaharlal Nehru Urban Renewal Mission with the budget provision for 2006-07 as under:

a. Sub-mission on Urban Infrastructure and Governance	INR 2287.15 crores
b. Sub-mission on Urban infrastructure for Small & Medium Towns (UIDSSMT)	INR 900.00 crores
c. Sub-mission on Basic Services for Urban Poor	INR 908.78 crores
d. Integrated Housing and Slum Development (IHSD)	INR 500.00 crores

There is provision for total outlay of INR 4595.93 crores for JNURM. Sub-Mission on Urban Infrastructure and Governance and Basic Services for Urban Poor are part of JNURM launched in select 65 cities. UIDSSMT is a long time running scheme of the Ministry, which is also now listed as a part of JNURM. Similarly, an earlier state plan scheme of Slum Development is listed as fourth component of JNURM. It seems that UIDSSMT and IHSD are not part of JNNURM, but shifted as state plan schemes from the financial year 2006-07.

Allocation Basis

GoI has promised to bear a part of the approved cost of projects as grants to the project. Percentage of cost as grants varies from 35 percent to 90 percent. Projects in cities with population of more than four million gets grants of 35 percent of the project cost whereas projects in cities with population between one to four million gets grants at 50 percent of the project cost. Projects in select cities in North-Eastern India and state of Jammu and Kashmir get 90 percent of the cost as central grant. Projects in other select cities and water desalination projects get 80 percent of the cost as grants. Projects of urban transport also are not governed by this formula-based grant system. Level of equity and/or loan support of the centre for the projects would be decided on case to case basis.

Fund Routing Arrangement

Funds under the Program were proposed in the JNURM guidelines issued in December 2005 to be released by Ministry of Urban Development to the designated state level agencies. However, GoI has now decided that JNURM would be a state sector scheme and budget provision for JNURM has again been made in the budget of Ministry of Finance. Funds of all state plan schemes are usually released to the state governments. It appears that the funds of JNURM will also go to the state governments first which in turn may be asked to release it to the state designated agencies.

Four Major Schemes Summarized

We summarize the objectives, allocation basis, budget outlay for 2005-06 and funds routing arrangements for the four major schemes reviewed in Table 4.3.

Table 4.3: Summary Position for Four Major Schemes Reviewed

Scheme	Objectives	Allocation Basis	Outlays 2005-06 BE	Fund Routing Arrangement
National Employment Guarantee Scheme	Conferring a statutory entitlement for at least 100 days of employment in one financial year on every rural household at statutory minimum wage rate in 200 notified districts of the country (to be extended to all districts of the country in five years) failing which state governments to pay an unemployment allowance	GoI to bear cost of wages and 75% cost of material, skilled and semiskilled workers. State governments to bear unemployment cost and 25% of the cost of material, skilled and semiskilled workers. No normative fund allocation basis. Requirement assessed on the basis of annual State Annual Work and Budget Proposals (AWBP) of states	Budget 2005-06 did not provide any specific outlay for NREGA as such. Outlays of National Food for Work Program (INR 5400 crores) for FY 2005-06 to be utilized for this purpose	The central funds under NREGA are to be transferred from the NREGF to the state/ district level "receptacle" designated by the state governments in their Rural Employment Guarantee Schemes. There is no transfer to the budget of the state government
Bharat Nirman A. Accelerated Irrigation Benefit Programme (AIBP)	Completion of ongoing irrigation/multipurpose projects in advance stage of construction in a time-bound manner with a view to creating additional irrigation potential	Allocation depends upon the number of projects approved under the AIBP and expected expenditure on such projects during the year	0	State Plan Schemes. From Ministry of Finance to State Governments on the basis of recommendations from Ministry of Water Resources
B. Accelerated Rural Water Supply Programme (AWRSP)	Provision of safe drinking water to rural habitations without or partial coverage of drinking water supply and to promote sustainability of safe drinking water systems	Allocated on the basis of a five point formula with weights: Rural Population (40); States with inaccessible areas (35); Not Covered / Partly Covered Villages in the ratio of 2:1 (10); Quality affected villages (5); and Overall water resources availability (10)	INR 4050 crores	CSS. Department of Drinking Water releases funds directly to state governments as well as to state water missions societies (composite routing)
C. Pradhan Mantri Gram Sarak Yojana (PMGSY)	Provision of rural connectivity, through all weather roads, to all rural habitations with population of more than 1000 (500 in case of hilly and desert villages and 250 in case of tribal villages)	Funds allocated on the basis of requirements of rural roads to complete all eligible rural roads in four years	INR 4235 crores	Department of Rural Development to State Rural Roads Development Agencies (SRRDAs) on the basis of recommendations of NRRDA (by-passes state budgets)

Table 4.3: Summary Position for Four Major Schemes Reviewed (Contd.)

Scheme	Objectives	Allocation Basis	Outlays 2005-06 BE	Fund Routing Arrangement
D. Indira Awas Yojana (AWY)	Provision of shelter to the rural poor by providing assistance for construction of dwelling units and upgradation of existing unserviceable nonpermanent houses for Scheduled Castes/ Scheduled Tribes and nonSC/ST rural families living below the poverty line	Funded in the ratio of 75:25 i.e., central government bears 75% of the cost of subsidy payable under the scheme, central funds are allocated on the basis of the poverty ratio and housing shortage with equal weightage to both the factors	INR 2775 crores	Department of Rural Development to District Rural Development Agencies/ Zila Parishads by-passing state budgets)
E. Rajiv Gandhi Grameen Vidyutikarann Yojana (RGGVY)	Creation of rural electricity infrastructure and household electrification for providing access to electricity to all rural households	On the basis of the backlog of targeted rural electricity infrastructure	INR 1100 crores	State Plan Scheme initially in BE 2005-06 converted in CSS later. Ministry of Power transfers funds to Rural Electrification Corporation (REC) which in turn releases to state-level implementing agencies
F. Village Public Telephone Scheme	Provision of a public telephone booth in villages	No budgetary outlay is allocated	No Budgetary Outlay	From Universal Obligation Fund in the Public Account to Public Sector Telecom Companies
National Rural Health Mission	NHRM aims at providing effective rural healthcare services, more specifically, in 18 states of India with relatively poorer health indicators and services. An umbrella program for all health care programs of combined Department of Health and Family Welfare in GoI, excluding only AIDS control program and the National Cancer Control Program	A resource envelope to support the implementation of an agreed State NRHM Sector Programme Implementation Plan (PIP) as indicated in the Memorandum of Understanding being signed with each of the states	INR 6508.05 crores (not indicated as NHRM outlay in 2005-06 budget as such. From 2006-07 to be indicated as NHRM outlay	Ministry of Health and Family Welfare to state-level societies. Part funds are released to the state governments directly

Table 4.3: Summary Position for Four Major Schemes Reviewed (Contd.)

Scheme	Objectives	Allocation Basis	Outlays 2005-06 BE	Fund Routing Arrangement
National Urban Renewal Mission	JNNRUM aims at reforms driven, fast track, planned development of identified cities with focus on efficiency in urban infrastructure/ services delivery mechanism, community participation and accountability of Urban Local Bodies (ULBs)/ Parastatals towards citizens	GoI bears a part of the approved cost of projects as grants (percentage varies from 35% to 90% depending upon parameters of scheme). Aggregate requirement for each state estimated on the basis of projects approved and their expenditure requirement	INR 1027.55 crores for sub-mission on Urban Infrastructure and Transport and INR 589.62 crores for sub-mission on Slum Development	State Plan Scheme. Funds released by Ministry of Finance to State Governments on the basis of recommendations of Ministry of Urban Development and Ministry for Urban Employment and Poverty for two respective sub-missions

Part 5: Recommendations for Strengthening Capacity of State Finance Departments

Stakes and Concerns of States for Special Purpose Schemes

States have tremendous stakes in central grant transfers, most particularly in special purpose conditional grants, usually referred to as centrally-sponsored schemes (CSS) and ACA schemes, in India. These schemes have provided major financial lever to Government of India to change states' choices in these subjects, which are constitutionally almost exclusively their mandates. Special purpose schemes have grown substantially over the years, have acquired many dimensions, most notably of by-passing the states budgets in last few years.

States have two kinds of principal questions facing them concerning these special purpose transfers. First, states in general, believe that these special purpose schemes, have grown too big and too many to take away their fiscal independence in much of the expenditure field and therefore, as a policy and general approach, these should be wound down and central funds should either be transferred to them as additional share in taxes or in the form of block grants. Second, not having been able to stop growth of CSS leave alone curtailing these despite several attempts, states want to take as much share of CSS funds, as is possible for them as CSS funds are grant funds. There is another set of dilemma which states face and that is internal to them. Finance Departments of most states are in favor of constraining CSS growth and receiving central funds in block form, whereas most of developmental line departments at state level favor schematic transfers from Centre, as such transfers assure them of earmarked outlays in their sectors, especially in the situation of fiscal stress faced by states.

Role of Transfers under Special Purpose and other Discretionary Grants from Centre in States Revenues

Our study has been able to place definitive numbers to the schematic transfers. Special purpose schemes role in states budgets can be viewed from the share these now command in the total revenue receipts of the states. States revenues were budgeted at INR 430270 crores in 2005-06 (BE). Importance of such transfers in terms of states total revenue receipts is encapsulated as under:

- CSS as such (going through state budgets or by-passing state budgets but not including state plan ACA schemes) make up for as much as 12.68 percent of states total revenue receipts. CSS going through the states budget were relatively much less at 4.71 percent of states revenue receipts, whereas CSS by-passing the states budget were much larger at 7.98 percent of states total revenue receipts (Table 5.1);
- Other special purpose schemes, budgeted as state plan schemes, in the budget of Finance Ministry and some other administrative Ministries/ Departments were also significantly large at 3.04 percent of states total revenue receipts. See Table 5.2;
- CSS and ACAs combined were significantly high at 15.72 percent of states total revenue receipts. Inclusive of normal central assistance and other non-schematic discretionary transfers, central discretionary transfers made as much as 20 percent of states total revenue receipts at 19.31 percent. See Table 5.3;

- Of total central discretion funds which are estimated to make up 19.31 percent of states budgets, 7.98 percent by-passed the state budgets and remaining 11.34 percent was expected to go through states budgets. See Table 5.4.

Possible Work Areas for USAID

USAID can contemplate programs for assisting the states keeping in consideration this obtaining state of many policy issues facing the states as well as the importance CSS funds play in states finances. Centre also seems to have

Table 5.1: CSS as a Proportion of Total Revenue Receipts (TRR)

CSS Parameters	Amount	% of TRR[19]
CSS Budgeted to go through state budgets	15637.23	3.63
Functional CSS going through state budgets	4617.76	1.07
Total CSS going through the state budgets	20254.99	4.71
CSS by-passing the state budgets	34324.67	7.98
Total CSS	54579.66	12.68

Table 5.2: State Plan Specific Purpose Schemes as a Percentage of TRR

Schemes Parameters	Amount	% of TRR
State Plan Outlays in Ministries/Departments Budgets	2018.51	0.47
Schematic State Plan Outlay of Finance Ministry	11049.05	2.57
Total Schematic Outlay of State Plans	13067.56	3.04

Table 5.3: Special Purpose Transfers and Total Discretionary Grants as a Proportion of TRR

CSS Parameters	Amount	% of TRR
Total Schematic State Sector Outlays	67647.22	15.72
Normal and Other Nonschematic Central Assistance in Finance Ministry	15450.95	3.59
Total State Sector Outlay in GBS	83098.17	19.31

Table 5.4: Central Discretionary Grants Passing Through and By-passing State Budgets

CSS Parameters	Amount	% of Total Revenue Receipts
CSS By-passing the State Budgets	34324.67	7.98
Total Schematic Outlays (State plan and CSS) going through State Budgets	33322.55	7.74
Total outlay going through State Budgets	48773.50	11.34

[19] TRR is Total Revenue Receipts which includes both tax and nontax receipts of states from their own sources and transfers from centre.

massive coordinational issues concerning special purpose schemes. There is no single nodal authority or department responsible for coordinating special purpose schemes at the central level. I primarily see following major work areas for USAID:

- Assist Planning Commission and the Ministry of Finance in developing a comprehensive data base on all the special purpose schemes (irrespective of their multiple nomenclatures currently);
- Assist Ministry of Finance (primarily Chief Controller of Government Accounts) to develop a good system to capture releases, receipts, utilization and certification of funds transferred by various Ministries/ Departments to states, states/district agencies of state governments and local bodies;
- Assist States in building up their case better for streamlining and drastic reduction of special purpose schemes; and
- Assist States in building up a good database on all special purpose schemes funded by the Centre, their allocation bases, share which any state can expect to get under these schemes, and current receipts against all these schemes. A serious review on the basis of such a review can assist the states in improving their share of funds in these schemes.

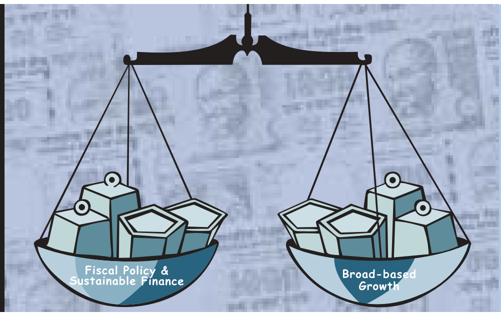
Choosing out of these work areas would depend upon strategic choice of where to work. If the USAID wants to develop work programs in the four states where USAID is currently working under REFORM project, it is felt that choice of item (d) would help USAID assist the concerned states in maximizing their receipts from Centre which would help their revenues. However, if USAID intends to work at larger policy level, it is felt that USAID can help in creating some forum of states like Empowered Committee on VAT which can help states draw up a coordinated strategy for working with Centre to streamline and reduce special purpose schemes which will help restore states autonomy in expenditure decisions. Another way of working for this objective can be to develop any one or two of the REFORM states as leaders of states and persuade them to raise these issues in National Development Committee meeting for constituting a group to go into all these issues. Alternatively, USAID can assist Arvind Verma Committee, presently working for NCMP mandate of curtailing all CSS, except national and regional priority CSS.

USAID can choose to decide to provide technical assistance to the Centre for assisting in creating coordinated database on special purpose schemes and streamlining transfers and monitoring use, thereof.

Building State Finance Department's Capacity to Better Manage Flows By-passing State Budgets

The issue of building capacity of state Finance Departments in view of large scale CSS funds by-passing the state budgets is quite real from the viewpoint of fiscal dimensions involved, as brought out above. Additionally, it is equally important from fiscal management viewpoint. The states have to provide counterpart funds to almost all CSS whether these are implemented through the budgets of state governments or by their agencies, by-passing the budgets. State agencies in any case are part of larger state level public sector and their states fiscal health depend upon the aggregate performance of all its agencies.

It is suggested that USAID work with states under REFORM project to develop a comprehensive and centralized database in Finance Departments on all central schemes which have provision for direct transfers to state agencies or local bodies. In many of these schemes, states have to also contribute counterpart funds. Such a centralized data base in Finance Departments should be able to capture all releases from the centre, releases from the state governments, funds in various bank and other accounts held by state agencies implementing these programs, progress of the use of funds and balances at weekly/ fortnightly intervals, utilizations furnished and other relevant parameters for all such schemes. State Finance Departments can use such database for monitoring the funds flow, funds utilization and also to budget and time the release of counterpart funds. State Finance Departments can also be assisted to create an investment arrangement to help these agencies manage their cash better to realize best treasury gains without compromising availability of required funds at all times for schematic objectives.



Annexures

Annexure I

Ministry/Department-wise Classification of GBS For Central Plan as per the Outcome Budget 2005-06 of Government of India

S. No.	Ministry / Department	Page No. of Outcome Budget	Revenue	Capital	Total
Part A: Plan Outlay in Outcome Budget					
	Ministry of Agriculture				
1	Department of Agriculture and Cooperation	1-47	3956.98	252.34	4209.32
2	Department of Agricultural Research and Education	48-80	1150.00	0.00	1150.00
3	Department of Animal Husbandry and Dairying	81-86	648.86	20.22	669.08
4	*Ministry of Agro and Rural Industries*	87-90	858.50	0.50	859.00
	Ministry of Chemicals and Fertilizers				
5	Department of Chemicals and Petrochemicals	91-93	62.00	21.00	83.00
6	Department of Fertilizers	94-103	18.04	93.78	111.82
7	*Ministry of Civil Aviation*	104-110	5.85	365.00	370.85
8	*Ministry of Coal*	111-114	152.05	0.00	152.05
9	*Ministry of Mines*	115-125	179.73	41.15	220.88
	Ministry of Commerce and Industry				
10	Department of Commerce	126-141	744.00	606.00	1350.00
11	Department of Industrial Policy and Promotion	142-147	544.00	6.00	550.00
	Ministry of Communications and IT				
12	Department of Posts	148-166	37.82	316.18	354.00
13	Department of Telecommunications	167-180	156.34	2.27	158.61
14	Department of Information Technology	181-200	838.30	91.00	929.30
	Ministry of Consumer Affairs, Food and Public Distribution				
15	Department of Consumer Affairs	201-204	98.38	9.56	107.94
16	Department of Food and Public Distribution	205-207	35.41	58.46	93.87
17	*Ministry of Culture*	208-216	489.32	61.80	551.12
18	*Ministry of Development of North Eastern Region*	217-218	1031.25	55.00	1086.25
19	*Ministry of Environment and Forests*	219-231	1223.99	10.92	1234.91
	Ministry of Finance				
20	Department of Economic Affairs	232-235	815.81	1400.00	2215.81
21	Payments to Financial Institutions	232-235	25.81	0.00	25.81
22	Department of Expenditure	236.00	0.50	0.00	0.50
23	*Ministry of Food Processing Industries*	237-238	180.00	0.00	180.00
	Ministry of Health and Family Welfare				
24	Department of Health	239-256	2881.77	0.00	2881.77
25	Department of Health and Family Welfare	239-256	6424.00	0.00	6424.00
26	Department of AYUSH	257-271	343.00	2.00	345.00
	Ministry of Heavy Industries and Public Enterprises				
27	Department of Heavy Industry	272-275	245.70	160.30	406.00
28	Department of Public Enterprises	276.00	30.00	0.00	30.00
29	*Ministry of Home Affairs*	277-280	47.00	253.00	300.00

Ministry/Department-wise Classification of GBS For Central Plan as per the Outcome Budget 2005-06 of Government of India (Contd.)

S. No.	Ministry / Department	Page No. of Outcome Budget	Revenue	Capital	Total
	Ministry of Human Resource Development				
30	Department of Elementary Education and Literacy	281-283	12531.76	0.00	12531.76
31	Department of Secondary and Higher Education	284-296	2710.49	0.01	2710.50
32	Department of Women and Child Development	297-306	3875.29	0.00	3875.29
33	*Ministry of Information and Broadcasting*	307-356	254.03	273.97	528.00
34	*Ministry of Labour and Employment*	357-359	219.48	0.00	219.48
	Ministry of Law and Justice				
35	Department of Justice	360.00	220.00	0.00	220.00
36	*Ministry of Non-Conventional Energy Sources*	361-369	529.70	70.05	599.75
37	*Ministry of Panchayati Raj*	370-374	50.00	0.00	50.00
38	Department of Ocean Development	375-389	340.00	0.00	340.00
39	*Ministry of Personnel, Public Grievances and Pensions*	390-400	53.91	21.09	75.00
40	*Ministry of Petroleum and Natural Gas*	401-403	0.00	0.00	0.00
41	*Ministry of Planning*	404-412	75.00	0.00	75.00
42	*Ministry of Power*	413-450	348.02	2651.98	3000.00
	Ministry of Rural Development				
43	Department of Rural Development	451-454	18329.21	4.79	18334.00
44	Department of Land Resources	455-458	1396.00	0.00	1396.00
45	Department of Drinking Water Supply	459-460	4750.00	0.00	4750.00
	Ministry of Science and Technology				
46	Department of Science and Technology	461-499	1092.65	147.35	1240.00
47	Department of Scientific and Industrial Research	500-513	825.03	20.97	846.00
48	Department of Biotechnology	514-564	443.00	2.00	445.00
	Ministry of Shipping, Road Transport and Highways				
49	Department of Shipping	565-578	155.79	379.21	535.00
50	Department of Road Transport and Highways	579-586	5099.34	7021.02	12120.36
51	*Ministry of Small Scale Industries*	587-591	390.71	18.20	408.91
52	*Ministry of Social Justice and Empowerment*	592-604	1415.60	118.10	1533.70
53	Department of Space	605-621	2192.16	607.84	2800.00
54	*Ministry of Statistics and Programme Implementation*	622-629	1670.47	22.23	1692.70
55	*Ministry of Steel*	630-633	0.00	15.00	15.00
56	*Ministry of Textiles*	634-647	1140.02	9.98	1150.00
57	*Ministry of Tourism*	648-660	300.25	485.75	786.00
58	*Ministry of Tribal Affairs*	661-670	1462.81	36.01	1498.82
59	*Ministry of Urban Development*	671-687	1294.90	785.43	2080.33
60	*Ministry of Urban Employment and Poverty Alleviation*	688-700	500.00	0.00	500.00
61	*Ministry of Water Resources*	701-709	575.86	45.14	621.00
62	*Ministry of Youth Affairs and Sports*	710-720	430.88	8.11	438.99
63	Railways	721-723	0.00	6520.00	6520.00
Total Part A- Plan In Outcome Budget			**87896.77**	**23090.71**	**110987.48**

Ministry/Department-wise Classification of GBS For Central Plan as per the Outcome Budget 2005-06 of Government of India (Contd.)

S. No.	Ministry / Department	Page No. of Outcome Budget	Revenue	Capital	Total
Part B: Plan Outlay Not in Outcome Budget					
	Atomic Energy		237.80	1249.63	1487.43
	Nuclear Power Schemes		0.00	2443.96	2443.96
	Ministry of External Affairs		479.00	286.00	765.00
	Transfer to States and Union Territories		26500.33	0.00	26500.33
	Transfer to Union Territories		409.05	0.00	409.05
	Andamans and Nicobar		263.55	234.76	498.31
	Chandigarh		112.92	85.04	197.96
	Dadra and Nagar Haveli		30.95	34.06	65.01
	Daman and Diu		20.29	39.01	59.30
	Lakshadweep		30.83	52.12	82.95
Total Part B- Plan Not in Outcome Budget			**28084.72**	**4424.58**	**32509.30**
Total Plan Outlay 2005-06 BE			**115981.49**	**27515.29**	**143496.78**

Annexure 2

Classification of Plan Outlay 2005-06 in Outcome Budget

S. No. of Outcome	Demand No. in Exp	Ministry/ Department	CSS through State Budgets	CSS Not Budgeted to go through State Budgets	Central Sector and Central Org Outlays	State Plan	Total
1	1	Department of Agriculture and Cooperation	1618.43	2365.43	195.46	30.00	4209.32
2	2	Department of Agricultural Research and Education	0.00	0.00	1150.00	0.00	1150.00
3	3	Department of Animal Husbandry and Dairying	402.15	142.74	124.19	0.00	669.08
4	4	Ministry of Agro and Rural Industries	23.00	218.50	617.50	0.00	859.00
5	7	Department of Chemicals and Petrochemicals	0.00	0.00	83.00	0.00	83.00
6	8	Department of Fertilizers	0.00	0.00	111.82	0.00	111.82
7	9	Ministry of Civil Aviation	1.00	0.00	369.85	0.00	370.85
8	10	Ministry of Coal	0.00	0.00	152.05	0.00	152.05
9	11	Ministry of Mines	0.00	0.00	220.88	0.00	220.88
10	12	Department of Commerce	0.00	0.00	1350.00	0.00	1350.00
11	13	Department of Industrial Policy and Promotion	0.00	0.00	550.00	0.00	550.00
12	14	Department of Posts	0.00	0.00	354.00	0.00	354.00
13	15	Department of Telecommunications	0.00	0.00	158.61	0.00	158.61
14	16	Department of Information Technology	0.00	0.00	929.30	0.00	929.30
15	18	Department of Consumer Affairs	2.00	0.00	105.94	0.00	107.94
16	19	Department of Food and Public Distribution	0.00	0.00	93.87	0.00	93.87
17	20	Ministry of Culture	37.90	0.00	513.22	0.00	551.12
18	29	Ministry of Development of North Eastern Region	0.00	0.00	169.75	916.50	1086.25

Classification of Plan Outlay 2005-06 in Outcome Budget (Contd.)

19	30	Ministry of Environment and Forests	126.59	780.85	327.47	0.00	1234.91
20	32	Department of Economic Affairs	0.00	0.00	2215.81	0.00	2215.81
20	34	Department of Economic Affairs	0.00	0.00	25.81	0.00	25.81
21	39	Department of Expenditure	0.00	0.00	0.50	0.00	0.50
22	46	Ministry of Food Processing Industries	0.00	0.00	180.00	0.00	180.00
23	47	Department of Health	665.20	938.25	1278.32	0.00	2881.77
24	48	Department of AYUSH	161.56	0.00	183.44	0.00	345.00
23	49	Department of Family Welfare	450.54	5920.96	52.50	0.00	6424.00
25	50	Department of Heavy Industry	0.00	0.00	406.00	0.00	406.00
26	51	Department of Public Enterprises	0.00	0.00	30.00	0.00	30.00
27	52,53,55	Ministry of Home Affairs	0.00	0.00	300.00	0.00	300.00
28	57	Department of Elementary Education and Literacy	3545.26	8902.20	84.30	0.00	12531.76
29	58	Department of Secondary and Higher Education	192.42	0.00	2518.08	0.00	2710.50
30	59	Department of Women and Child Development	3711.80	5.00	158.49	0.00	3875.29
31	60	Ministry of Information and Broadcasting	0.00	0.00	528.00	0.00	528.00
32	61	Ministry of Labour and Employment	42.69	128.30	48.49	0.00	219.48
33	63	Department of Justice	5.00	0.00	215.00	0.00	220.00
34	65	Ministry of Non-Conventional Energy Sources	16.00	326.00	257.75	0.00	599.75
35	67	Ministry of Panchayati Raj	29.40	0.00	20.60	0.00	50.00
36	68	Department of Ocean Development	0.00	0.00	340.00	0.00	340.00
37	70	Ministry of Personnel, Public Grievances and Pensions	0.00	0.00	75.00	0.00	75.00
38	71	Ministry of Petroleum and Natural Gas	0.00	0.00	0.00	0.00	0.00

Classification of Plan Outlay 2005-06 in Outcome Budget (Contd.)

39	72	Ministry of Planning	10.12	0.00	64.88	0.00	75.00
40	73	Ministry of Power	0.00	0.00	3000.00	0.00	3000.00
41	79	Department of Rural Development	0.00	18254.00	80.00	0.00	18334.00
42	80	Department of Land Resources	143.00	1186.00	67.00	0.00	1396.00
43	81	Department of Drinking Water Supply	4050.00	700.00	0.00	0.00	4750.00
44	82	Department of Science and Technology	0.00	0.00	1240.00	0.00	1240.00
45	83	Department of Scientific and Industrial Research	0.00	0.00	846.00	0.00	846.00
46	84	Department of Biotechnology	0.00	0.00	445.00	0.00	445.00
47	85	Department of Shipping	20.24	0.00	514.76	0.00	535.00
48	86	Department of Road Transport and Highways	72.00	0.00	12048.36	0.00	12120.36
49	87	Ministry of Small Scale Industries	12.91	0.00	396.00	0.00	408.91
50	88	Ministry of Social Justice and Empowerment	998.66	32.50	502.54	0.00	1533.70
51	89	Department of Space	0.00	0.00	2800.00	0.00	2800.00
52	90	Ministry of Statistics and Programme Implementation	62.37	1580.00	50.33	0.00	1692.70
53	91	Ministry of Steel	0.00	0.00	15.00	0.00	15.00
54	92	Ministry of Textiles	96.00	0.00	1054.00		1150.00
55	93	Ministry of Tourism	0.00	0.00	786.00	0.00	786.00
56	94	Ministry of Tribal Affairs	304.00	32.00	55.81	1107.01	1498.82
57	100-101	Ministry of Urban Development	250.00	935.24	895.09	0.00	2080.33
58	103	Ministry of Urban Employment and Poverty Alleviation	160.00	340.00	0.00	0.00	500.00
59	104	Ministry of Water Resources	306.00	0.00	315.00	0.00	621.00
60	105	Ministry of Youth Affairs and Sports	35.50	0.00	403.49	0.00	438.99
61	-	Railways	0.00	0.00	6520.00	0.00	6520.00
		Totals	**17551.74**	**42787.97**	**48594.26**	**2053.51**	**110987.48**

Annexure 3

Centrally-sponsored Schemes through State Budgets

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
1	1	Integrated Scheme of Oilseeds, Pulses, Oil Palm and Maize (ISOPOM)	To provide flexibility to the states in implementation of the programs based on regionally differentiated approach and to promote crop diversification	240.00	178.75
2	6	Technology Mission on Cotton-MM-II (TMC)	To increase production and productivity of cotton	50.00	44.25
3	8	Enhancing Sustainability of Dry-land Farming Systems	Increasing the agricultural productivity of dryland farming systems through rainwater harvesting and its utilization and adoption of improved dryland production technologies.	200.00	195.00
4	10	Improvement of Agriculture Statistics	Basic objective of the Scheme is to collect and improve Agricultural Statistics of Principal Agricultural Crops and selected Horticultural Crops	24.00	22.86
5	20	Central Sector Scheme for Strengthening/Promoting Agricultural Information System in the Department of Agriculture and Cooperation	To facilitate e-Governance and ICT applications in agriculture specially G2G and G2C services	27.50	19.00
6	21	Promotion and Strengthening of Agricultural Mechanization through Training, Testing and Demonstration	Human Resource Development for agricultural mechanization, performance evaluation of agricultural machines/equipment and induction of improved/new technology in agricultural production	10.00	3.2
7	31	Development and Strengthening of Seed Infrastructure Facilities for Production and Distribution of seeds	To develop and strengthen the seed infrastructure facilities including therein the private sector; and to improve the quality of farm saved seed, making provision for additional availability of seed during natural calamities; ensuring availability of quality seeds in North-Eastern and other remote areas of hill regions at reasonable price; and strengthening of quality control organizations	40.56	9.03
8	33	Capacity Building to Enhance the Competitiveness of Indian Agriculture	To retain Agriculture as a remunerative and viable occupation, it is necessary to build capacities in the system, such that it is able to withstand the forces of globalization and compete wherever possible. While there are a large number		

Centrally-sponsored Schemes through State Budgets (Contd.)

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
			of issues to be addressed in this context at the micro and macro levels, this scheme, aims to address some limited microlevel capacity creation	1.00	1.00
9	34	Agriculture Census	Collection of information on structure of land holdings; tenancy particulars, cropping pattern; irrigation status and input uses	14.00	9.15
10	36	National Project on Organic Farming	Production, Promotion and Market Development of Organic Farming in the country	27.00	0.15
11	38	Strengthening and Modernization of Pest Management Approach in India	(1) Implementation of Insecticides Act — This is a regulatory Scheme to implement the Insecticides Act, 1968. Major components are: registration, testing and training of officers, Locust Control and Integrated Pest Management	17.00	1.41
12	40	Support to State Extension Programs for Extension Reforms	Extension reforms through new Institutional arrangements	45.00	39.00
13	41	Establishment of AgriClinics and Agri-Business Centres by Agricultural Graduates	Training of unemployed agriculture graduates in setting up of agriclinics and agri-business centres	9.75	0
14	48	Macro Management of Agriculture	Supplementation/Complementation of States' efforts through Work Plans (Macro Management) by integrating 27 schemes, providing flexibility to the States to develop and pursue activities on the basis of their regional priorities, treatment of degraded catchment areas, development of salt affected areas, watershed development in rain fed areas	912.62	745.09
			Total — Agriculture and Cooperation	**1618.43**	**1267.89**
Department of Animal Husbandry and Dairy					
15	2	National Project for Cattle and Buffalo Breeding	Genetic upgradation, development and conservation of important indigenous breeds, etc.	95.00	1.00
16	4	Assistance to States for Fodder Development	For supplementing the efforts of State in feed and fodder development	15.50	13.50
17	5	Assistance to States for Control of Animal Diseases	For control of economically important diseases of livestock and poultry by way of immunization, strengthening of State Veterinary Biological Production Units	55.00	67.40

Centrally-sponsored Schemes through State Budgets (Contd.)

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
18	9	Integrated Dairy Development Project	For development of milch cattle, increasing the milk production by providing technical input services, procurement, processing and marketing of milk, etc.	50.00	26.50
19	10	Strengthening Infrastructure for Quality and Clean Milk Production	To improve the quality of milk produced at the village level in the country.	20.00	10.00
20	17	Development of Inland Fisheries and Aquaculture	For development of inland and brackish water aquaculture, cold water fisheries, reservoirs, etc.	25.00	25.50
21	18	Establishment of Fishing Harbors and Fish Landing Centres	Development of infrastructure, facilities for fishery sector for landing and berthing of fishing vessels	15.00	12.00
22	19	Development of Marine Fisheries	Development of traditional, small mechanized and deep sea fishing sectors including safety of fishermen	32.50	46.60
23	23	Macro Management Scheme	Improvement in production and productivity of livestock	63.00	101.10
24	26	Livestock census	For conducting census of the livestock	5.00	4.20
25	27	Other schemes under Animal Husbandry and Dairying		26.15	0.00
			Total — Department of Animal Husbandry and Dairy	**402.15**	**307.80**
Ministry of Agro and Rural Industries					
26	2	Promotion of Coir Industries	To promote, growth and development of coir industry	23	1
			Total — Ministry of Agro and Rural Industries	**23**	**1**
Ministry of Civil Aviation					
27	1	Aero sports development	Promotion of aero sports in the country	1	0.05
			Total - Civil Aviation	**1**	**0.05**
Department of Consumer Affairs					
28	5	Integrated Consumer Protection	Consolidation and upgradation of existing infrastructure for consumer protection, Taking proactive measures for promoting and safeguarding the interest of consumers and incentive grants for forums	2	1.5
			Total — Department of Consumer Affairs	**2**	**1.5**

Centrally-sponsored Schemes through State Budgets (Contd.)

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
Ministry of Culture					
29	4	Public Libraries	Promote and support adequate library services. Popularizing reading habits, particularly in rural areas with active cooperation of the Library authorities and voluntary organizations operating in the field of library services	37.9	1.79
			Total — Ministry of Culture	**37.9**	**1.79**
Ministry of Environment and Forests					
30	3	National Afforestation Programme (Centre 100%)	To increase forest cover		3
31	4	Project Tiger (Centre 100% for Nonrecurring, 50:50 for recurring)	In situ conservation of wildlife in their natural habitat in protected areas for maintaining a viable population and reflected in the assessment scoring by independent monitors, in terms of an internationally accepted methodology, with peer review of the reports	32	28.5
32	5	Assistance for Development of National Parks and Sanctuaries (as for Project Tiger)	In situ conservation of wildlife in their natural habitat in protected areas for maintaining a viable population and reflected in the assessment scoring by independent monitors, in terms of an internationally accepted methodology, with peer review of the reports	59	48
33	12	Conservation and Management of Mangroves, Coral Reefs and Wetlands	Strengthening of shoreline with mangrove vegetation, increase in aquatic and marine biodiversity and conservation of wetlands for increase in biodiversity and improvement in soil moisture in catchment area	12	9
34	13	Biosphere Reserves	Intensive in-situ conservation of biospheres	8	4.1
35	41	Project Elephant	To assist States having free ranging populations of wild elephants to ensure long-term survival of identified viable populations of elephants as their natural habitats	15.59	11.59
			Total — Ministry of Environment and Forests	**126.59**	**104.19**

Centrally-sponsored Schemes through State Budgets (Contd.)

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
Department of Health					
36	I.	National Vector Borne Disease Control Programme	Malaria, Lymphatic Filariasis, Kalaazar, Japanese Encelphalitis, Dengue	348.45	220.28
37	III.	National Programme for Control of Blindness	Reduction in the prevalence of blindness to 0.8% by end of the 10'h Plan.	89	32
38	VI.	National Leprosy Eradication Programme	Reduce the prevalence level of leprosy	41.75	13.1
39	VII	Revised National TB Control Programme (RNTCP)	To cover the entire population of the country under the Revised National TB Control Programme and achieve global target of cure rate of 85%.	186	24.99
40	XIIA	Other programs	Iodine Deficiency Disorders Control Programme		0.96
41	XIIB	Other programs	Communicable Diseases		0.25
42	XIIIC	Other programs	Other Schemes		31.5
			Total—Department of Health	**665.2**	**323.08**
Department of AYUSH					
43	1	Development of Institutions	Improvement in the infrastructure and quality of teaching in Government and Government-aided AYUSH Hospital and colleges, adding new PG Departments in existing institutions, upgrading knowledge of ISMH practitioners for better facilities to patients in these Hospitals	37.56	133.7
44	2	Hospitals and Dispensaries	To make treatment facility of ISM&H available to general public in the allopathic hospitals with an alternative choice and strengthening of AYUSH system. To improve the position of short supply of drugs of ISM&H dispensaries in the States to give benefit to general public	90	
45	6	Medicinal Plants	Promotional and commercial cultivation schemes for cultivation and development of medicinal plants	30	
46	8	Information, Education and Communication	To create and increase awareness among the community about the preventive, promotive and curative of AYUSH systems	4	
			Total—Department of AYUSH	**161.56**	**133.7**

Centrally-sponsored Schemes through State Budgets (Contd.)

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
Department of Family Welfare					
47	I	National Rural Health Mission	Strengthening integrated Primary Health Care Services in Rural Areas (includes reproductive and child health, routine immunization, pulse polio and sterilization. Budgeting being changed from next year)		3133.54
48	2	Urban FW Services and Urban Slums	Maintenance of Urban FW Centres and Urban Health Posts	170.33	132.48
49	3	Direction and Admn.	Maintenance of State and District FW Bureau	280.21	249.84
			Total — Department of Family Welfare	**450.54**	**3515.86**
Department of Elementary Education					
50	2	Midday Meal	Improving nutritional status of children, universalized supply of cooked meal to Primary School children in Govt./Aided/Local Bodies/EGS/AIE Centres	3345.26	1825.07
51	3.1	Strengthening of Teachers Training		200.00	169.70
52	3.AE.2	Continuing Education for Neoliterates		0.00	1.80
			Total — Department of Elementary Education	**3545.26**	**1996.57**
Department of Secondary Education					
53	1	ICT in Schools — The only Centrally-sponsored Scheme approved by the Cabinet	To impart computer literacy to students of State Government and aided schools. (Establishment of SMART schools and universalization of computer literacy through network of KVs and JNVs to neighborhood schools through KVs and NVs)	50	37.25
54	I3A	Integrated Education for Disabled Child	Provision of educational opportunities to disabled children in normal schools to facilitate their retention and ultimate integration in general school system	40.5	27
55	I3B	Qualify Improvement in Schools	Development of infrastructure that has bearing upon quality of education in schools, bring into focus the issue of equity and diversity common school system and to encourage networking and sharing of resources	9	4.75

Centrally-sponsored Schemes through State Budgets (Contd.)

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
56	I3C	Access and Equity	Assistance to NGOs for setting up girls hostels	9	2.1
57	II3A	Appointment of Language Teachers	Financing appointment of Hindi, Urdu and Modern languages teachers	14.4	14.38
58	II3B	Development of Sanskrit Education	Financial assistance to eminent Sanskrit pundits, modernization of Sanskrit pathshalas, providing facilities for teaching Sanskrit, etc.	15.52	15.1
59	II3C	Area Intensive and Madarasa Modernization	Financial assistance for modernization of Madarasa school system	26.1	26.1
60	II3D	National Merit Scholarship Scheme	Support talented students by giving recognition and financial assistance from post-metric level	9.9	9.4
61	III9A	Vocationalisation of Education	Financial assistance for introducing job-oriented education at secondary school level	18	16.5
			Total—Secondary Education	**192.42**	**152.58**
Department of Women and Child Development					
62	1	Integrated Child Development Services (ICDS)	i) To improve the nutritional and health status of preschool children in the age group of 0-6 years so as to reduce the incidence of mortality, morbidity, malnutrition and school dropout; ii) To lay the foundation of proper psychological development of child; iii) To enhance the capability of mother to look after the normal health and nutritional needs of the child through proper nutrition and health education, targeting adolescent girls and pregnant and lactating mothers (Kishori Shakti Yojana (KSY) is also implemented as part of ICDS to improve the nutritional and health status of adolescent girls	3685.3	3254.43
63	4	Swayam-sidha	Establishment of Self-Help Groups (SHGs)	20	15.5
64	6	Scheme of financial assistance for construction of Hostel Building for Working Women	To provide suitable, safe and inexpensive accommodation to women residing in places away from their hometowns to be able to work	6.5	0.03
			Total—Women and Child Development	**3711.80**	**3269.96**

Centrally-sponsored Schemes through State Budgets (Contd.)

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
Ministry of Labour					
65	1	Establishment of New Training Institutes in the North-eastern States, Sikkim and J&K	i) Construction of 22 new ITIs in the N.E. States and Sikkim and Strengthening of 35 existing ITIs; ii) Strengthening and Modernization of 37 existing ITIs and establishment of 1 new Woman's ITI in the State of J&K	22.69	25.4
66	2	Upgradation of 100 ITIs into Centres of Excellence	To upgrade the existing 100 ITIs into Centres of Excellence for producing multiskilled workforce	20	
67	6A	Other Schemes	Rehabilitation of Bonded Laborers		1.07
			Total — Ministry of Labour	**42.69**	**26.47**
Ministry of Law and Justice					
68	2	Centrally-sponsored Scheme for development of infrastructural facilities for the Judiciary	Supplementing the resources of the State Governments for construction of court buildings and residential premises of Judges and Judicial Officers.	5	3
			Total — Ministry of Law and Justice	**5**	**3.00**
Ministry of Non-Conventional Energy Resources					
69	7	Remote Village Electrification Programme (RVEP)	To provide decentralized electricity in 25000 remote unelectrified census villages where grid extension is neither feasible nor economically viable	0	1.22
70	8	Biogas Plants	To provide clean fuel for cooking, lighting and motive power	16	8.01
			Total — MNES	**16**	**9.23**
Ministry of Panchayati Raj					
71	1	Training of elected representatives for implementing various developmental programs through local self-governance	To build up the capacity of elected representatives of Panchayats so that they can effectively carry out their duties and responsibilities as envisaged in the Constitution: (i) grant-in-aid to training institutions (12.4); and (ii) grant-in-aid to state governments (12) and provision for NE states (5)	29.4	12
			Total — Ministry of Panchayati Raj	**29.4**	**12**
Ministry of Planning					
72	1	Plan Scheme "50th Year Initiative for Planning"	(i) Preparation of State Development Report (SDRs); and (ii) Financial Assistance in the form of grant-in-aid from the Planning Commission's Project Preparation Facility (PCPPF) and other schemes	10.12	3.02
			Total — Ministry of Planning	**10.12**	**3.02**

Centrally-sponsored Schemes through State Budgets (Contd.)

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
Department of Rural Development					
73	6	Training SIRDs/ETCs/OTC/IT	To provide training to the functionaries of Panchayati Raj Institutions	24	4.79
			Total — Department of Rural Development	**24**	**4.79**
Department of Land Resources					
74	1	Integrated Wastelands Development Programme (IWDP)	Increase in water table, drinking water security, increased production of biomass, reduction in soil erosion, etc.		2
75	5	Computerisation of Land Records (CLR)	Computerization of ownership and plot-wise details for issue of timely and accurate copy of the record of rights to the land owners	100	122
76	6	Strengthening of Revenue Administration and Updation of Land Records (SRA & ULR)	Updation of land records by taking up survey and settlement operations by induction of new technology, strengthening of training infrastructure, creation of facilities for maintenance and storage of land records, etc.	40	
77	9	Others	Miscellaneous provision for publicity, monitoring and evaluation, training, workshops, etc.	3	2
			Total — Department of Land Resources	**143**	**126**
Department of Drinking Water Supply					
78	1	Accelerated Rural Water Supply Programme (ARWSP)	i) to provide safe drinking water to rural habitations (i.e., "Not Covered" (NC), "Partially Covered (PC) of CAP 99 "Quality affected" habitations) and rural schools; and ii) to promote sustainability of safe drinking water systems	4050	2259.75
			Total — Department of Drinking Water Supply	**4050**	**2259.75**
Ministry of Shipping					
79	6 (Port Sector)	Others — R&D/Training, Minor Ports Studies, TAMP	Associated/support services	5.24	0.5
80	6 (Inland Waterways Authority)	Centrally-sponsored Scheme on Development of Inland Water Transport	Assistance to States for Development of inland water transport through Inland Waterways Authority of India	15	15
			Total — Ministry of Shipping	**20.24**	**15.5**

Centrally-sponsored Schemes through State Budgets (Contd.)

S.No. of Scheme	Scheme No in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
Department of Road Transport and Safety					
81	3 (BRDB)	Strategic roads under Border Roads Development Board	Improve roads of strategic importance	71	66
82	2 (Road Transport)	Pollution testing and control	To provide central assistance to States to procure and install pollution measurement equipments to combat problems of vehicular pollution	1	1
			Total — Department of Road Transport	**72**	**67**
Ministry of Small Scale Industries					
83	1A	Small Industries Development Organisation	Promotion of Small Scale Industries	12.91	4
			Total — Ministry of Small Scale Industries	**12.91**	**4**
Ministry of Social Justice and Empowerment					
84	1	Special Central Assistance (SCA) to Special Component Plan (SCP) for Scheduled Castes	To provide thrust to least privileged among SCs. 100% grant-in-aid is provided to States/UTs as an additive to SCP	407.36	489.97
85	5	Setting up of Residential Schools for SC students studying in Class VI to XII	To provide good quality modern education and to inculcate values to the talented children predominantly from the SC communities	5	5.03
86	8	Post-Metric Scholarships and Book Banks for SC students	To promote higher education (above Matric level) by offering scholarships and text books for SC students studying in Medical, Veterinary, Engineering and other professional courses	379.59	370.69
87	9	Pre-matric Scholarships for those engaged in unclean occupations	To encourage the children of scavengers, sweepers, flayers and tanners to promote education and wean away them from their traditional occupation	16	0.01
88	10	Hostels for SC and OBC Boys and Girls	To provide hostel facilities to SC, OBC students studying in Middle/Higher Secondary Schools, Colleges and Universities for enabling them to pursue higher studies	61	0.03
89	14	Implementation of PCR Act, 1955 and SC/ST (POA) Act, 1989	To provide grant-in-aid to State/UTs for prevention of atrocities and protection of civil rights and for strengthening the implementing machinery for effective implementation of the Acts and rehabilitation to the victims	37.91	35.91

Centrally-sponsored Schemes through State Budgets (Contd.)

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
90	15	Merit based Scholarships for SCs, OBCs and Minority Students: (i) Pre and Post Matric Scholarships for OBC; and (ii) Merit based scholarships for OBC and Minorities Students	To provide financial assistance to OBCs and Minority students to enable them to complete their higher education	69.11	52.96
91	15 (Disabled)	Scheme for Prevention and Control of Juvenile Social Maladjustment	A comprehensive scheme for care, protection, treatment, development and rehabilitation of neglected and delinquent juveniles	22.69	0.01
			Total — Ministry of Social Justice and Empowerment	**998.66**	**954.61**
Ministry of Statistics and Programme Implementation					
92	1	Fifth Economic Census	Availability of data on geographical distribution of various types of economic units and the employment, therein	45.59	37.13
93	2	Institutional Development and Capacity Building	Improved training facilities in official statistics. Upgradation of knowledge base and skills of Central and State Statistical Officers	16.78	
			Total — Ministry of Statistics and Program Imp.	**62.37**	**37.13**
Ministry of Textiles					
94	1	Deen Dayal Hathkargha Protsahan Yojana	Assistance for basic inputs, restructuring of national and state level handloom organizations	70.1	62.85
95	2	Workshed cum Housing Scheme	To provide worksheds/housing for weavers	5	5.75
96	3	Weavers Welfare Schemes	Health package, thrift fund, Group Insurance Scheme, etc.	5	5
97	6	Design Development and Training Programs	To undertake R&E, setting up of WSCs/IIHTs, on line and off line of NCTD, design development, J&K package, etc.	10.4	0.2
98	9	Bunkar Bima Yojana	Insurance Scheme for Handloom Weavers	5.5	1
			Total — Ministry of Textiles	**96**	**74.8**

Centrally-sponsored Schemes through State Budgets (Contd.)

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
Ministry of Tribal Affairs					
99	2	Vocational Training Centres in Tribal Areas	To provide skill upgradation training to tribal youths for better employment avenue	6	6
100	3	Educational Complex in low literacy pockets	To impart both formal as well as vocational education to tribal girls in rural areas where the literacy rate of ST girls is very low	6	6
101	7	Development of PTGs	Protection, survival and development of Primitive Tribal Groups (PTGs) spread over in 15 States/UTs	25	25
102	12	Scheme of Post Matric, Book Banks & Upgradation of Merit of ST students	To promote higher education among STs. To provide text books to St students pursuing higher education and to provide special and remedial coaching to ST students study in classes XI & XII	260.5	230.15
103	15	Research Information and Mass Education Tribal Festivals and others	To conduct action research, evaluation studies holding seminars/workshops, tribal museum, exhibition of artefacts on socioeconomic development of tribals	6.5	2.3
			Total — Ministry of Tribal Affairs	**304**	**269.45**
Department of Urban Development and Works					
104 105	6 7	Integrated Development of Small and Medium Towns (IDSMT) — CSS Mega City Scheme — CSS	These schemes shall be subsumed under proposed NURM/UIDSSMT and no new projects are to be sanctioned. Hence, the issue of identifying/fixing outcomes of these schemes does not arise	100 150	99.5 149.5
			Total — Department of Urban Development and Works	**250**	**249**
Ministry of Urban Employment					
106	1	Swarna Jayanti Shahari Rojgar Yojana (SJSRY) — CSS	To facilitate/provide self-employment, skill upgradation and wage employment to BPL persons	160	150.9
			Total — Ministry of Urban Development	**160**	**150.9**

Centrally-sponsored Schemes through State Budgets (Contd.)

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
Department of Water Resources					
	1	Command Area Development and Water Management Programme	The objective is to bridge the gap between irrigation potential created and its utilization and optimizing agricultural productivity/production through integrated and coordinated approach for efficient land and water management in the irrigated commands	199	196.5
	2	Critical anti-erosion works in Ganga States	To provide support to various State Governments in Ganga basin for taking up anti-erosion works	100	70
	5A	Data Collection and investigation (various schemes related to data collection and investigation for water resources development.	Rationalization of Minor Irrigation Schemes	7	6.56
			Total — Ministry of Water Resources	**306**	**273.06**
Ministry of Youth Affairs and Sports					
	1	National Service Scheme (NSS)	To develop the personality of students through community service	29	20.45
	8	Promotion of Scouting and guiding	(i) To develop their character and inculcate in youths a spirit of patriotism, social service and communal harmony to make them responsible citizen of the country; and (ii) To inculcate a sense of adventure particularly, in nonstudent young people in rural areas	1.5	1
	10	Youth Hostels	To promote youth travel with the country.	5	0.1
			Total — Ministry of Youth Affairs and Sports	**35.5**	**21.55**
			Total — CSS Going Through Budgets	**17551.74**	**15637.23**

Annexure 4

Functionally Budgted Centrally-sponsored Schemes Going through the State Budgets

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
Department of Agriculture and Cooperation					
1	3	Integrated Development of Tree Borne Oilseeds	Improve, Promote, Develop, Create awareness through training seminars, workshop, publication and publicity, etc., among farmers and primary processing industries for improved agronomic practices and new technologies	16.00	16.00
2	7	On Farm Water Management for increasing Crop Production in Eastern India	To increase the production and productivity of different crops in eastern India by exploiting abundant ground and surface water resources	25.00	25.00
3	12	Forecasting and Remote Sensing Application in Crop Husbandry	(i) Coordinating and strengthening the system of forecasting of crop production; (ii) develop methodology and arrive at estimates of area and yield using Remote Sensing Technology; and (iii) provide quarterly estimates of Agricultural production.	5.43	5.43
4	14	National Horticulture Mission	To promote holistic growth of Horticulture Sector covering fruits, flowers, vegetables, root and tuber crops, mushroom, spices, aromatic plants, cashew and cocoa, etc.	645.00	645.00
5	15	Technology Mission for Integrated Development of Horticulture in NE States, Sikkim, J&K, HP and Uttaranchal	Integrated development of horticulture in a Mission Mode to fully exploit tremendous potential for the horticulture development in these areas	170.00	170.00
6	16	Integrated Development of coconut Industry in India including Technology Mission on Coconut (implemented by Coconut Development Board)	Achieving a balanced development of coconut and its industry and promoting its marketing	20.00	20.00
7	17	National Horticulture Board (including Cold Chain)	Development of Commercial Horticulture through production and post harvest management, Capital Investment Subsidy Scheme for Construction/Expansion/ Modernization of Cold storages for horticulture produce	70.00	70.00
8	18	Micro Irrigation	To increase the coverage of area under drip and sprinkler irrigation in the country for improving crop productivity with efficient use of available water/ resources and to develop the skills of farmers and field functionaries through human resource development (HRD)	400.00	400.00

Functionally Budgted Centrally-sponsored Schemes Going through the State Budgets (Contd.)

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
9	19	National Bamboo Mission	To promote holistic growth of the bamboo sector through area based regionally differentiated strategies; extend the coverage of area under bamboo to potential areas; to promote post harvest management, product development and marketing; promote bamboo shoots as nutritional supplement; and to generate employment opportunities for skilled and unskilled persons, especially unemployed youths	100.00	100.00
10	25	Construction of Rural God owns	The main objectives of the scheme include creation of scientific storage capacity with allied facilities in rural areas to meet the requirements of farmers for storing farm produce; to prevent distress sale of produce; promote pledge financing and marketing credit; and to introduce a national system of warehouse receipts for agricultural commodities stored in such godowns	70.00	70.00
11	26	Development of Agricultural Marketing Infrastructure, Grading and Standardization	To provide additional agricultural marketing infrastructure to cope up with the large expected marketable surpluses of agricultural and allied commodities including dairy, poultry, fishery, livestock and minor forest produce; to promote competitive alternative agricultural marketing infrastructure by inducement of private and cooperative sector investments; to promote direct marketing through reduction in intermediaries and handling channels, thus, enhancing farmers' income; and to provide infrastructure facilities for grading, standardization	70.00	70.00
12	28	Agribusiness Project Development through Venture Capital Assistance	To promote Agri-Business Projects	10.00	10.00
13	43	Mass Media Support to Agriculture Extension	Agriculture Extension through Mass Media	71.00	71.00
14	47	Cooperative Education and Training	Providing training and education, for manpower development, to the personnel in Cooperative Department of State Govts/Cooperative Societies	70.00	70.00
15	49	Other Schemes		8.00	8.00
			Total — Department of Agriculture and Cooperation	**2365.43**	**1750.43**

Functionally Budgted Centrally-sponsored Schemes Going through the State Budgets (Contd.)

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
Department of Animal Husbandry and Dairy					
16	8	Conservation of Threatened Breeds of Small Ruminants, Pigs, Pack Animals, Equines and Yak	Conservation of threatened breeds of livestock	6.00	6.00
17	12	Assistance to State Poultry Farm		12.00	12.00
18	15	Integrated Fisheries Project	Processing, popularization and test marketing of unconventional varieties of fish	1.14	1.14
19	20	National Welfare of Fishermen	Development of modern fishermen villages, group accident insurance for active fishermen, etc.	25.00	25.00
20	21	Training and Extension	To provide training to fishery personnel so as to assist them in fisheries extension program	1.50	1.50
21	22	Strengthening of Database and Information Networking for Fisheries	Catch assessment survey of inland and marine fisheries, census of important attributes of inland fisheries etc.	5.10	5.10
22	25	Rinderpest Eradication Programme	Eradication of rinderpest and surveillance	7.00	7.00
23	6	Foot and Mouth Disease Control Programme	Control of foot and mouth disease with funding to States including the cost of vaccine and supporting expenses	35.00	35.00
24	24	Livestock insurance	Insurance of livestock	50.00	50.00
			Total — Department of Animal Husbandry and Dairy	**142.74**	**142.74**
Ministry of Environment and Forests					
25	1	National River Conservation Plan (NRCP) and National River Conservation Directorate (NRCD)	To reduce pollution load in major rivers.	355	347.5
26	2	National Lake Conservation Plan (NLCP) Centre: State 70:30	To reduce pollution load in lakes	70	68
27	3	National Afforestation Programme (Centre 100%)	To increase forest cover	320.85	233.85
28	21	Environment Education and, Training and Awareness	To promote environment education and awareness through formal and informal education systems	35	35
			Total — Ministry of Environment and Forests	**780.85**	**684.35**

Functionally Budgted Centrally-sponsored Schemes Going through the State Budgets (Contd.)

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
Department of Health					
29	I.	National Vector Borne Disease Control Programme	Malaria, Lymphatic Filariasis, Kalaazar, Japanese Encelphalitis, Dengue		100
30	II.	Integrated Disease Surveillance Project	Set up disease surveillance network to identify epidemics early for timely interventions	88	35
31	III.	National Programme for Control of Blindness	Reduction in the prevalence of blindness to 0.8% by end of the 10^{th} Plan.	89	50
32	V.	National AIDS Control Programme	To reduce the growth of HIV infection and Strengthen India's capacity to respond to HIV/AIDs	533.5	450
33	VI.	National Leprosy Eradication Programme	Reduce the prevalence level of leprosy	41.75	20
34	VII	Revised National TB Control Programme (RNTCP)	To cover the entire population of the country under the Revised National TB Control Programme and achieve global target of cure rate of 85%	186	110
			Total — Department of Health	**938.25**	**765**
Ministry of Urban Development and Works					
35	3	Viability Gap Funding (Other Metro Projects)	Assistance for MRTS Projects. (A tentative provision of INR 500.00 crores has also been kept for Urban Transport under NURM)	600	600
36	5	National Mission Mode Project on e-Governance in Municipalities	Reduction in time-lag in delivery of services, viz. issue of birth and death certificates, assessment and collection of property tax, payment of utility bills, etc; improved quality of service	25	25
37	8	Accelerated Urban Water Supply Programme-CSS	These schemes shall be subsumed under proposed NURM/UIDSSMT and no new projects are to be sanctioned. Hence, the issue of identifying/fixing outcomes of these schemes does not arise	95.24	95.24
38	9	New Central Sector Scheme of Solid Waste Management & Drainage in Ten Selected Airfield Towns	To provide Solid Waste Management and drainage facilities for the ten selected Airfield cities having Indian Air Force Stations in order to mitigate the bird hit menace by reducing bird activities, denying food and shelter to the birds	55	55
39	10	10% Lump-sum Provision for the benefit of North-eastern Region including Sikkim	To ensure speedy development of infrastructure in North-eastern Region including Sikkim. Water supply, sewerage, water drainage (30), roads, bylanes, flyovers/bridges (50) and civic amenities (80)	160	160
			Total — Ministry of Urban Development and Works	**935.24**	**935.24**

Functionally Budgted Centrally-sponsored Schemes Going through the State Budgets (Contd.)

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
Ministry of Urban Employment and Poverty Alleviation					
40	2	Projects / Schemes for the Development of North Eastern States including Sikkim under 10% Lump sum Provision — CS	Providing houses to the urban poor, improvement/up gradation of Slums and urban poverty alleviation	50.1	50.1
41	3	Valmiki Ambedkar Awas Yojana (VAMBAY) — CSS	To provide shelter or upgrade the existing shelter for people living below poverty line in urban slums	249	249
42	4	Integrated Low Cost Sanitation Scheme (ILCS) — CSS	Total elimination of manual scavenging and conversion of dry latrines into low cost twin pit sanitary latrines	30	30
43	5	Other Central Sector Schemes		10.9	10.9
			Total — Ministry of Urban Employment and Poverty Alleviation	**340**	**340**
			Functionally Budgeted CSS Routed through States		**4617.76**

Annexure 5

Functionally Budgted Centrally-sponsored Schemes Bypassing the State Budgets

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
Department of Agriculture and Cooperation					
1	4	Investment in Debentures of State Land Development Banks	Investment in Debentures of State Land Development Banks floated by State Land Development Banks (SLDBs/State Cooperative Agriculture and Rural Development Banks (SCARDBs) for mobilization of funds for minor irrigation, horticulture, plantation, farm mechanization, land improvement, customization of compound walls, cattle sheds and farm houses	65.00	65.00
2	5	National Agricultural Insurance Scheme (NAIS) (including INR one crore for NER)	NAIS is under implementation since Rabi 1999-2000 season with the objectives — to provide insurance coverage and financial support to the farmers in the event of failure of any of the notified crops as a result of natural calamities, pests and diseases; to encourage the farmers to adopt progressive farming practices, high value inputs and higher technology in agriculture and to help stabilize farm incomes, particularly in disaster years	550.00	550.00
			Total — Department of Agriculture and Cooperation	**2365.43**	**615.00**
Ministry of Agro and Rural Industries					
3	3	Prime Minister's Rojgar Yojana	To provide institutional finance to the educated, but unemployed youths without collateral guarantee to set up business/industrial ventures to create self-employment	218.5	218.5
			Total — Ministry of Agro and Rural Industries	**218.5**	**218.5**
Department of Family Welfare					
4	I	National Rural Health Mission	Strengthening integrated Primary Health Care Services in Rural Areas (includes reproductive and child health, routine immunization, pulse polio and sterilization. Budgeting being changed from next year)	5920.96	1846.48
			Total — Department of Family Welfare	**5920.96**	**1846.48**

Functionally Budgted Centrally-sponsored Schemes Bypassing the State Budgets (Contd.)

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
Department of Elementary Education					
5	1	Sarva Shiksha Abhiyan (SSA)	Enrolling all children of 6-14 years in elementary schools/EGS/AIE Centre by improving access, enrolment, retention and quality of elementary education and school infrastructure	7800.00	7129.53
6	3.2	Shiksha Karmi Project		6.50	6.50
7	3.3	Mahila Samakhya		30.00	29.85
8	3.5	District Primary Education		600.00	597.91
9	3.6	National Council of Teacher Education		5.00	4.50
10	3.7	Kasturba Gandhi Balika Vidyalaya		250.00	225.00
11	3.AE2	Continuing Education for Neo-literates		184.45	164.12
12	3.AE3	Literacy Campaign and Operation Restoration		25.00	22.50
13	3.AE7	Population Education in Adult Education		1.25	1.12
			Total — Department of Elementary Education	**8902.20**	**8181.03**
Department of Women and Child Development					
14	5	Swa Shakti (Rural Women Development and Empowerment Project (World Bank and IFAD funded)	Establish women's SHGs which build self-reliance and self-confidence and promote greater access to and control over resources	5	5.00
			Total — Department of Women and Child Development	**5.00**	**5.00**
Ministry of Labour					
15	3	National Child Labour Project	To identify child labor and rehabilitate them through Special Schools, and mainstream them into normal schools	103.3	125.05
16	4	Indo-US Child Labour Project	To Create an enabling environment where children would be induced to refrain from working and households would be provided with alternatives so that they refrain from sending their children to work	25	
			Total — Ministry of Labour	**128.3**	**125.05**

Functionally Budgted Centrally-sponsored Schemes Bypassing the State Budgets (Contd.)

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
Ministry of Non-Conventional Energy Resources					
17	1	Wind Power	To promote commercial wind power projects	5	5
18	2	Small Hydro (upto 25 MW)	Setting of SHP projects	50	10
19	7	Remote Village Electrification Programme (RVEP)	To provide decentralized electricity in 25000 remote unelectrified census villages where grid extension is neither feasible nor economically viable	185	180
20	9	Solar Photovoltaic Programme (SPV)	To provide SPV lighting systems in non remote electrified villages and industrial, commercial and urban applications	27	27
21	10	SPV Pumps	To provide SPV water pumping systems for community applications only	5	5
22	11	Wind Pumps and Hybrid Systems	To provide wind pumps and hybrid systems	2	2
23	12	Solar Thermal Energy Programme	To install solar water heating and other solar thermal systems	52	50
			Total — MNES	**326.00**	**279.00**
Department of Rural Development					
24	1	Sampoorna Grameen Rojgar Yojana (SGRY)	Provide wage employment and food security	4000	4000
25	2	National Food for Work Programme	Provide wage employment and food security in the selected most backward districts of the country	6000	6000
26	3	Swarnjayanti Gram Swarozgar Yojana (SGSY)	To provide sustainable self-employment to the rural poor	960	960
27	4	Rural Housing	To provide shelter to the rural poor	2775	2775
28	5	Pradhan Mantri Gram Sadak Yojana (PMGSY)	To provide rural connectivity	4235	4235
29	6	Training SIRDs/ETCs/OTC/IT	To provide training to: the functionaries of Panchayati Raj Institutions	24	19.21
30	9	Others		260	260
			Total — Department of Rural Development	**18254**	**18249.21**
Department of Land Resources					
31	1	Integrated Wastelands Development Programme (IWDP)	Increase in water table, drinking water security, increased production of biomass, reduction in soil erosion, etc	485	445
32	2	Drought Prone Areas Programme (DPAP)	- Do-	353	353
33	3	Desert Development Programme (DDP)	-Do-	268	268
34	4A	(i) Andhra Pradesh Rural Livelihoods Project (APRLP)	-Do-	60	60

Functionally Budgted Centrally-sponsored Schemes Bypassing the State Budgets (Contd.)

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
35	4B	(ii) Western Orissa Rural Livelihoods Project (WORLP)	-Do-	20	20
			Total — Department of Land Resources	**1186**	**1146**
Department of Drinking Water					
36	1	Accelerated Rural Water Supply Programme (ARWSP)	(i) to provide safe drinking water to rural habitations (i.e. "Not Covered" (NC), "Partially Covered" (PC) of CAP 99 "Quality affected" habitations) and rural schools; and (ii) to promote sustainability of safe drinking water systems	4050	1384.9
37	2	Central Rural Sanitation Programme (Total Sanitation Campaign)	(i) Accelerate sanitation coverage in the rural areas; (ii) Generate felt demand for sanitation facilities (iii) Cover schools in rural areas with sanitation facilities and promote sanitary habits; and (iv) Encourage cost-effective and appropriate technologies in sanitation and bring about an improvement in the general quality of life in rural areas	700	630
			Total — Department of Drinking Water	**700.00**	**2014.90**
Ministry of Social Justice and Empowerment					
38	11	Assistance to State Scheduled Castes Development Corporation (SCDCs)	SCDCs to act as promoters and catalysts for generating credit for finance institutions and act as guarantors to provide margin money loan and subsidy to the target groups	32.5	32.5
			Total — Ministry of Social Justice and Empowerment	**32.5**	**32.5**
Ministry of Statistics and Programme Implementation					
39	2	Member of Parliament Local Development Scheme (MPLADS)	To release the funds to DC/DM for execution of developmental durable works recommended by Members of Parliament	1580	1580
			Total — MoPSI	**1580**	**1580**
Ministry of Tribal Affairs					
40	5	Grant-in-aid to STDCs for MFPs	Financial support for STDC to increase the quantum of MFPs collections by STs by ensuring remunerative price and for setting up of warehousing facilities	12	12
41	8	Support to National/State ST Finance and Development Corporations	To accelerate economic and income generation development activities amongst STs whose annual income is below double the poverty line	20	20
			Total — Ministry of Tribal Affairs	**32**	**32**
			Functionally Budgeted Bypassing States Budgets		**34324.67**

Annexure 6

State Plan Schemes in Administrative Ministries/Departments

S.No. of Scheme	Scheme No. in Outcome Budget	Scheme Name	Objectives	Outlay	Transfer to States
Department of Agriculture and Cooperation					
1	50	State Plan Scheme-Watershed Development Projects in Shifting Cultivation Areas. (State Plan Scheme)	Promoting watershed, preventing land degradation by discouraging shifting Cultivation	30.00	30.00
			Total — Ministry of Agriculture and Cooperation	**30.00**	**30.00**
Department of North-eastern Development					
2	1	NLCPR	Project specific sanctions are made to the states of NE by DoNER in various sectors. Project proposals are submitted by the States (including INR 100 crores for BTC area in Assam)	650.00	585.00
3	2	NEC	Balanced socioeconomic development in the region by taking up projects of regional importance/Interstate projects in the NE and regional planning	266.50	296.50
			Total — DoNER	**916.50**	**881.50**
Ministry of Tribal Affairs					
4	1	Special Central Assistance to TSP (SCA to TSP)	To provide financial support to States/ UTs for implementing family oriented income-generating activities amongst STs living in below the poverty line	727.01	727.01
5	2	G.I.A. under Article 275(1) of the Constitution	To meet the cost of development schemes/projects for promoting welfare of STs also to raise the Scheduled Areas Administration	380.00	380.00
			Total — Ministry of Tribal Affairs	**1107.01**	**1107.01**
			Total — All Ministries and Departments	**2053.51**	**2018.51**

Annexure 7

Schematic State Plan Assistance to States (Through Ministry of Finance)

S. No.	Name of the Scheme	Outlay in 2005-06 (INR Crores)
1	Special Central Assistance for Hill Areas (Hills Area Development Programme)	144.00
2	Special Central Assistance Border Areas (Border Areas Development Programme)	325.00
3	Additional Central Assistance (ACA) for Externally-aided Projects	587.33
4	ACA for Other Projects	0.00
1	Accelerated Irrigation Benefit Programme (AIBP)	0.00
2	Accelerated Power Development and Reforms Programme (APDRP)	630.00
3	National Social Assistance	1182.58
4	Nutrition of Adolescent Girls	162.97
5	National E-governance Plan	300.00
6	Household Electrification	1100.00
7	National Urban Reform Mission (NURM)-Sub Mission on Slums	589.62
8	National Urban Reform Mission 12. NURM-Sub Mission on Urban Infra and Transport	1027.55
9	Backward Areas/District Fund	5000.00
	Total — Through Finance Ministry	**11049.05**

Annexure 8

Flow of Aggregate CSS/CP Grants to States (1990-05)

(INR Crores)

Year	Central Plan Schemes	Centrally-sponsored Schemes	NEC/ Special Plan Scheme	Total Centrally-sponsored/ Central Plan Grants
1990-91	813.42	3763.76	0.00	4577.18
1991-92	749.83	4623.46	0.00	5373.29
1992-93	1035.43	5485.73	31.70	6552.86
1993-94	1130.00	6581.93	69.83	7781.76
1994-95	1079.42	4540.87	964.57	6584.86
1995-96	1585.87	4867.01	431.93	6884.81
1996-97	857.44	5235.24	110.85	6203.53
1997-98	1141.03	5495.29	119.91	6756.23
1998-99	1080.48	5929.07	109.52	7119.07
1999-00	1078.34	6971.60	109.50	8159.44
2000-01	1132.61	7128.44	127.35	8388.40
2001-02	1270.52	8337.02	214.89	9822.43
2002-03	1717.89	8652.40	217.27	10587.56
2003-04[1]	1352.14	9841.93	289.50	11483.57
2004-05 (RE)	4044.93	13690.98	558.92	18294.83

Sources: RBI Handbook on State Finances for data for 1990-2002, RBI Study of State Budgets 2004-05 for data for 2002-03 (actuals) and RBI Study of State Budgets 2005-06 for data on 2003-04 (actuals) and 2004-05 (RE).

[1] Numbers for Bihar, Jharkhand and Jammu & Kashmir are RE instead of actuals for the year 2003-04. Rest are actuals.

Annexure 9

CSS/CP Grants to States as a Proportion of Total Central Grants and States Total Revenues

(INR Crores)

Year	Total Centrally-sponsored/ Central Plan Grants	Total Central Grants	States' Total Revenues	CSS Growth Over Previous Year	CSS/CP as a Proportion of Total Central Grants	CSS/CP Grants as a proportion to total revenues
1990-91	4577.18	12643.29	66466.78		36.20	6.89
1991-92	5373.29	15225.68	80535.7	17.39	35.29	6.67
1992-93	6552.86	17758.83	91091.13	21.95	36.90	7.19
1993-94	7781.76	21176.00	104996.83	18.75	36.75	7.41
1994-95	6584.86	19911.03	120303.26	-15.38	33.07	5.47
1995-96	6884.81	20873.48	134506.87	4.56	32.98	5.12
1996-97	6203.53	22949.29	150040.39	-9.90	27.03	4.13
1997-98	6756.23	23852.90	166820.06	8.91	28.32	4.05
1998-99	7119.07	23480.06	172787.62	5.37	30.32	4.12
1999-2000	8159.44	30177.39	202926.81	14.61	27.04	4.02
2000-01	8388.40	37288.76	232508.95	2.81	22.50	3.61
2001-02	9822.43	42601.44	249421.46	17.10	23.06	3.94
2002-03	10587.56	45170.35	273673.67	7.79	23.44	3.87
2003-04[1]	11483.57	50833.56	309186.96	8.46	22.59	3.71
2004-05 (RE)	18294.83	66524.12	376378.33	59.31	27.50	4.86

Source: RBI Handbook on State Finances for data for 1990-2002, RBI Study of State Budgets 2004-05 for data for 2002-03 (actuals) and RBI Study of State Budgets 2005-06 for data on 2003-04 (actuals) and 2004-05 (RE).

[1] Numbers for Bihar, Jharkhand and Jammu and Kashmir are RE instead of actuals for the year 2003-04. Rest are actuals.

Annexure 10

State-wise Receipts of CSS/CP Grants and their Ratio to Total Central Grants and their Total Revenue Receipts

	CSS/CP Grants	% of Total Grants	% of Total Revenue Receipts	CSS/CP Grants	% of Total Grants	% of Total Revenue Receipts	CSS/CP Grants	% of Total Grants	% of Total Revenue Receipts
	Andhra Pradesh			Arunachal Pradesh			Assam		
1990-91	378.82	48.81	7.08	21.93	9.43	6.12	122.49	20.71	6.89
1991-92	490.35	51.60	7.81	21.73	7.37	4.88	145.27	13.06	6.01
1992-93	508.75	48.31	7.20	22.61	6.87	4.49	139.12	13.31	5.32
1993-94	673.29	48.82	8.16	33.22	9.78	6.08	157.02	9.95	4.73
1994-95	544.23	47.52	6.19	42.93	11.08	7.09	344.27	29.12	11.63
1995-96	546.79	34.47	5.54	34.54	6.39	4.58	187.34	13.15	5.55
1996-97	668.25	38.23	5.97	41.08	7.38	5.08	185.62	11.67	4.81
1997-98	597.14	39.06	4.31	67.31	12.73	8.04	155.76	9.81	3.60
1998-99	638.10	44.22	4.47	64.47	11.14	6.98	220.41	12.79	4.89
1999-00	751.65	37.37	4.47	76.32	12.76	7.48	243.35	14.13	5.03
2000-01	833.32	37.86	4.28	75.95	9.99	7.91	277.49	13.75	4.92
2001-02	844.93	25.49	3.87	91.37	10.24	8.64	367.98	16.97	6.17
2002-03	776.45	30.57	3.38	111.37	12.76	10.05	389.54	16.57	5.73
2003-04[1]	988.29	22.52	3.68	129.88	10.38	8.24	454.85	17.58	5.86
2004-05 (RE)	1793.66	44.11	5.61	58.80	6.40	4.34	1277.94	24.72	9.11
	Bihar			Chhattisgarh			Goa		
1990-91	254.05	31.79	5.88	0.00			9.91	13.24	3.51
1991-92	494.93	45.59	10.20	0.00			11.34	18.98	3.52
1992-93	685.63	51.40	11.50	0.00			13.57	20.99	3.49
1993-94	770.07	51.43	11.62	0.00			15.03	24.43	3.24
1994-95	418.58	34.91	6.16	0.00			18.62	26.21	3.49
1995-96	660.61	65.79	8.95	0.00			13.92	19.00	1.70
1996-97	105.93	16.36	1.32	0.00			18.19	26.06	2.24
1997-98	273.94	14.91	3.15	0.00			15.28	23.95	1.38
1998-99	93.67	9.24	1.01	0.00			11.85	27.99	1.03
1999-00	698.44	33.53	5.55	0.00			14.46	36.04	1.18
2000-01	522.44	48.82	4.59	65.16	19.45	3.46	25.87	38.64	1.74
2001-02	442.07	35.45	4.33	151.57	31.29	3.46	23.06	38.89	1.23
2002-03	707.59	40.27	6.12	300.94	38.41	5.56	19.65	25.51	1.07
2003-04[1]	674.59	30.88	4.99	263.77	38.96	4.43	16.39	31.19	1.01
2004-05 (RE)	645.45	16.59	3.84	449.15	35.27	6.02	36.67	27.64	1.89

Source: as noted under Annexure 7-8

State-wise Receipts of CSS/CP Grants and their Ratio to Total Central Grants and their Total Revenue Receipts (Contd.)

	CSS/CP Grants	% of Total Grants	% of Total Revenue Receipts	CSS/CP Grants	% of Total Grants	% of Total Revenue Receipts	CSS/CP Grants	% of Total Grants	% of Total Revenue Receipts
	Gujarat			Haryana			Himachal Pradesh		
1990-91	164.15	55.49	4.86	84.10	57.26	4.40	54.67	13.72	6.78
1991-92	93.74	28.71	2.01	105.56	59.96	4.71	104.81	21.60	10.56
1992-93	194.20	40.17	3.29	120.82	57.93	5.08	74.74	15.32	7.10
1993-94	434.22	61.47	6.18	169.99	63.07	4.88	92.95	11.63	6.34
1994-95	330.89	55.44	4.24	117.12	57.41	1.99	85.95	17.01	6.58
1995-96	184.40	38.36	2.16	136.78	45.82	2.73	87.91	9.82	5.01
1996-97	197.24	23.07	2.04	182.68	53.63	3.02	93.94	9.46	4.72
1997-98	283.97	38.43	2.55	183.00	51.01	3.10	89.80	10.94	4.14
1998-99	236.85	32.95	1.86	186.27	51.60	3.40	102.34	12.68	4.43
1999-00	319.09	27.64	2.30	213.64	45.96	3.70	130.61	11.68	3.52
2000-01	249.51	14.11	1.59	163.64	34.22	2.49	179.20	9.90	5.88
2001-02	385.52	25.87	2.41	159.52	31.09	2.10	186.88	8.21	5.03
2002-03	321.53	10.73	1.80	219.82	40.49	2.54	197.68	8.79	5.40
2003-04[1]	326.12	17.76	1.79	216.75	32.27	2.20	159.89	7.09	4.02
2004-05 (RE)	534.59	24.25	2.65	289.98	38.66	2.55	116.75	4.83	2.53
	Jammu and Kashmir			Jharkhand			Karnataka		
1990-91	67.36	11.22	5.82	0.00			249.13	65.13	6.40
1991-92	9.32	1.00	0.57	0.00			283.49	60.07	5.94
1992-93	115.14	9.34	5.62	0.00			335.21	56.88	6.18
1993-94	107.61	7.92	4.83	0.00			467.54	61.41	7.39
1994-95	1021.40	49.62	33.74	0.00			451.16	64.87	6.47
1995-96	510.18	23.50	15.67	0.00			363.27	61.63	4.25
1996-97	155.53	6.42	4.21	0.00			416.17	53.20	4.33
1997-98	244.21	9.72	5.70	0.00			421.74	55.43	3.97
1998-99	124.85	4.84	2.77	0.00			405.06	45.33	3.61
1999-00	115.27	3.49	2.09	0.00			734.59	51.80	5.69
2000-01	145.62	3.84	2.68	0.00			678.49	43.88	4.58
2001-02	180.00	3.62	2.62	352.77	40.48	5.78	805.01	45.97	5.25
2002-03	180.00	3.57	2.55	1302.98	69.96	17.59	674.46	40.50	4.17
2003-04[1]	459.00	7.43	5.40	1303.90	69.92	17.52	661.14	33.28	3.18
2004-05 (RE)	350.00	5.24	3.58	853.22	70.80	11.68	985.36	41.84	3.89

Source: as noted under Annexure 7-8

State-wise Receipts of CSS/CP Grants and their Ratio to Total Central Grants and their Total Revenue Receipts (Contd.)

	CSS/CP Grants	% of Total Grants	% of Total Revenue Receipts	CSS/CP Grants	% of Total Grants	% of Total Revenue Receipts	CSS/CP Grants	% of Total Grants	% of Total Revenue Receipts
	Kerala			Madhya Pradesh			Maharashtra		
1990-91	149.09	40.57	6.20	431.92	50.32	9.50	463.31	58.26	5.33
1991-92	137.68	37.51	4.83	435.02	46.85	8.09	490.39	60.47	5.02
1992-93	208.21	44.74	6.27	587.19	52.00	9.11	538.16	58.01	4.97
1993-94	218.23	43.40	5.56	670.77	51.29	9.49	701.41	51.34	5.40
1994-95	293.77	46.44	6.30	622.92	49.55	8.18	461.82	45.63	3.06
1995-96	246.23	52.56	4.54	843.31	72.52	9.75	553.67	47.24	3.34
1996-97	286.98	58.55	4.67	691.37	53.17	6.90	586.26	38.81	3.04
1997-98	248.40	31.31	3.49	857.93	63.66	7.62	466.15	38.07	2.29
1998-99	302.85	49.76	4.21	950.45	62.40	8.38	468.85	45.08	2.16
1999-00	273.79	40.13	3.45	628.25	37.44	4.76	492.40	33.75	1.95
2000-01	277.43	45.04	3.18	707.42	46.54	5.18	709.58	48.51	2.40
2001-02	552.45	56.64	6.10	519.69	34.85	4.64	724.33	43.08	2.41
2002-03	265.44	28.29	2.50	777.74	41.78	5.81	582.06	38.65	1.87
2003-04[1]	327.33	36.07	2.77	620.35	34.99	4.34	833.99	36.74	2.43
2004-05 (RE)	571.61	36.77	3.99	1285.68	45.36	6.28	2036.10	50.62	4.75
	Manipur			Meghalaya			Mizoram		
1990-91	20.86	8.59	5.27	28.41	13.04	8.05	26.14	11.57	5.66
1991-92	32.55	11.54	7.22	25.53	10.95	6.32	29.26	11.76	7.31
1992-93	24.18	8.50	5.04	29.51	12.27	6.89	17.13	7.01	4.07
1993-94	41.91	11.31	7.24	44.51	15.01	8.89	56.03	17.28	11.15
1994-95	46.85	13.91	7.91	42.88	14.75	8.09	16.67	4.91	3.10
1995-96	44.44	9.82	6.42	42.39	10.84	6.20	61.42	13.59	9.79
1996-97	65.52	13.03	8.11	35.48	9.14	4.86	50.20	11.60	7.52
1997-98	62.04	13.04	7.19	30.69	10.01	4.40	69.07	16.45	9.57
1998-99	59.76	11.88	6.66	54.84	13.98	6.59	84.55	20.65	11.50
1999-00	148.33	24.74	13.86	49.20	11.85	5.21	94.21	16.34	9.88
2000-01	74.12	9.38	7.10	73.75	9.67	6.51	72.28	10.54	8.73
2001-02	59.29	6.21	5.04	79.27	10.88	7.06	83.67	11.01	9.64
2002-03	111.57	10.96	8.40	94.28	10.77	7.31	99.73	11.78	9.76
2003-04[1]	84.93	8.00	5.98	76.28	8.80	5.45	120.14	10.46	8.76
2004-05 (RE)	96.62	7.77	5.65	242.47	21.45	14.09	180.78	14.77	12.22

Source: as noted under Annexure 7-8

State-wise Receipts of CSS/CP Grants and their Ratio to Total Central Grants and their Total Revenue Receipts (Contd.)

	CSS/CP Grants	% of Total Grants	% of Total Revenue Receipts	CSS/CP Grants	% of Total Grants	% of Total Revenue Receipts	CSS/CP Grants	% of Total Grants	% of Total Revenue Receipts
	Nagaland			Orissa			Punjab		
1990-91	37.40	15.04	8.98	258.73	42.63	11.92	83.34	46.01	4.22
1991-92	59.51	19.53	12.02	297.64	43.56	12.16	105.70	45.19	2.84
1992-93	29.08	9.80	5.66	339.92	44.25	11.67	137.25	39.17	4.92
1993-94	50.54	12.15	7.99	373.83	43.24	11.65	152.98	45.78	4.67
1994-95	65.16	18.62	10.33	283.77	34.40	7.94	149.04	54.41	2.81
1995-96	52.98	10.04	6.78	296.07	34.82	7.61	133.26	42.36	2.57
1996-97	59.05	11.21	6.76	315.46	35.17	7.36	153.57	42.56	2.76
1997-98	111.16	22.46	11.20	256.92	23.23	5.55	110.14	37.58	1.73
1998-99	113.18	21.84	10.93	291.16	35.71	6.39	167.82	42.10	2.92
1999-00	138.04	25.40	12.07	279.62	16.30	4.75	223.74	43.00	3.00
2000-01	120.72	9.76	8.50	359.75	25.18	5.21	192.22	23.24	2.05
2001-02	94.88	7.46	6.34	277.64	22.38	3.94	195.42	36.36	2.19
2002-03	145.54	12.18	10.40	383.68	21.31	4.55	130.39	19.30	1.18
2003-04[1]	146.89	7.44	6.22	402.02	23.42	4.26	193.65	33.79	1.60
2004-05 (RE)	249.44	14.65	12.35	674.17	24.82	5.87	730.67	55.34	4.77
	Rajasthan			Sikkim			Tamil Nadu		
1990-91	379.00	44.46	10.39	0.00	0.00	0.00	296.56	51.18	5.83
1991-92	405.85	42.63	9.83	15.35	13.60	8.41	329.18	44.87	4.86
1992-93	453.05	42.15	9.27	16.64	13.20	7.95	411.46	50.07	5.86
1993-94	577.89	44.07	10.33	0.00	0.00	0.00	501.56	49.74	6.22
1994-95	604.38	42.34	9.56	0.00	0.00	0.00	361.44	41.19	3.92
1995-96	605.31	52.22	7.93	0.00	0.00	0.00	330.62	42.17	3.12
1996-97	657.40	50.22	8.70	0.00	0.00	0.00	269.17	29.04	2.25
1997-98	578.06	35.63	6.88	0.00	0.00	0.00	462.94	44.04	3.41
1998-99	593.84	44.91	6.92	0.00	0.00	0.00	513.33	47.98	3.60
1999-00	640.68	42.71	6.54	0.00	0.00	0.00	568.17	41.03	3.48
2000-01	737.92	28.63	5.95	0.00	0.00	0.00	595.06	38.64	3.25
2001-02	740.96	35.43	6.10	63.94	12.45	3.54	545.94	39.52	2.90
2002-03	766.25	34.89	5.86	58.78	10.10	2.83	529.58	33.37	2.54
2003-04[1]	830.65	33.18	5.39	62.54	10.72	4.66	654.12	30.81	2.76
2004-05 (RE)	1049.47	38.26	6.00	167.05	20.02	8.13	501.32	23.37	1.85

Source: as noted under Annexure 7-8

State-wise Receipts of CSS/CP Grants and their Ratio to Total Central Grants and their Total Revenue Receipts (Contd.)

	CSS/CP Grants	% of Total Grants	% of Total Revenue Receipts	CSS/CP Grants	% of Total Grants	% of Total Revenue Receipts
	Tripura			Uttar Pradesh		
1990-91	24.96	8.46	5.04	831.96	40.29	10.01
1991-92	33.88	10.33	6.02	926.05	39.20	9.57
1992-93	27.97	8.36	4.63	1338.14	45.05	11.46
1993-94	51.31	14.21	7.98	1195.81	43.81	9.86
1994-95	84.82	19.92	11.44	0.00	0.00	0.00
1995-96	104.52	16.79	11.15	599.32	25.91	3.94
1996-97	86.68	14.23	8.42	602.85	25.85	3.76
1997-98	101.04	18.51	9.34	713.79	32.95	4.06
1998-99	132.33	19.39	10.43	821.24	36.95	4.73
1999-00	109.76	15.01	7.63	877.11	33.69	4.08
2000-01	125.19	10.59	7.64	578.17	20.85	2.34
2001-02	161.26	11.70	8.64	844.24	25.65	3.30
2002-03	156.74	11.62	8.34	660.83	28.62	2.38
2003-04[1]	100.24	6.88	4.62	565.95	22.81	1.79
2004-05 (RE)	330.86	20.40	13.61	1700.00	34.77	4.42
	Uttaranchal			West Bengal		
1990-91	0.00			138.89	19.50	3.38
1991-92	0.00			289.16	38.55	6.18
1992-93	0.00			185.18	20.65	3.54
1993-94	0.00			224.04	20.55	3.78
1994-95	0.00			176.19	17.74	2.57
1995-96	0.00			245.53	27.33	3.33
1996-97	0.00			278.91	24.67	3.39
1997-98	0.00			355.75	35.09	3.94
1998-99	0.00			481.00	31.32	5.12
1999-00	0.00			338.72	22.01	3.32
2000-01	24.44	5.47	2.64	523.66	16.60	3.61
2001-02	218.19	16.48	7.98	670.58	22.82	4.61
2002-03	82.81	5.71	2.57	540.13	24.13	3.72
2003-04[1]	124.66	7.95	3.46	685.26	36.20	4.13
2004-05 (RE)	481.53	17.66	9.70	605.49	21.95	2.97

Source: as noted under Annexure 7-8

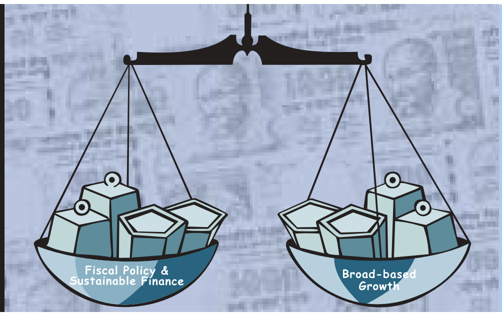
Annexure 11

Objectives and Budget Outlays of Components of Bharat Nirman Programme

Program	Objectives	Budget Outlay (2005-06)
Accelerated Irrigation Benefit Programme (AIBP)	To complete ongoing irrigation/multipurpose projects (mostly started in pre-fifth plan period i.e., before 1974-79) in advance stage of construction and which are beyond the resources capability of State Governments in a time-bound manner with a view to (i) creating additional irrigation potential; and (ii) deriving envisaged benefits from these projects (last mile projects)	INR 4500 crores[18]
Accelerated Rural Water Supply Programme (AWRSP)	(i) to provide safe drinking water to 3522 rural habitations classified as "Not Covered" (NC), and 8375 habitations classified as "Partially Covered" (PC) in the Comprehensive Action Plan 1999 and over 14000 rural schools; and (ii) to promote sustainability of safe drinking water systems	INR 4050 crores
Pradhan Mantri Gram Sarak Yojana (PMGSY)	To provide rural connectivity, through all weather roads, to all rural habitations with population of more than 1000 (500 in case of hilly and desert villages and 250 in case of tribal villages)	4235.00
Indira Awas Yojana (AWY)	To provide shelter to the rural poor by providing assistance for construction of dwelling units and upgradation of existing unserviceable nonpermanent houses for Scheduled Castes/Scheduled Tribes and nonSC/ST rural families[19] living below the poverty line.	2775.00
Rajiv Gandhi Grameen Vidyutikarann Yojana (RGGVY)	A scheme for creating rural electricity infrastructure and household electrification for providing access to electricity to all rural households over a period of four years.	INR 1100 crores
Village Public Telephone Scheme	To provide a public telephone booth in villages	No budgetary outlay.

[18] AIBP is a state plan ACA scheme. It was funded with 100 percent loan assistance till 2004-05. As GoI stopped providing loans to states (allowing states to raise these resources from the market), there was no grant support in the BE 2005-06. RE 2005-06 (as per budget 2006-07 papers) provide for grants of INR 1680 crores for AIBP.

[19] This scheme was proposed as a state plan scheme in the budget 2005-06, but was later shifted during the year as a centrally-sponsored scheme of the Ministry of Power. Budget 2006-07 makes provision for an outlay of INR 3000 crores in the budget of Ministry of Power.



India: Fiscal Condition of the States, International Experience, and Options for Reform

2005

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This paper was part of the USAID/India REFORM Project, prepared in 2005. The objective was to inform officials of Indian central and state governments, dealing with sub-national fiscal reforms, on fiscal management structures and systems to enable fiscal consolidation, in other large federally-structured countries (e.g., Australia, Brazil, Canada, Russia, and the United States). Some of the facts and figures may be out dated and some of the recommendations may no longer be operative due to changes in ground realities. However, the analysis and approach of the paper continue to have value and some of the recommendations useful even today

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Acknowledgments

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List of Abbreviations

ACA	Additional Central Assistance
AFP	*Administradoras de Fondos de Pensiones* – Chile's Pension Fund Administrators
AS	Autonomous School
BBR	Balance Budget Rule
BE	Budget Estimates
CD	*Consejos Directivos* – Local School Councils
CDU	Christian Democratic Union
CGC	Commonwealth Grants Commission
CHST	Canada Health and Social Transfer
CIA	Central Intelligence Agency
CoA	Commonwealth of Australia
COAG	Council of Australian Governments
CONFAZ	Secretaries of Finance of the States - Brazil
CPP	Canadian Pension Plan
CSS	Centrally Sponsored Scheme
CST	Central Sales Tax
CVAT	Compensating Value-Added Tax
DB	Defined Benefit
DC	Defined Contribution
DM	Dutch Mark
DPEP	District Primary Education Program
ECOFIN	Council of Ministers of the European Union
EDUCO	Education with Community Participation
EFC	Eleventh Finance Commission
EFSR	Economic Fiscal Strategy Report
EU	European Union
FCPC	Fifth Central Pay Commission
FERS	Federal Employees Retirement System
FFSR	Financial Support of the Regions
FPE	*Fundo de Participação dos Estados* – Brazilian Federal District and State Participation Fund
FPP	*Fundo de Participação dos Munícipios* – Brazilian Municipal Participation Fund
FRA	Fiscal Responsibility Act
FRF	Fiscal Reforms Facility
FRL	Fiscal Responsibility Law
FUNDEF	*Fundo para Manutenção e Desenvolvimento do Ensino Fundamental* e *Valorização do Magistério* – Fund for Maintenance and Development of the Fundamental Education and Valorisation of Teaching
GCS	General Category States
GDP	Gross Domestic Product
GIA	Grant-in-Aid
GoI	Government of India
GSDP	Gross State Domestic Product
GST	Goods and Services Tax
HMT	Her Majesty's Treasury
HST	Harmonized Sales Tax
IBGE	Brazilian Institute of Geography and Statistics
ICMS	*Imposto sobre Comercialização de Mercadorias e Serviços de Transporte e Comunicação* - Brazilian State VAT
IMF	International Monetary Fund
IPI	*Imposto sobre Produtos Industrializados* - Brazilian Federal VAT
IRPF	Individual Income Tax - Brazil
IRPJ	Corporate Income Tax - Brazil
ISP	Internal Stability Pact
ISS	*Imposto Sobre Serviços* - Brazilian Municipal Tax
MoE	Ministry of Education
MoF	Ministry of Finance
MTEF	Medium Term Expenditure Framework
NCA	Normal Central Assistance
NCMP	National Common Minimum Programme
NDC	National Development Council
NER	*Núcleos Educativos Rurales Autónomos* – Cluster of schools
NSSF	National Small Savings Fund
NZSF	New Zealand Superannuation Fund
O&M	Operation and Maintenance

OECD	Organisation for Economic Cooperation and Development
OTR	Own Tax Revenue
PAYGO	Pay as you go
PIP	Public Investment Programme
PPP	Purchasing Power Parity
PRI	Panchayat Raj Institution
PSE	Public Sector Enterprise
PST	Provincial Sales Tax
QST	Quebec Sales Tax
RBI	Reserve Bank of India
RD	Revenue Deficit
RE	Revised Estimates
RR	Revenue Receipts
RST	Retail Sales Tax
SBM	School-Based Management
SCS	Special Category States
SEB	State Electricity Board
SFC	State Finance Commission
SGP	Stability and Growth Pact
SLR	Statutory Liquidity Ratio
SNG	Subnational Government
SOE	State-owned Enterprise
SPD	Social Democratic Party
SPP	Specific Purpose Payment
TFC	Twelfth Finance Commission
TRE	Total Revenue Expenditure
TRR	Total Revenue Receipt
TSP	Thrift Savings Plan
U.K.	United Kingdom
U.S.	United States of America
VAT	Value-Added Tax
VIVAT	Viable Integrated Value-Added Tax
VFI	Vertical Fiscal Imbalance

Glossary

Crore
10,000,000

Lakh
100,000

Panchayat
Rural local government body

Fiscal Year
April 1 – March 31

Currency Equivalents:
Indian (INR) USD 1.00 = INR 43.3 (April, 2005)

Executive Summary

India is a Union of 28 States, two Union Territories with legislatures, and five Union Territories without legislatures. The Seventh Schedule of India's Constitution provides for a separate State List, which enumerates exclusive legislative and executive authority that lies with state governments. The State List entrusts major responsibilities in the areas of human and physical development to the states. These responsibilities require major expenditures by the states, but the tax revenue sources assigned to the states, although they have not been fully used, are not sufficient to meet these expenditure responsibilities. The resulting fiscal imbalances of the states is addressed through a complex system of intergovernmental transfers in various forms and through several other channels, including borrowings.

Over the years, in practice, the States of India have sought to finance their increasing needs for expenditures through different forms of transfers from the Union Government and loans, rather than by raising additional tax revenues and/or charging for services delivered. This has resulted in the states running large revenue and fiscal deficits and accumulating potentially unsustainable debt burdens. In this process, most states have compromised budgetary discipline, resorted to off-budget forms of borrowings, and accumulated large contingent liabilities, with the attendant risks of default.

The lack of fiscal discipline among the states is symptomatic of a flawed intergovernmental fiscal system. In addition to the lack of aggregate fiscal discipline, the level and quality of services delivered by the states are well below where they ought to be with the money actually spent. There is much evidence of inefficient service delivery. For example, many states have high rates of illiteracy, particularly among women, and high infant and maternal mortality rates. In addition, the quality of economic services provided by the states, particularly electricity and transportation, is poor.

Due to the deteriorating fiscal situation of the states, the Government of India has taken several initiatives, including the creation of a Fiscal Reform Facility, which sought to provide financial-grant incentives to the states, in order to encourage a movement toward budget balance over the five year period coinciding with the implementation period of the Eleventh Finance Commission (2000-2005). The largely unsuccessful experience with the implementation of the Facility has made it necessary to explore other policy alternatives and, in particular, to examine what lessons international experience offers in managing subnational fiscal crises and improving fiscal management of subnational governments. The purpose of this report is to undertake that task.

This report begins by reviewing the key issues responsible for the current fiscal condition of the States of India. Then, it provides an analysis of relevant international experience in this respect. Finally, it evaluates various options for reform in India suggested by lessons drawn from international experience, and it provides a set of recommendations for the consideration of Indian policy makers.

Part 1: Major Challenges and Issues in Subnational Fiscal Reforms in India

Expenditure Assignments and Policies

The role of the states is unclear in regard to concurrent responsibilities with the Union, and local governments lack any exclusive responsibilities. A large fraction of state budgets goes to cover committed or nondiscretionary expenditures on wages, pensions, and interest. Subsidies are large and poorly targeted. Due to the need to compress expenditures, state policies are depriving public infrastructure and important social services of funds. As a result, the quality of state services is suffering.

Revenue Assignments and Policies

In India, tax assignments among the tiers of government are based on the constitutional principle of separation of bases. The inability of the states to tax nonagricultural income and services has hindered their ability to access broadbased and more buoyant taxes. The state sales tax regime is highly distortionary; other taxes remain unexploited (e.g., the property tax, professions tax, and the like); and there is very low cost recovery rates from economic services provided by the states (e.g., irrigation, power, and transportation).

Intergovernmental Fiscal Transfer System

The high transfer dependency of the states has weakened accountability and fiscal discipline. The transfer system is very complex and lacks coordination among the three current institutions in charge of implementing transfers, which together produce a cycle of distorting incentives. The transfer formulae are also complex and lack clearly defined objectives, such as reducing horizontal fiscal imbalances. In particular, centrally sponsored schemes are nontransparent, and they compromise the expenditure autonomy of the states.

Revenue Deficits and Debt

The Centre has not fully exercised hierarchical control over state borrowing. The states have been able to avert the Centre's constitutional debt controls through off-budget borrowings and guarantees. Market borrowings of the states do not reflect creditworthiness, which contributes to the lack of fiscal discipline among the states. Further, the states are operating under soft budget constraints which foster fiscal profligacy as well.

Economic Reforms

State-owned enterprises lack a commercial orientation; user fees are set well below cost recovery in many cases; and rates of return on public investments are low or negative, especially in the power sector. The current political economy of state-owned enterprises does not favor privatization.

Local Governments

Decentralization has not gone far beyond the states, contributing to low levels of efficiency and accountability, poor monitoring, and low quality of local public services. In many cases, local bodies have not been empowered with adequate revenue sources by the State Finance Commissions, which are assigned this task in the Constitution.

Part 2: Lessons from International Experience

In this Part, we draw upon international experience to provide a set of reform options that address the foregoing issues confronting India's intergovernmental fiscal system.

Expenditure Assignments and Policies

International experience shows that transparency, accountability, and efficiency are enhanced when subnational governments are assigned exclusive expenditure responsibilities. Fiscal rules including expenditure limits, expenditure floors on capital investment, formal deficit and debt rules, and transparency rules have proven effective in controlling subnational fiscal profligacy as long as the rules are reasonable and strictly enforced. Countries have pursued a variety of different approaches to pension reform, but most of them are moving in the direction of full-funding and price indexation. Experiences in Latin America and elsewhere show that devolving some subfunctions related to education and health care delivery to lower levels of government and even down to the institutions themselves improves access, accountability, monitoring, and performance.

Revenue Assignments and Policies

International experience demonstrates the benefits of providing subnational governments with substantial revenue autonomy, particularly rate setting authority. Multiple-use of the same tax bases and piggyback arrangements, if properly coordinated, are proven ways to simplify tax administration, reduce compliance costs, and provide subnational governments with access to buoyant sources of revenue. Many federal countries allow subnational governments to levy piggyback income taxes as well as special excise taxes on beverage alcohol, transportation fuels, and tobacco products. Additionally, property taxes, betterment levies, a vehicle tax of some sort, and user fees are proven sources of local government revenue.

Intergovernmental Fiscal Transfer System

Most federal countries use equalization grants to address horizontal fiscal disparities among jurisdictions. Equalization transfers typically are unconditional, formula-based, and include criteria to measure differences in expenditure needs and fiscal capacity. Special purpose grants are used in many countries to promote national priorities and address interjurisdictional spillovers. The current trend is to have a small number of conditional block grants to avoid over burdening the administrative capacity of subnational governments and to provide them with more discretion in the use of these funds.

Deficits and Debt

Australia, Canada, and the U.S. are federal countries that have generally achieved a high degree of fiscal discipline without federally imposed borrowing limits on subnational governments. These countries generally rely on market discipline to control borrowing by subnational governments. Other countries, particularly in the developing world that lack deep and sophisticated financial markets, may achieve fiscal discipline through a combination of rules, statutory limits, and intergovernmental coordination. A third strategy for limiting subnational fiscal indiscipline includes direct hierarchical controls. The reliance on one approach to the exclusion of the other two has generally not proven to be successful.

Economic Reforms

Governments have taken many actions to address the problems of state-owned enterprises, including reforms that promote competition and commercialization as well as reforms addressing corporate governance; restructuring of management, organization, and operations; and privatization. Privatization reforms are not limited to full transfer of ownership but include a public/private combination of ownership, management, and contracting-out of certain subfunctions. Generally speaking, the international trend is toward creating an arms-length relationship between government and state-owned enterprises; operating state-owned enterprises on a commercial basis; and subjecting them to hard budget constraints.

Local Governments

The trend in federal countries is to devolve functions to local bodies according to administrative capacity. Large and diverse countries have opted for asymmetric decentralization, such as separate devolutions to urban and rural bodies. Local governments can be empowered with significant and stable tax assignments, including property taxes, user charges, betterment levies, vehicle levies, and so on. Transfers to local governments are generally formula based, providing for high local autonomy. International experience shows that there are effective ways to constrain local governments to responsible borrowing, avoiding the associated moral hazard problems that arise in this context. Municipal bonds are used only with significant local data disclosure, monitoring, and developed market discipline.

Part 3: Recommendations for Reform of India's Intergovernmental Fiscal System

There is no one magic, simple way to optimally reform India's intergovernmental fiscal system. The best intergovernmental fiscal reform for India depends on a clear statement of what government most wants to accomplish. As such, a reform process should begin with a set of general goals or objectives. We offer the following five general reform objectives:

A. Improve the quality of public services

B. Impose aggregate fiscal discipline on the states

C. Extend decentralization to the local government level

D. Get the intergovernmental system in synch with the economic reforms

E. Redesign institutions to match the new realities of Indian federalism.

The challenges facing India's decentralized system of finance run wide and deep. Many of the key problems with the current system have their roots in the Constitution and legal system. These problems will be difficult but necessary to address. Other problems can be addressed by fine tuning current institutions and processes. The Government of India should begin the reform process by developing a policy stance on the overall goals of intergovernmental fiscal reform.

We offer the following set of recommendations for reform of the intergovernmental fiscal system for the consideration of Indian policy-makers.

Expenditure Assignments and Policies

Recommendation 1: The Government of India should make it mandatory that no new centrally sponsored scheme be introduced unless approved by the National Development Council, after proposal, discussion, and comment of the public in this respect. Cost-benefit analysis should be done for each existing centrally sponsored scheme and approval of National Development Council sought for the same. Existing centrally sponsored schemes should be consolidated into a small number of them, reflecting major national priorities as conditional block grants and periodically reviewed for continued relevance.

Recommendation 2: The Government of India should encourage the states to pass balanced budget laws and the golden rule for capital expenditures, by using the leverage and incentives provided by the Twelfth Finance Commission and exercising its authority under

Article 293 to impose borrowing ceilings. Fiscal Responsibility Laws should have procedures and penalties that discourage the practice of passing budgets with unrealistic forecasts of expenditures and revenues.

Recommendation 3: New employees should adopt a defined contribution scheme or a multipillar scheme, with full set apart funding of defined benefits based on annual actuarial evaluation. If a satisfactory assessment of the accrued rights is done, it should be possible to require existing employees whose term of service does not exceed a certain number of years to move over to the defined contribution scheme for the remaining term of their employment. For existing pensioners, there should be exclusively price indexation, and no further wage indexation should be provided.

Recommendation 4: There should be transparency in the state of affairs of the state-owned enterprises. Privatize profitable state-owned enterprises that are producing private goods in competitive industries. In the case of loss-making state-owned enterprises, it is better to close them down as soon as private provision of such services is ensured. In the meantime, such public sector enterprises should be managed with full cost recovery to prepare them for privatization. There should be better targeting of subsidies for public sector enterprises providing merit services. Accordingly, state budgets should clearly show the amount of each subsidy, the intended beneficiaries, and the economic and/or social rational for each subsidy. There is no alternative to public financing of public goods. The Government should be concentrating on efficient management of such enterprises and ensure delivery of quality services.

Recommendation 5: States should adopt the golden rule. Allow the states to decide their capital expenditures. Do not limit the opportunities for creative financing. Where the assets are revenue producing, the better course is to issue revenue bonds or specific loan financing. In the case of nonrevenue producing projects, use of general obligation bonds should continue as at present.

Revenue Assignments and Policies

Recommendation 6: International experience suggests that a centralized goods and services tax/value-added tax (GST/VAT) with a portion shared with the states based on a formula is the most simple, prevalent, and successful model for indirect taxation. Given the constitutional position and processes at work presently in India, however it would be advisable for all states to switch over to a uniform value-added tax using the platform provided by the Empowered VAT Committee and for the Centre to fully integrate manufacturing stage VAT and services tax into a Central goods and services tax, with the objective of integrating the two in a national GST with a common tax base with both Centre and the states levying taxation thereon along the lines suggested by the Kelkar Report .

Recommendation 7: The states may not be fully using available taxing authority because available tax assignments are poorly conceived. In addition, the lack of a hard budget constraint undermines the incentives for states to utilize fully their own tax revenue raising authority. The Government of India also should examine the taxing powers of the states in terms of revenue sufficiency. However, this examination must take place in the light of analysis of the desired vertical gap and the transfer system. The states should be encouraged to use their existing taxes optimally. The Government of India can help to reform these taxes as well as enhancing their yields. An optimal way to enhance the revenue autonomy of the states is through a piggyback personal income tax. The states would use the same base as the Union's personal income tax, but each state would choose a flat rate between a minimum and maximum set in the federal law.

Recommendation 8: It is recommended that the authority to levy and administer the property tax to be truly decentralized to local bodies. The urban and rural areas should be assisted in developing the capacity to develop and administer a modern real estate tax. The Government of India and the states should provide technical assistance, especially to rural local bodies, to improve administration of a simplified property tax.

Recommendation 9: It is recommended that the states be encouraged to do a critical analysis of all merit and private goods delivered by them departmentally and the present rate of recoveries for such services. The states should then take up a well-designed and publicly shared program to manage the costs of delivering these services and levy user charges at appropriate levels and gradually close the cost-recovery gap. Similarly, the states should critically examine the returns accruing to them from their investments. Investments must be made to perform and yield market returns, or they should be written off.

Intergovernmental Fiscal Transfer System

Recommendation 10: Equalization should be exclusively pursued by an improved and explicitly dedicated equalization grant system by merging the present tax share, Finance Commission's grants, and Planning Commission's normal central assistance. The equalization grant would be funded by a stable formula as a share of dedicated central government revenues. The measurement of expenditure needs would be based on a weighted index of need proxies, and fiscal capacity would be measured by a modified representative revenue system that takes into account the revenue potential of the taxes assigned to the states. The Finance Commission should be entrusted with this job, and the Ministry of Finance would be responsible for implementation. It may be necessary to make the Finance Commission a regular body in order to implement this recommendation.

Recommendation 11: The existing centrally sponsored schemes should be rationalized and simplified into a small number of specific purpose conditional grants. The Centre should indicate the broad mandate and objective of these grants, rather than issuing detailed guidelines which micromanages state affairs and uses a one size fits all approach among the states with different on the ground realities. The states should be free to design their programs and projects consistent with the objectives of the grant. The Centre should focus on evaluating the efficacy of these state programs and projects as well as the sufficiency and timeliness of funding.

Recommendation 12: The Government of India should establish conditional matching grants for capital infrastructure purposes, after assessing the viability gap by way of grants (i.e. without any borrowing component). These grants would be distributed to the states according to a formula based on population, land area, and an index of infrastructure deprivation. These transfers could be administered by the Ministry of Finance.

Recommendation 13: The Planning Commission should be given a new set of responsibilities that is consistent with the economic and intergovernmental reforms currently underway in India. These new responsibilities could include appraisal, evaluation, and monitoring of the programs and the schemes; evaluating the creditworthiness of the states; and reporting to the nation about the success or failure of projects. The distribution of block grants by the Planning Commission in the form of normal central assistance should be transferred to the Finance Commission.

Revenue Deficit and Debt

Recommendation 14: States should be encouraged to adopt fiscal responsibility laws imposing a strict fiscal constraint. The Centre should simultaneously use its authority under Article 293(3) for imposing prudent borrowing control. Following recommendations of the Twelfth Finance Commission, loans from the Centre should be discontinued. Gradually all borrowing from special sources (required holdings of state government bonds by commercial banks, borrowing from pension funds, and shares of rural small savings, and so on) should also be eliminated.

Recommendation 15: Establish a clear set of policies regarding the circumstances under which debt forgiveness will be granted to a state in the case of fiscal insolvency. It may be advisable to bring a law under the financial emergency provision of the Constitution to define the conditions under which a state may be declared to be in financial emergency and rules for its resolution mandating states to undertake politically difficult reforms, such as restructuring and privatizing state-owned enterprises, eliminating subsidies, cutting down on salaries, and pension reforms to name just a few.

Economic Reforms

Recommendation 16: The states should be required either to privatize or establish an arms-length relationship with state-owned enterprises producing private goods/services. The Union Government should agree with the states to develop state-owned enterprise rationalization and/or privatization plans, which would be executed over a period of years. Incentives and significant penalties should be attached to these agreements. In the meantime, the state-owned enterprises should be required to maintain a separate and proper set of books that are subject to annual audits by an independent body or private firm. Any subsidy from the state to state-owned enterprises, implicit or otherwise, should be explicit in state budgets, clearly documenting their cost, intended recipients, and economic and/or social rationale.

Local Governments

Recommendation 17: The Government of India could legislate a much more defined structure for the relationship between the states and the local governments. Recognizing the diversity of local governments and their variations in scale, tax bases, poverty levels, and administrative capacity, India could take an asymmetric decentralization approach to local governments as far as categorizing them to determine spending, tax, and borrowing authority as well as reporting requirements.

Recommendation 18: Designate exclusive subfunction expenditure assignments and insofar as is possible develop a minimum set of revenue assignments and develop the administrative capacity of local governments.

Recommendation 19: Provide urban local governments with revenue raising autonomy by allowing them to levy a modern real estate property tax, introduce betterment or improvement levies, and introduce some form of tax on motor vehicles.

Recommendation 20: Reform the system of state-local government transfers by phasing out the state-based schemes in favor of block grants and allocate them according to formulae. The central government should monitor and evaluate the performance of the State Finance Commissions.

Recommendation 21: The Centre and/or states should provide conditional grants to local governments for their capital projects. Local bodies should be authorized on an application basis, subject to statutory limits, to borrow funds on a creditworthiness basis subject to the following two conditions: (i) the local body has the revenue capacity to repay the loan and (ii) the local body has sufficient administrative capacity to monitor the proper disposition, management, and repayment of the loan funds.

Part 1: Current Issues in Subnational Fiscal Management and the Intergovernmental Fiscal Transfer System of India

Overview

India is a Union of 28 States, two Union Territories with legislatures and five Union Territories without legislatures. Like many federal countries, India's Constitution assigns substantial tax and expenditure assignments to the state level. More specifically, the Seventh Schedule of the Constitution provides for a separate State List, which enumerates exclusive legislative and executive authority that lies with state governments. States can also exercise legislative and executive authority for subjects enumerated in the concurrent list of the Seventh Schedule as long as there is no Union law to the contrary on that subject.

The State List entrusts the states with major responsibilities in the areas of human and physical development. These responsibilities require major expenditures by the states. The tax revenues of the states are not sufficient to meet these expenditure responsibilities. The resulting fiscal imbalances of the states are addressed through a complex system of intergovernmental transfers in various forms and through various channels.

Over the years, the States of India have sought to finance their increasing needs for expenditures through different forms of transfers from the Union Government and by loans, rather than by raising additional tax revenues and/or charging for services delivered. This has led to the states running large revenue and fiscal deficits and accumulating unsustainable debt burdens. In this process most states have compromised budgetary discipline, resorted to off-budget forms of borrowings, and accumulated large contingent liabilities, with attendant risks of default.

Due to the deteriorating fiscal situation of the states, the Government of India (GoI) has taken several initiatives, including the creation of a Fiscal Reform Facility, which sought to provide financial-grant incentives to the states in order to encourage a movement toward budget balance over the five-year period coinciding with the implementation period of the Eleventh Finance Commission (EFC). The largely unsuccessful experience with the implementation of the Facility has made it necessary to explore other policy alternatives. In particular, to examine what lessons international experience offers in managing subnational fiscal crises and improving fiscal management of subnational governments. The purpose of this report is to undertake that task.

This report, first, reviews the key issues responsible for the current fiscal crisis of the States of India. Second, it provides an analysis of relevant international experience in this respect. Third, it evaluates various options for reform in India suggested by lessons from international experience. Finally, it provides a set of recommendations for the consideration of Indian policy makers.

Before taking stock of the major issues and challenges facing the states, we provide a snapshot of the condition of state finances and the intergovernmental fiscal system. The major trends in Centre and state finances are summarized in the Data Appendix at the end of this volume.

The Condition of State Finances

During the ten-year period beginning in the mid-1980s, there was a slow but steady deterioration in the revenue deficits of the states. Starting in 1997-98, however, this steady decline turned into a sharp deterioration. More specifically, state revenue deficits averaged 0.8 percent of gross domestic product (GDP) between 1987-88 and 1996-97, and 2.8 percent of GDP from 1997-98 to 2000-01. Then, in both 2001-02 and 2002-03, the states made some progress in reducing their revenue deficits. However, the revised estimates for 2003-04 show another sharp deterioration in state fiscal balances. The states are financing these deficits through borrowings. Consequently, the total debt of the states has increased from the already high-level of 20.7 percent of GDP in 1987-88 to 35 percent of GDP in 2004-05 (Budget Estimates).

Figure 1.1: Fiscal Condition of the States

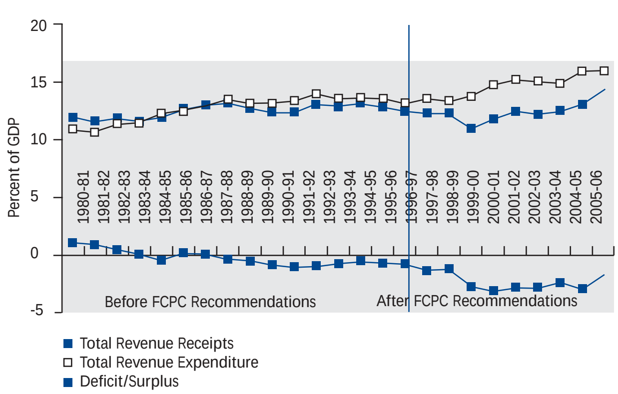
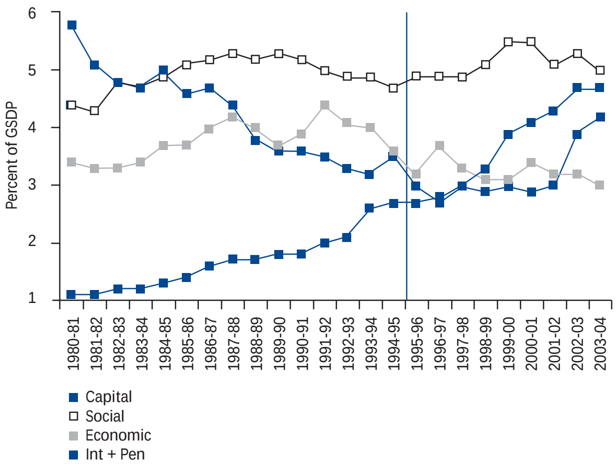


Figure I.1 shows the obvious fact that the growth in state revenue deficits is attributable to the failure of revenue receipts to keep pace with the growth in revenue expenditures. From 1998-99 to 2002-03, revenue expenditures as a share of GDP grew by 13 percent. Meanwhile, the total revenue receipts of the states as a share of GDP increased by only 8 percent. Absent a matching increase in revenue receipts, the fiscal shock represented by the large wage and pension increases by the states in 1997-98 has led the way to large and persistent revenue deficits and growing state debt burdens as a share of GDP.

In addition to the growing debt burdens of the states, the composition of state expenditures is a source of serious concern. In 2003-04 (Revised Estimates), for example, state expenditures on wages, pensions, and interest on debt were approximately 76 percent of the total revenue receipts of the states. Since these are largely committed or nondiscretionary expenditures, many states are severely constrained in their ability to compress revenue expenditures as a means of balancing their revenue accounts.

Figure I.2 shows that state expenditures on interest and pensions have overtaken the share of GDP spent by the states on economic services and capital expenditures and is rapidly approaching the share of GDP that states are now spending on social services. Although capital expenditures as a share of GDP are beginning to recover to the levels of the early 1990s, they are still substantially lower as a share of GDP than in the early 1980s. The share of GDP spent on economic services has declined sharply as well. Expenditures on the operation and maintenance of capital assets used in each of these sectors have declined, while explicit and implicit subsidies to

Figure 1.1: Trend in the Composition of State Expenditure



GDP Source: NAS from 1980-81 to 1992-93.

irrigation, power, and transport have increased.

Table I.1 provides information on three indicators of fiscal imbalance: revenue deficit, fiscal deficit, and primary deficit. The revenue deficit indicates the extent to which current receipts are not able to cover revenue expenditures necessitating borrowing to finance current, nonasset building, expenditure. It represents government consumption expenditures that are financed by capital receipts. Capital receipts, apart from a small portion of nondebt capital receipts, consist of net borrowing, which is called the fiscal deficit. The fiscal deficit represents the net inflow of borrowed funds. The primary deficit is equal to the fiscal deficit minus interest payments, which represent outflows in the form of transfers. Primary deficits accumulate into debt unless offset by an excess of GDP growth rate over the interest rate.

Table I.1 shows the aggregate trends in state deficits, including the steady but persistent revenue deficits in the early to mid-1990s and the sharp deterioration in revenue deficits beginning in 1998-99. The most persistent deterioration is observed in the ratio of revenue deficit to fiscal deficit, which indicates the extent to which borrowed funds are used to finance current expenditures. In 1993-94, this ratio was about 19 percent. It has increased steadily to approximately 58 percent by 2002-03. Finally, we see the accumulation of state debt, which was approximately 22 percent of GDP in 1993-94, and, as of 2002-03, stands at 31.15 percent of GDP.

A Brief Summary of Aggregate Trends in State Finances

The main trends relating to aggregate state finances, comparing the average over 1993-96 with that of 2000-03 may be summarized as follows (Twelfth Finance Commission Report, 2005):

- The revenue deficit of the states rose from 0.62 percent of GDP in 1993-96 to 2.53 percent in 2000-03, implying an increase of 1.9 percentage points.
- The fiscal deficit of the states increased from 2.55 percent during 1993-96 on average to about 4 percent of GDP, implying an increase of about 1.5 percentage points.
- During the period from 1996-97 to 2002-03, the debt-GDP ratio of the states increased by a massive margin of about 9 percentage points of GDP, rising from 21.8 percent of GDP in 1996-97 to 31.2 percent in 2002-03.
- The own tax revenues of the states showed an increase from 5.3 percent of GDP during 1993-96 on an average to 5.5 percent during 2000-03. But own nontax revenues as also the central transfers relative to GDP fell during this period. The fall in transfers was mainly on

Table 1.1: Aggregate State Finances: Alternative Deficit Indicators (percent of GDP)

Year	Revenue Deficit	Fiscal Deficit	Primary Deficit	Revenue Deficit/ Fiscal Deficit	Debt/GDP
1993-94	0.45	2.35	0.52	19.05	21.79
1994-95	0.69	2.72	0.79	25.55	21.40
1995-96	0.73	2.59	0.76	28.06	21.00
1996-97	1.31	2.77	0.90	47.37	21.00
1997-98	1.23	2.94	0.93	42.01	21.73
1998-99	2.61	4.31	2.24	60.48	23.02
1999-00	2.82	4.64	2.34	60.87	25.20
2000-01	2.61	4.16	1.69	62.60	27.42
2001-02	2.68	4.09	1.41	65.49	29.37
2002-03	2.29	3.94	1.14	58.09	31.15
Averages					
1993-96 [A]	0.62	2.55	0.69	24.22	21.79
2000-03 [B]	2.53	4.07	1.41	62.06	31.15
[B]-[A]	1.90	1.51	0.72	37.84	9.36

Source: Twelfth Finance Commission Report (2005).

account of nonfinance Commission transfers.

- On the expenditure side, interest payments and pensions increased. In the case of interest payments, the rise amounted to 0.79 percentage points, rising from 1.86 during 1993-96 to 2.65 during 2000-03. In fact, if only end years 1993-94 and 2002-03 are compared, the increase is a clear one percentage point of GDP. Pensions rose by 0.62 percentage points comparing the averages for the two periods under review.

India's Intergovernmental Fiscal System

India has an elaborate multichannel, intergovernmental fiscal system. The GoI has been sharing central taxes with the states and has been providing conditional and unconditional grants and loans to the states. These transfers are substantial. Shared taxes and grants from the Centre to the states represent over 4.5 percent of GDP. The Centre also transfers close to one percent of GDP in the form of loans to the states. These resources constitute over one-third of the aggregate fiscal resources available to the states. Major trends in state revenues are summarized in Table 1.2.

Major Challenges and Issues with India's Subnational Fiscal Reforms

Expenditure Assignments and Policies

STRUCTURAL ISSUES

1. *Unclear expenditure assignments*: The Seventh Schedule seeks to make expenditure assignments explicitly divisible between the Centre and the states. The Concurrent List provides for overlapping competencies. The Concurrent List is expanding. For example, education, earlier part of the State List, is now part of the Concurrent List. Nevertheless, the

Table 1.2: Aggregate State Finances: Main Fiscal Indicators(percent of GDP)

Year	Own Tax Revenues	Own Nontax Revenues	Finance Transfers Commission	Nonfinance Commission Transfers	Total Revenue
1993-94	5.30	1.59	3.05	2.02	11.96
1994-95	5.31	1.55	2.86	1.55	11.27
1995-96	5.20	1.51	2.90	1.30	10.91
1996-97	5.01	1.47	2.94	1.29	10.71
1997-98	5.14	1.43	2.90	1.33	10.80
1998-99	4.93	1.26	2.44	1.17	9.31
1999-00	5.09	1.38	2.50	1.29	10.26
2000-01	5.46	1.37	3.02	1.20	11.04
2001-02	5.32	1.19	2.84	1.28	10.63
2002-03	5.52	1.23	2.80	1.22	10.77
Averages					
1993-96 [A]	5.27	1.55	2.94	1.62	11.38
2000-03 [B]	5.44	1.26	2.88	1.23	10.81
[B]-[A]	0.17	-0.29	-0.05	-0.39	-0.57

Source: (Basic Data): State Finance Accounts

fiscal inadequacy of the states and the desire of the Centre to spend on subjects reserved for the states have resulted in the Centre designing and implementing over 200 centrally sponsored schemes (CSSs). Many central ministries, like agriculture, rural development, urban development and employment, and so on are handling competencies that are listed as exclusively those of the states. The predominance of centrally sponsored schemes in these areas has made the role of the states quite unclear in practice. Expansion of the Centre into these areas has resulted in the states not being fully accountable to their constituencies for these activities.

2. *Inflexible budgets*: The revenue expenditures of the states are dominated by committed expenditures, specifically on wages, pensions, and interest. This has made it extremely difficult for the states to compress expenditures in response to persistent revenue deficits.

POLICY CHALLENGES

1. *Personnel*: The civil service in India is smaller in comparison to OECD countries and most developing countries, yet the wage bill of the states is too large relative to total revenue expenditures. As expenditure on salaries and wages is not directly relatable to the development outcomes and services received by the public, there is a widespread perception that expenditure on personnel is unproductive as well.

2. *Pensions*: The states are spending a growing share of total revenue receipts on pension payments, in aggregate constituting over 10 percent of their entire expenditures. The states also are facing substantial unfunded future pension liabilities which are not yet assessed. Several parametric aspects of civil service

pensions like the commutation discount rate, the commutation factor, the definition of last pay, and so on are also very generous.

3. *Interest*: The states have to pay a large and growing share of total revenue receipts to meet debt-servicing obligations, which averaged more than 25 percent of their revenue receipts in 2003-04, with this ratio exceeding 35 percent in the case of three states. Despite the Debt Swap Scheme sponsored by the Centre, the share of state budgets that goes to interest on debt is likely to continue to grow, particularly if the states continue to run large revenue deficits.

4. *Subsidies to state-owned enterprises*: Subsidies to state-owned enterprises are poorly targeted and regressive, especially in the power sector. Aggregate losses in the power sector exceed one percent of GDP, part of which is paid for by cross-subsidization or explicit subsidies from the states. However, a good part still remains uncovered in the accounts of the utilities. There is a lack of transparency in public sector undertakings and an increasing amount of implicit subsidies. The losses that result from low cost-recovery are financed by borrowing that is guaranteed by the states and accumulation of arrears.

5. *Other subsidies*: The implicit subsidies to higher education and primary health care are high, even those who can afford to pay for social services are charged very little or nothing. As a result of budget pressures, the quality of important social services is deteriorating due to low cost recovery. As a result the growing middle class is increasingly using private sector alternatives rather than state offerings.

6. *Capital outlays*: State borrowings, ostensibly to finance infrastructure development, are diverted to finance persistent state revenue account deficits. Consequently, expenditures on important infrastructure investments have declined relative to the share of GDP devoted by the states to economic development in the early 1980s. Furthermore, capital outlays are poorly targeted, and the projects often take too long to complete. Expenditures on maintenance and repair of infrastructure are inadequate. Therefore, the states are living off of depreciation of existing assets. Given the long time horizons required to replace existing infrastructure and put new infrastructure investments into place, addressing this issue should be a high priority.

7. *Health and education*: The quality of state social services is very low, which results in high illiteracy rates, high rates of infant mortality and malnutrition, and the like. Furthermore, the wage bill as a share of total expenditures on health and education are too high. As a result, clinics and schools lack vital supplies and equipment further compromising the quality of important social services provided by the states. There is high absenteeism and shirking by skilled employees in these sectors, despite high public sector compensation relative to comparable jobs in the private sector. Clearly, the low quality of critical public services is not just a matter of the lack of fiscal resources but also mismanagement and inefficient use of existing resources.

Revenue Assignments and Policies

STRUCTURAL ISSUES

1. *Separation of tax powers*: India has clearly demarcated taxation powers. While this gives the states complete authority within the demarcated boundaries to choose the tax

structure best suited to the state, India's States have not been able to take advantage of the revenue buoyancy and cost savings associated with piggyback arrangements on central taxes. The structure of indirect taxes has become very complicated due to the division of taxation powers between the GoI and the states related to goods at various stages of production. The lack of a clear arrangement for the taxation of services has added further complexities. While the tax on manufactured goods is levied by the central government, taxes on the sales of goods are levied by the states. Power to levy taxes on services, except some specific services like entertainment or electricity, has been assumed by the Centre by the current interpretation of the Constitution.

2. *Vertical fiscal imbalance*: There is an imbalance by design between state revenue assignments relative to their expenditure assignments. As a result, the states are highly dependent on the Centre for resource transfers. High transfer dependency breaks the Wicksellian connection between the costs and benefits of state services. This, in turn, leads to a mentality of dependency, a lack of fiscal transparency, lack of accountability, fiscal profligacy, and inefficient fiscal policies.

3. *Inadequate local revenue assignments*: Local governments are dependent upon the state governments to give them taxation powers, as local bodies have no direct constitutional authority for taxing any tax base. The states need to pass laws to delegate taxation powers to the local governments. Local governments have not been empowered with clearly defined own source revenues, detracting from their overall efficiency and accountability to their constituencies. Often, transfers to local governments are only sufficient to cover the costs of electricity used by local bodies.

4. *Unexploited taxes*: There are taxes that states can levy but that have remained unexploited or under exploited (i.e., agricultural income tax, profession tax, urban property tax, etc.). The states are clearly unwilling to take the political risks of levying additional taxes when they can simply use loan funds. The fact that there are unexploited taxes when state budgets are in such bad shape points to the perverse incentives that are created by the existing soft budget constraint at the subnational level.

POLICY CHALLENGES

Sales Tax:

- The system of sales tax prevailing in India is a form of restricted cascading type origin tax. This system hinders the smooth flow of interstate trade and the growth of a common market. The central sales tax (CST) treatment of state exports enables them to extend their sales tax jurisdiction beyond their territories and thereby raise revenues from citizens of other states. The ability of the states to export taxes on to those who do not enjoy the benefits of state services breaks the Wicksellian connection between the costs and benefits of government expenditures. Breaking this connection leads to inefficient expenditure policies;
- The lack of harmonization in the state sales tax structures results in tax competition, which in turn results in low tax to Gross State Domestic Product (GSDP) ratios and undermines budgetary balances. The complexity of the state sales tax systems also burdens taxpayers and tax administration;
- Taxing at the first point of sale narrows the sales tax base. States, in addition, are conferred

with the authority to levy tax only on select services like entertainment, electricity, and transportation. As a result, sales tax rates have to be higher on taxable commodities in order to raise a given level of revenue, thus, making the sales tax more distortionary and inefficient;

- Driven by pressures to raise more and more revenue from a relatively narrow and inelastic sales tax base, many states levy turnover taxes on all transactions (nine states), surcharges on the basic sales tax liability and additional sales tax (14 states), and entry taxes (Six states);
- The states decided to adopt uniform floor rates in 1999 and 21 of 28 states have implemented a destination based VAT starting April 1, 2005. The Union Government has made a commitment to the states to compensate for the loss of their revenues to the extent of 100 percent of the loss in the first year, 75 percent of the loss in the second year, and 50 percent of the loss in the third year; and
- There is a proposal for an integrated goods and services tax (GST), with a common tax base and joint administration, with the Centre levying 12 percent and states another 8 percent.

Property tax:

- Property taxes are within the jurisdiction of the states, although most of the states have conferred powers to levy property taxes on the municipalities. The current property tax systems of the states are characterized by the lack of professionally-trained assessors, subjective assessments in a corruption-prone administrative environment, scope for excessive use of discretionary powers for individual assessments, absence of records of landownership, absence of tax mapping initiatives, defective rate structures whereby higher valuation properties get away with lower tax burdens, and proportionately more cases involving appeals and litigation;
- It is not uncommon for the assessment of comparable properties to differ by occupant (old versus new tenants in the same premises), different apartments in the same building (some on the same floor with identical use, old versus new structures for identical uses, in the same vicinities), and between different geographic areas in the city (high-priced inner-city area versus the newly-developed areas and suburbs). The assessment of property tax is linked to rent control; and
- Despite these problems, over the last five years the revenue from property taxes has been growing both as a share of state total revenue receipts and relative to GDP. However, major deficiencies remain in the administration of this tax.

Other taxes:

- *Electricity taxes* are levied by the states on consumption of electricity. This is a major source of tax revenues for the states. However, as this tax is collected though power utilities in the state sector and the power utilities are running large losses, the revenues collected are used by the electricity boards/utilities as partial payment of the states' obligations to provide subsidies to cover the operating losses of the power utilities;
- *Entertainment taxes* are levied mostly on the cinema going public. However, there are exceptions for multiplexes. This tax is a stagnant source of revenues. Although this tax has all the features of a local tax, it is levied and

collected by the state government in most states;

- *Luxury tax* is imposed in some of the states on consumer items imported into the states, such as tobacco, gutka, tobacco mixed pan-masala, and expensive fabrics (e.g., silk and woolens). The luxury tax may be justified by the desire to introduce greater progressivity into the tax system. However, generally speaking, subnational governments should leave redistributive taxes to the Centre. Most importantly, like many other consumption taxes levied by the states, the luxury tax often appears to be designed to protect domestic producers rather than as a source of revenue. These taxes also provide subnational governments with the ability to levy taxes that interfere with intrastate trade;
- *Professional tax* can be levied on professions, trades, callings, or employment at a rate not to exceed INR 2,500 per taxpayer per year. Many states either do not levy it or levy it at low rates. This tax has been assigned to local bodies in only a handful of states. The absolute ceiling is presently fixed in the Constitution and changing it would require a constitutional amendment;
- *Transportation taxes* like taxes on vehicles and transportation of goods and passengers are also complex in India. While there has been a conversion of taxes on vehicles as a one time levy, taxes on transportation of goods and services is beset with problems of issuing permits and collection of the tax; and
- *Stamps and registration* represent the third or fourth largest source of own revenues to the states. However, rates of conveyance duties are very steep in India, discouraging registration of conveyances at full value. Stamp duties on many other documents are also very high, discouraging adoption of many new instruments like mortgage based debt, securitization instruments, and the like. The tax regime for stamps and registration has not been overhauled for quite some time.

4. *Nontax revenue*:

   User charges, interest, and royalties are not regularly updated; they tend to be highly politicized; and they are used for providing high rates of subsidization. This has meant low rates of cost recovery across many economic and social services. The resulting operating losses tend to be financed by borrowed funds that are guaranteed by the states. Low cost recovery in the power sector impedes private investment in this sector and has led to low quality supply.

Intergovernmental Fiscal Transfer System

STRUCTURAL ISSUES

1. *Multiplicity of transfer channels:* India has a very elaborate and complex system of resource transfers from the Centre to the states. All three types of resources (taxes, grants, and loans) are shared with or transferred to the states. There are several hundred types of conditional grants mostly delivered through the line Ministries. In addition, there are unconditional grants implemented through the Planning Commission for development purposes. The Finance Commission recommends a system of unconditional transfers for equalization purposes, which are implemented by the Ministry of Finance (MoF).
2. *High transfer dependency*: The high transfer dependency of the states breaks the Wicksellian link between costs and benefits for

citizens, which weakens accountability and fiscal discipline. In practice, the recurrence to transfers to finance increased expenditure needs has softened the budget constraints of the states.

3. *Lack of coordination*: There is a lack of coordination among the three current institutions in charge of implementing transfers. The development grants implemented by the Planning Commission create future nonplan expenditure liabilities for the states (i.e., debt service liabilities, infrastructure maintenance costs, and personnel costs). It is implicit in the gap filling of the grants-in-aid (GIA) approach that larger plan outlays financed by larger borrowing create larger state liabilities, which, in turn, generate larger claims for additional fiscal transfer from the Finance Commissions. Furthermore, the Planning Commission often receives pressure from the Centre and the states to accept that the states will be able to generate additional resources. Based on such arguments, the Planning Commission then authorizes the states to borrow additional amounts. Thus, there is a cycle of distorting incentives due to the fact that the decision process is fragmented, without any single institution being responsible for looking at the system of transfers as a whole.

4. *Transfer formulae*:

Finance Commission:

- The formula used for tax devolution by the EFC (2000-2005) mixed variables pertaining to fiscal capacity and expenditure needs, but it did not differentiate in a transparent way between these two fundamental means of equalization;
- The criteria of population, land area, and infrastructure index measure expenditure needs. But there is more to the measurement of expenditure need that is not covered by these indices, in particular the poverty rate, the unemployment rate, age structure, and the like;
- The only criterion for fiscal capacity, although with a weight of 62.5 percent, is income disparity. However, there are more direct methods to measure fiscal capacity, such as the size of tax bases and their potential yield. The Twelfth Finance Commission (TFC) is actually moving in this direction;
- The EFC formula is pursuing more than an equalization objective because tax effort and fiscal discipline are in the formula. While these are worthwhile objectives, it is far from clear that they should be pursued within the framework of an equalization formula. The states also are unlikely to respond to these incentives due to their small weights in the formula. In many ways, the Finance Commission formula is not part of an equalization grant system but rather part of general or unconditional funding, which has equalization grant features; and
- The TFC has tried to bring in the equalization principle for certain specific grants for education and health on the expenditure side. Although equalization should be pursued mostly, if not exclusively, by the equalization grant system in order to free up other grant instruments to pursue other objectives, this is a temporary positive move given the present need for more equalization in the system.

Planning Commission

- The Planning Commission's formula, better known as the Gadgil formula, is also a mixture of expenditure need and fiscal capacity elements, which are again mixed with other objectives (i.e. tax effort, fiscal management, national objectives, and special problems). The Finance Commission's transfers are much more equalizing than the Planning Commission's because the criterion of per capita income disparities is much more equalizing than the population criterion. The Finance Commission's formula weights income disparities much more heavily than the Planning Commission's formula (62.5 versus 25 percent, respectively); and the Planning Commission weights population more heavily than the Finance Commission (60 versus 10 percent, respectively).

- The Gadgil formula is applied for allocation of only what is known as normal central assistance (NCA). There are several schematic allocations going through the state plan channel, which has different bases for resource allocation.
- There is a loan and grant mix in the Planning Commission transfers. There are various kinds of models ranging from 100 percent grants to 100 percent loans.

POLICY CHALLENGES

1. *Tax transfer*: The tax transfer is not sufficiently equalizing, as a result some states get too much revenue relative to their tax capacity, and the low-income states get too little. As all the tax sources of the Centre are now shared, the states share in the buoyancy, or lack of it, of the central taxes. While the states stand to gain when the central taxes are buoyant, the reverse happened in the first few years of the EFC period, when central taxes did not grow as expected.
2. *Grants-in-aid*: The Finance Commission grants are specific purpose as well as unconditional to cover the assessed resource gap of the states. The assessed revenue deficit grant, which acquires the character of gap-filling grants, discourage fiscal discipline.
3. *Loan transfers*: The Planning Commission's Gadgil formula [i.e., 70:30 (10:90) loan grant mix] is outdated and creates incentives for the states to make irresponsible and unsustainable borrowing decisions, especially because the grant cannot be taken without the loan transfer. Furthermore, the states are using plan borrowings to finance their revenue deficits. Plan borrowings are meant to finance economic development. This is extremely short-sighted and, if allowed to continue, will jeopardize the ability of India's economy to sustain robust economic growth.
4. *Centrally sponsored schemes*: The CSSs are not transparent; there are too many of them; and they compromise the expenditure autonomy of the states.

Revenue Deficit and Debt

STRUCTURAL ISSUES

1. *Centre encourages excessive borrowing*: The Gadgil formula and the small savings scheme encourage autonomous borrowing by the states. Such policies compromise the ability of the Centre to make a credible commitment to a no bailout policy. While there does not seem to be evidence of government borrowing crowding-out private investment at this time, the low rate of return on government investment is a very serious problem for the short-run and long-run vitality of India's economy. The low rate of return on government investment is due to the long time that it takes to complete a project.
2. *No bailout policy lacks credibility*: In the past,

the Centre has rescheduled state debt and granted waivers of interest and principle, usually on the basis of recommendations of the Finance Commissions. The TFC has again recommended major debt-rescheduling with a lower rate of interest and a debt-waiver scheme. However, this has been linked to states adopting fiscal responsibility legislation and also to eliminating revenue deficits over a five-year period. Nevertheless, such waivers may create expectations that the Centre will bailout the states in the event of a future fiscal crisis. In which case, the states lack incentives to behave in a fiscally prudent manner.

3. *Hierarchical controls are not used*: The Centre is not fully exercising *ex ante* control over state borrowing, although a move in this direction has been made in the last two years. The Centre is not exercising *ex post* control over states that divert plan borrowing to finance revenue deficits. In fact, state plan borrowings are routinely diverted to finance persistent state revenue account deficits. This policy softens state budget constraints and enables them to pursue inefficient, nontransparent, and profligate fiscal policies without having to make greater use of their own tax and nontax revenues.

POLICY CHALLENGES

1. *Debt financing through central government*: Central government loans primarily include plan loans. In addition, the net collections of small savings in a state are invested in the securities of that state government of the national small savings fund (NSSF). Central plan loans are tied to a grant, and states did not have the option of taking the grant without the loan. NSSF loans to states have become relatively costlier in view of higher rate of interest paid on savings instruments and the cost of collections, making this source of loan relatively costlier than other sources, without the states having the option of not taking these loans. The central government is not imposing aggregate controls on state borrowing, and as a result there is excess debt accumulation by the states. However, the GoI has recently decided to do away with providing plan loans to the states. It will be a major challenge to implement this important decision.
2. *Debt financing through market borrowings*: Banks are mandated by the central legislation to invest 25 percent of their time and demand deposits in loans approved for this purpose. State market borrowings are also approved for this purpose. Other financial institutions also subscribe to state paper. A few years back, the statutory liquidity ratio (SLR) was much higher and the banks, who may not have otherwise subscribed to this paper, in a way were forced to lend to the states. However, for the last few years, the situation has changed. There is no longer pressure on banks to subscribe to these papers. In any case, current bank holding of SLR paper is much more than the statutory requirement. As most of the state paper is issued as Tap issues, market rates do not reflect the creditworthiness of the state. Therefore, market borrowings are not creating market discipline by allowing interest rates to reflect creditworthiness or ration credit.
3. *Debt financing through financial institutions*: The states negotiate loans with GoI owned financial institutions (i.e., insurance companies, etc.) Their size is indicated at the time of the annual plan finalization and there is plenty of room for the discretionary allocation of these loans. In particular, this practice does not help

to discipline the borrowing activities of the states, and it contributes to excess debt accumulation of this type by the states.

4. *Debt financing through other financing*: Many states use off-budget borrowings and accumulation of arrears. Various orders have been issued by the GoI and the Reserve Bank of India (RBI), which would, if implemented, bring off-budget borrowing to an end. These forms of debt financing are not transparent and are harmful to budget discipline.

Economic Reforms

STRUCTURAL ISSUES

1. *Lack of commercial orientation by state-owned enterprises*: There is insufficient autonomy and accountability in the management of public enterprises. The pricing policies of state-owned enterprises result in low cost recovery. This lack of commercial orientation, as evidenced, for example, by their pricing policies, accounts for the negative or at best very low rates of return from public investments in power, irrigation, and transportation. The return on public investments in these important economic sectors has not been adequate to service the debt acquired to finance these projects. Attempts at privatizing and/or increasing the commercial orientation of state-owned enterprises have not been successful.

POLICY CHALLENGES

1. *Power sector reforms*: Indian industry pays world-record prices for low-quality electricity. Indian farmers get very cheap power, but of very poor quality. The nonprice rationing regime of electricity in agriculture is harmful to agriculture and the environment. Indian agriculture is stuck in a low-price, low-quality electricity supply trap. The low rate of return on investments in this sector puts considerable pressure on state budgets. Power subsidies are not under the control of finance departments. The political-economy of state-owned enterprises does not favor privatization, at least in the short-run.

2. *Transport sector reforms*: Generally speaking there is a lack of commercial orientation in state-owned enterprises in the transport sector; fares are set below cost recovery; there is low or negative return on investment; there is a lack of investment; and maintenance and repair are neglected. The quality of the service is very poor, as the age and condition of bus fleets make abundantly clear.

Local Governments

STRUCTURAL ISSUES

1. *Lack of genuine decentralization to local bodies*: Expenditure assignments for local public goods (e.g., water, sanitation, and primary education) have, in general, not been transferred to local bodies. Local governments have better knowledge of local preferences, local problems, and alternative production technologies. Given the population size distribution of the States of India, the lack of genuine decentralization to local bodies has led to low accountability, poor monitoring, and low quality of local public services.

2. *Local bodies lack revenue autonomy*: Local bodies lack revenue autonomy, which is essential if local leaders and constituents are going to internalize the costs of locally provided services. Property and many other taxes (e.g., electricity tax, entertainment tax, hotel tax, and taxes on vehicles), which are

currently assigned to the states, are more appropriately local taxes.

POLICY CHALLENGES

1. *Central to local government transfers*: The GoI does not transfer funds directly to local bodies, except for implementation of some specific programs of rural development, health, and education. In many of these cases, funds are transferred to specially created institutions and district level societies. These societies are not politically responsible to local government institutions.
2. *State to local government transfers*: State to local transfers are inadequate for local bodies to carry out their responsibilities, and instead the states are passing plan borrowings on to local bodies.

Part 2: Lessons from International Experience

Overview

As we have seen in Part 1, there are a number of structural problems with the design of India's intergovernmental system. For space reasons those problems will not be repeated here, but it should suffice to note here that the majority of India's States are running large revenue and fiscal deficits and accumulating what soon may become unsustainable debt burdens. The causes of the current problems are complex, and the solutions are not immediate. However, other countries around the world have experienced, at some point in time, similar problems, and/or they have been able to devise institutions that have sufficiently addressed these problems. The purpose of this Part is to draw upon international experience to extract lessons to address the difficult issues currently confronting India's intergovernmental fiscal system. The analysis draws from many countries but pays special attention to the experiences of a set of federal countries visited over the course of the last two years (Australia, Brazil, Canada, Russia and the United States). This Part follows the same issues identified in Part 1.

Expenditure Assignments and Policies

ISSUE 1: CONCURRENT LIST OF EXPENDITURE ASSIGNMENTS

1. Federal countries have long dealt with instability, lack of clarity, and controversy in the practice of the assignment of competencies and expenditure obligations at different levels of government. A major problem has been the failure to recognize that the assignment of any expenditure responsibility also implies responsibility for a multidimensional array of attributes, including: (i) actually producing a good or delivering a service; (ii) providing or administering the service; (iii) financing a service; and (iv) setting standards, regulations, and policies guiding the provision of government services. While there is no problem, with assigning competencies over these attributes in the case of exclusive assignments, there is a need to be explicit about their assignment in the case of concurrent expenditure assignments. In short, there are important issues in India concerning the concurrent list of responsibilities between the Centre and the states and the states and local bodies. In the latter case, all responsibilities are concurrent.

International Experience

1. In Brazil and the Russian Federation, there is still a lack of exclusive responsibilities to subnational governments and a lack of clarity regarding who is responsible for what in the case of many overlapping functions. As is the case in India, the lack of clarity in assignments is more acute in the division of responsibilities between the intermediate level and local governments. In the Russian Federation, for example, the lack of clarity in the assignment of responsibility for primary and secondary education between the regional and local levels of government has meant that in some regions teacher salaries simply went unpaid as different government levels argued about who was responsible for paying teacher salaries.
2. Highly decentralized and successful federations such as Canada and the United States (US) have taken years of friction and disputes to reach their current distribution of responsibility across levels of government.

Thus, practice can substitute for explicit assignments in the law, but relatively younger federations may avoid these costly transactions through more explicit and clear assignments. This is precisely what the Russian Federation attempted to do in the comprehensive Budget Code of 2002, although it fell short of achieving this aim.

3. Besides clarifying the assignments of attributes for concurrent responsibilities, the best way to deal with the lack of clarity is to seek ways to assign exclusive responsibilities wherever this is possible. Practically, in all decentralized countries, and this is certainly true of Australia, Brazil, Canada, the Russian Federation, and the U.S., there are a number of responsibilities that are exclusively assigned to local governments. This is even true in countries like Canada and the US where the local governments are "creatures" of the states.

4. The fact that the devolution of expenditure functions often involves several levels of government emphasizes the need for intergovernmental cooperation in order to assure the successful implementation of decentralization reforms. This is especially necessary in some priority sectors, such as education and health. When multiple levels of government are involved in the same sector, governments need broad and formal coordinating institutions. In Germany's "cooperative federalism" all decisions are coordinated through an extensive net of multilevel committees. In the US, the pattern of assigning responsibilities varies widely from sector to sector and state to state, so sectoral coordination is done by technocrats in some areas where there is a clear need, such as highways and law enforcement. Somewhere in between the German and US models are the practices of Australia, Canada, and New Zealand, countries that use periodic formal meetings of elected officials and bureaucrats to discuss mutually important fiscal issues. For example, Canada has two organizations for coordination, dialog, and conflict resolution: (i) functional federalism, ministers and officials from federal and provincial departments meet to discuss issues of policy coordination and program delivery mechanisms; and (ii) summit federalism, where first ministers meet for negotiations of difficult "horizontal" problems, that is problems of one specific government department. Similarly, in Australia, the Council of Australian Governments (COAG) initiates, develops, and monitors the implementation of policy reforms that are of national significance and which require cooperative action by Australian governments (CoA, 2001).

5. Other problems with expenditure assignments are apparent in international experience. Some central governments play a larger direct role in service provision than theory and international best practice would suggest. In Brazil, for example, the central government has found it difficult to withdraw from some purely local functions such as public markets, local schools, and local bridges after more than a decade since adoption of the 1988 Constitution which assigned these functions to local governments (Shah and Thompson, 2004). Another type of problem is unfunded expenditure mandates. These were very common in the Russian Federation, until the approval of the Budget Code in 2002 that made them an illegal practice and forced the federal government to provide targeted transfers for each mandate. In Canada, local governments have complained of provincial abuse due to unfunded mandates, and in the US there is still an ongoing debate between the federal and state authorities on this issue.

Lessons for India

1. International experience shows that the best practice is to assign exclusive expenditure responsibilities to all three levels of government wherever possible. Wherever the assignment of concurrent responsibilities is needed, it is desirable to have clearly stated assignments of subfunctions for regulation, financing, provision, and service delivery across the different tiers of government.
2. The constitution may not be the best vehicle for achieving this level of specificity in concurrent expenditure assignments. It is advisable to elaborate the concurrent list in terms of subfunctions through national laws passed by parliament.
3. Institutions for cooperation and dialog should be strengthened and have regular periodic meetings to help clarify many other issues associated with concurrent responsibilities. These institutions should have the participation of representatives from each level of subnational government.

ISSUE 2: COMPRESSION OF EXPENDITURES

Although the level and composition of expenditures vary considerably between the low and high income States of India, most states have shown worrisome trends. Increasing budget shares go to pay salaries, interest on debt, and pensions. In addition, many states are behaving in a fiscally irresponsible manner by running large deficits and routinely borrowing to finance current expenditures. International experience is rich with examples of countries that have gone through similar situations.

International Experience

1. *Formal deficit and debt rules*: An increasing number of countries, federal and unitary, have recently adopted formal fiscal rules, such as a balanced-budget rules that limit discretionary fiscal policy, and new budget procedures, such as new multiyear frameworks to impose controls on government spending.[1] The proponents of rules contend that the commitment to these rules makes it easier for fiscal authorities to withstand pressures for higher spending. The good news is that most countries adopting such rules have experienced substantial fiscal consolidation. The approaches followed exhibit considerable variety regarding the choice of target, degree of flexibility, and so on. Such institutional reforms can be classified into three broad groups, which are sometimes used alone or in combination. Regardless of how they are introduced, however, they often seem to have an ameliorative effect on expenditure trends (Brumby and Cangiano, 2001).[2]
2. *Expenditure limits*: Finland, the Netherlands, Sweden, and the US have emphasized expenditure limits, supported by procedural requirements, whereby proposals resulting in overruns in certain expenditure areas must be accompanied by offsetting expenditure cuts elsewhere or by revenue increases. Expenditure rules typically impose ceilings on

[1] Other public expenditure management reforms, including mechanisms to strengthen budgetary procedures and to enhance flexibility while strengthening expenditure control, have contributed significantly to expenditure restraint. Among these measures are ex ante and ex post program evaluation in Australia, creating responsibility centres in France, and performance agreements in New Zealand and the United Kingdom (Brumby and Cangiano, 2001).

[2] It is important to note that many studies have found that fiscal consolidation associated with expenditure restraint, particularly reductions in primary current expenditure have proved more durable. See, for example, Alesina and Perotti (1995); Alesina and Ardagna (1998); Perotti et al (1998); and von Hagen et al (2001).

specific areas of expenditure or for particular programs. The advantage of capping expenditure is that the process is well understood by players in budget negotiations and the wider public, and it tackles deficit bias by addressing the principal source of rising deficits. In addition, governments are made accountable for what they can control most directly, in contrast with deficit limits. A disadvantage of an expenditure limit is that it does not necessarily correct a tendency toward excessive deficits, for instance through large tax cuts or the systematic over prediction of revenues. To overcome this deficit risk, the expenditure rule can be combined with a medium-term target for budget balance as is the case in Sweden.

3. *Transparency*: New Zealand pioneered an approach to fiscal management that places primary and explicit emphasis on transparency with the Fiscal Responsibility Act of 1994. Australia and the UK have since adopted similar approaches, as has Brazil and other countries in Latin America.

4. These three approaches are sometimes combined. For example, Australia, New Zealand, and the UK combine legally mandated transparency with rules or objectives for deficits and debt levels. In contrast, the Netherlands uses expenditure and revenue rules to meet its requirements under the Stability and Growth Pact. By and large these approaches have worked. In Australia, for example, the new framework contributed to a decline in the deficit from about 4 percent of GDP in 1992-93 to a surplus of 2 percent of GDP in 1999-00. Spending has increased only slightly, and the tax burden has remained constant. In addition, transparency improved as a result of new reporting requirements (Daban et al, 2003).

5. Brazil has also combined all three types of policies (formal deficit and debt rules, expenditure limits, and transparency) into one fiscal responsibility legislation. The Fiscal Responsibility Law (FRL) provides for the following: (i) defined ceilings for payroll expenses;
(ii) defined subceilings for the same expenses by branch of government; (iii) fixed limits on official actions, with certain restrictions in election years; (iv) transparency rules for reporting public sector accounts; and (v) prohibits new refinancing of the debt of subnational states by federal authorities. Regarding expenditure ceilings, the FRL provides targets for a limit on wages. The FRL states that expenditures on personnel should not exceed 60 percent of the net current revenue of the state, and similarly 60 percent for municipalities. While some states have proven to be successful at containing committed expenditures, others have turned to virtually zero investment.

6. In Canada, the Fiscal Spending Control Act of 1992 established a nominal expenditure limit for the period 1992 to 1996. In addition, since 1994 the government introduced several policy rules that were not formally legislated. The main objective was to control public expenditure growth, reduce fiscal imbalances, and stop the increase in public debt. The deficit of five percent of GDP in 1995 became a surplus of more than one percent of GDP by 1999, and the ratio of net public debt to GDP was reduced from around 70 percent in 1995 to 52 percent in 2000. (Daban et al, 2003).

7. In the US, many studies have concluded that the specific expenditure ceilings embodied in the Budget Enforcement Act have played a significant role in reducing expenditure. This approach may have been better suited to the US

budget process than the earlier deficit reduction targets contained in the Gramm-Rudman-Hollings Act, which provided for automatic spending cuts to take effect if the president and Congress failed to reach established targets; the US comptroller general was given the right to order spending cuts.

Lessons for India

1. International experience shows that fiscal consolidation associated with expenditure restraint, particularly reductions in primary current expenditure have proved more durable historically. The advantage of capping expenditure is that the process is well understood by players in budget negotiations and the wider public, and it tackles deficit bias by addressing the principal source of rising deficits.
2. Fiscal responsibility legislation at all levels of government should provide for expenditure limits, formal deficit and debt rules, and transparency. Transparency, in particular, is important for monitoring subnational government progress and fostering greater accountability of political leaders to their constituents.
3. Fiscal rules are a proven way to control subnational fiscal profligacy, if the rules are reasonable and enforced. However, expenditure limits may lead subnational governments to neglect the quality of public expenditure.

ISSUE 3: PENSION REFORM

Pensions are a major expenditure item in India's State budgets. On average, nearly 11 percent of revenue receipts go to this expenditure item. The annual average increase in pension spending was 30 percent between 1995-96 and 2000-01, making pensions the fastest growing expenditure item in state budgets (the World Bank, 2004). This implies that reforming the current pension system is crucial to the fiscal sustainability of the states. The crux of the issue is that the current practice in most states of unfunded noncontributory defined benefit (DB) schemes is no longer fiscally sustainable.

Consequently, two types of reforms are in progress. First structural reforms are being pursued to enable the states to shift to a cheaper and less fiscally-risky defined contribution (DC) schemes. Second, parametric reforms are being pursued to contain the cost of the current noncontributory DB schemes.[3] In 2003, the GoI approved the introduction of a restructured DC scheme for new civil servants to replace the existing DB scheme, but this reform has been limited to the Centre. Although the scheme is open to interested states on a voluntary basis, only a few have initiated measures to introduce a DC scheme, namely, Himachal Pradesh, Maharashtra, Rajasthan, and Tamil Nadu (the World Bank, 2004). While the proposed new DC scheme will have transitional fiscal costs, it has the potential to deliver major fiscal gains. However, if restricted to new civil servants only, the shift to a DC scheme will not have a positive fiscal impact for another 30 years or more. Thus, parametric changes in the current DB pension scheme for both the existing employees and pensioners have become unavoidable.[4]

[3] The term PAYGO system in India is also used for the unfunded pension noncontributory schemes where current (state) revenues fund pension benefits.

[4] Some of these include the elimination of the fixing of pensions on the basis of only one-month's pay or the elimination of wage indexation of pensions (RBI, 2003a).

To be sure, existing pension schemes across states have many common features, but there are certain variations. For example, while pension schemes cover state government employees in all the states, some of them have accepted the entire burden of salary and pension expenditure of employees of grant-in-aid (GIA) institutions and local bodies. There are also variations in terms of eligibility, computation, family pension, commutation, gratuities, and nonpension benefits. Given that there are significant interstate differences relating to pension payments, more than one policy approach to address pension issues at the state level will be needed.

International Experience

1. Pension reforms undertaken by a large number of countries have led to a variety of pension systems ranging from DB pensions that may or may not be integrated with the national social security system; plans that may or may not be contributory; and plans that may or may not be funded. Most industrialized countries separate civil servant pensions from the national social insurance schemes. Other countries, such as Argentina, Chile, Peru, and many East European countries have moved towards complete integration of the civil service pension plan with the national social insurance plan. A recent survey by the World Bank indicates that out of 128 countries, 46 countries have fully integrated civil service schemes, while 82 have separate schemes (RBI, 2003b).
2. Regarding pension scheme structures, several countries have adopted a multipillar approach in recent years, consisting of an unfunded mandatory pillar, a funded mandatory pillar, and a voluntary private pillar. At one end is the Latin American experience of the individual account model with only one DC pillar as established in Chile in 1980 (see below) and later followed by Argentina, Bolivia, Colombia, Mexico, Peru, and Uruguay. This has made the Latin American experience with privatization in pension reform a model to learn from for many other countries. The second model is the OECD employer sponsored model adopted in Australia, Denmark, Switzerland, and the United Kingdom. A feature of this model is that the employer and/or union trustees choose the investment manager for the company or occupational group as a whole. The third model is the notional defined contribution system which originated in Sweden and was adopted in Italy, Latvia, and Poland. This scheme is a type of DC scheme where the individual has an account in which his contributions are credited but no funds are deposited. The account is periodically revalued-upwards based on the index adopted.
3. In Chile, the pension reform of 1980 created a new system known as the AFP (*Administradoras de Fondos de Pensiones*) system which completely replaced the government run PAYGO social security system with an investment-based private system of individual retirement accounts. The new pension system gives workers covered by the scheme the choice between different forms of payout after their retirement. Workers who were already in the labor force were given the option of staying in the old system or moving to the new system. Those who stayed in the old system had their pension rights guaranteed under the new law. The main characteristics of the Chilean system are as follows:
   - Contributions are capitalized in individual

accounts, and the rate of contribution is defined in the law as a proportion of the wage;

- The value of old-age pensions depends on the balance accumulated in the personal account of each worker;
- Disability and survivorship pensions are defined benefits with a value proportional to the taxable wage of the member;
- The worker is free to choose among different registered, single-purpose pension management institutions (the AFPs);
- AFPs are private and competitive firms whose purpose is to invest the funds in the capital market on behalf of its members;
- At retirement, the worker can choose among three different ways in which he can receive the pension; and
- The State plays mainly a subsidiary role manifested in its responsibility to regulate and supervise the system, finance minimum pensions, and provide certain guarantees.

4. Some drawbacks of this system include high administrative costs, lack of portfolio choice, and a high number of switchovers from one fund to another. More importantly, since the system is a pure DC scheme the employees are exposed to the risk of volatility in the market prices of the investment assets, and the system may not provide security in old age. This risk may be reduced by using a mixture of DB and DC plans, which is the rationale for a multipillar system.

5. In the US, in 1983, all new employees were introduced to a new system, the Federal Employees Retirement System (FERS). FERS provides for a three-tier retirement plan consisting of (general) social security, a DB plan, and the Thrift Savings Plan (TSP), which is a DC plan. FERS' retirement income is similar to that provided by large employers in the private sector. The TPS is administered by an independent agency which operates the plan prudently and solely in the interest of the participants and their beneficiaries. The reform in the US has achieved the following: it integrated the newly recruited civil servants under the social security system; it provided a retirement system comparable to those for private sector workers; it raised the minimum retirement age by two years; it partially privatized federal government retirement by instituting a funded DC plan with some private sector investments; and it has improved portability for federal government employees. In addition, the state governments in the US have begun shifting public employee pensions towards DC plans: three states have or are phasing in a system based on a DC plan only; 6 states have, or are phasing in, a system allowing state employees and/or school teachers the freedom to choose to substitute a DC plan for the old DB plan. Three states have hybrid DB/DC plans, 48 states allow workers to choose a supplemental DC plan in addition to the main DB or DC plan, and 49 states offer at least some workers some DC plan.

6. In Brazil, other than at the federal level, each of the 27 states have their own PAYGO pension system The growing pressure of pensions on state expenditures has led to proposals to reform the pension system, but no significant structural changes have been achieved. Brazil has encountered significant legal and political obstacles to reforming the pension system. State governments faced with tight budgets have taken initiatives for reform. The most

common has been to create a prefunded component to guarantee existing benefits. These funds have been generally financed by privatization receipts and/or increased contribution rates. However, these prefunded systems are not actuarially balanced, and they merely provide temporary relief to State government accounts rather than a permanent solution.

7. Some countries have approached pension reform from another angle. Canada and Japan have reformed their existing prefunding arrangements, and New Zealand has taken initiatives to build pension reserves.

8. *Canada:* The Canadian Pension Plan (CPP) was founded in 1966 as a PAYGO scheme, indexed to inflation. The scheme requires mandatory contributions by all employees and employers. The Federal and Provincial Governments of Canada have no liability towards the CPP. However, governments make matching contributions like other employers. The ratio of the number of employees to pensioners is expected to decline sharply in the future. Thus a number of measures have been taken, as follows: (i) increasing the current employer contribution rate from six percent to 9.9 percent; (ii) creating an independent corporation to manage reserves, the CPP Investment Board; (iii) allowing the CPP, which previously only could be invested in Provincial government securities, to invest in capital markets and even foreign markets; and (iv) requiring CPP to disclose quarterly financial results.

9. *Japan:* Major reforms to the pension system have been introduced in the past decade with the aim of reducing benefit levels. Demography and reliance on public pensions implies that Japan has the largest unfunded pension liabilities in the world. A new pension reform went into effect in 2001, including a reduction in the accrual rate, an increase in the normal retirement age, and a switchover from wage to price indexation. Before the reform, pension reserves were borrowed by the central government in the form of nonmarketable government bonds, and a small portion was invested in the capital market. After the reforms, funds are increasingly invested in nongovernment loans.

10. *New Zealand:* The pension scheme is a universal flat benefit financed by general revenues. In view of a large increase in pension expenditures, the government introduced measures toward prefunding the pension scheme in 2001. The reform provides for a partial prefunding target through annual contributions from the budget and for setting up the New Zealand Superannuation Fund (NZSF). Withdrawals from the fund are not allowed until 2020, and the governance is entrusted to a public corporation run by a board, which is responsible for investing the funds on a prudent commercial basis.

Lessons for India

1. One size does not fit all. Countries with different circumstances and different pension system histories have undertaken different reforms which are working for them. Given the variety of circumstances in the States of India, different pension scheme reforms may be needed to adapt to the situation of each state. The range of potential reforms include a pure DC scheme for new employees, hybrid DC-DB schemes, or a two-tier scheme for new employees with a DC-DB tier supplemented with a mandatory DC scheme. The reforms should be mandatory for new employees, but

incentives may be provided to existing employees to choose the new scheme. Pension fund management can be the responsibility of an independent institution based on established guidelines. During the transition period, it may be necessary to introduce parametric changes to benefits/ contributions. Good data and information systems are critical to studying the options and arriving at sound policy prescriptions.

2. Most countries have moved away from wage indexation in favor of price indexation. As the States of India provide for both wage and price indexation, they should move to price indexation only.
3. The pension burdens of other public institution employees (for example, new GIA and local bodies in India) may not be similar to state employees and should be paid for by the respective institutions/bodies.

ISSUE 4: SUBSIDIES TO STATE-OWNED ENTERPRISES

At the state level, power subsidies have represented a long-standing problem as they are considered inefficient, regressive, and highly political. In addition, poor cost recovery and theft have contributed to power sector losses which have been financed through cross-subsidization mainly by industrial and commercial consumers and also via subventions from state governments (RBI, 2004). Thus, not only are explicit subsidies a drain on state budgets, but the lack of transparency in implicit subsidies and the resulting contingent liabilities contribute to the financial risks borne by the states. Previous efforts by state and central governments to take coordinated action to raise tariffs and to phase out agricultural subsidies have failed, as have previous efforts at privatization. We proceed with a discussion of international experience in addressing the issue of subsidies.

International Experience

1. *Eliminate the subsidy*: The most obvious means to improve economic efficiency would be to curtail all subsidies. While politically this may be difficult to achieve, it has been done in some countries. Russia, for example, has had a long history of poorly targeted subsidies of various goods and services including utilities, housing, food, and transportation. Reforms included the devolution of subsidy responsibility to lower levels of government (i.e., regional and local levels) in the form of unfunded mandates under the assumption that lower level government have more information to better target subsidies. However, provided that regional and local governments were unable to finance these subsidies, these were eventually phased out.
2. *Target the subsidy:* Subsidies can be trimmed by restraining the number of individuals or companies who are eligible for a subsidy. Ideally, they should be directly targeted to the needy. Targeting subsidies in other countries include the design of direct subsidies for the poor. This approach was first used in water sector reforms in Chile in the early 1990s as an alternative to the practice of paying subsidies directly to utilities often allowing the price to fall below economic costs indiscriminately. In this scheme, government funds are used to cover part of the cost of subsistence consumption for households that meet certain poverty-related criteria. This makes subsidies more transparent and explicit and minimizes distortions in the behavior of water utilities and their customers. The main drawbacks of direct subsidies are higher administrative costs and the difficulty of designing suitable eligibility criteria (World Bank, 2000a).
3. *Market the resource:* Tariff policies should be

based on the principle of full cost recovery. To start with power and water must be appropriately priced. This would release resources for public investment in infrastructure projects and to maintain existing facilities. User charges shift the burden of financing goods and services from taxpayers generally to those who benefit directly. Less than full recovery amounts to an implicit subsidy to users at the expense of taxpayers. Although most countries make much less use of user charges than desirable, countries such as Argentina, Australia, Canada, and the US heavily rely on user charges. Generally, charges are set at competitive private levels, with no tax or subsidy element included, or the subsidy element, if present, is accounted for separately.

4. *Privatize the resource:* The most dramatic reform would be to transfer the provision of some subsidized goods to private firms. Many countries have adopted privatization programs as part of structural reforms and to alleviate budget problems.[5]

Lessons For India

1. The deepest reform would be the privatization or closure of SOEs providing private goods. Absent privatization, tariff policies should still be based on the principle of full cost recovery in order to shift the burden of financing services from taxpayers generally to service users.
2. In the case of merit goods, tariff policies should still be based on the principle of full cost recovery. Any subsidies to protect the poor should be explicit and targeted.
3. The biggest challenge in targeting subsidies is the design of direct subsidies for the poor. Generally recognizable criteria may be used as opposed to more complex income or means testing. For example, the irrigation subsidy may be targeted to small family farmers.
4. The provision of implicit subsidies is a practice to be avoided. If subsidies are kept at the enterprise level, these subsidies should be made explicit, with transparent resource transfers from the subnational government to the enterprise explicitly shown in state budgets.
5. Whenever efficiency gains are possible provision may be contracted out to the private sector.

ISSUE 5: DECLINING EXPENDITURES ON CAPITAL OUTLAYS

Subnational government capital outlays in India have been declining as a share of GDP. State borrowings, presumably to finance infrastructure development, are being diverted to finance persistent state revenue deficits. Additionally, capital outlays are poorly targeted, and the projects often take too long to complete. Expenditures on maintenance and repair of infrastructure are also inadequate. Furthermore, there are inappropriate incentives and control systems and poor planning which has resulted in poor performance by a number of investment projects.

International Experience

1. The UK put in place a policy framework in the *Finance Act 1998* and in the *Code for Fiscal Stability* to tackle problems similar to those now being experienced in India. The two key fiscal rules, which mostly affect public investment, are the following:

[5] The issue of privatization of state-owned enterprises is discussed in greater detail later in this Part under economic reforms.

- *Golden rule*: Over the economic cycle, the government will borrow only to invest and not to fund current spending; and
- *Sustainable investment rule*: Public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level (currently 40 percent of GDP).

2. Other countries also practise the golden rule at the subnational level (e.g., Brazil, Canada, Germany, South Africa, and the US). However, by itself the golden rule does not guarantee sound and sustainable public investment. To address this issue the U.K. government has also introduced a new control regime for public expenditure which checks on the quality of investment. This is known as the Economic and Fiscal Strategy Report (EFSR), which, among other things, requires that capital expenditures are planned separately from current expenditure and protected through separate capital budgets within each department's expenditure limit. This aims at ensuring that worthwhile capital investment projects are not sacrificed to meet short-term pressures. In addition, departments are allowed to reinvest any savings they make in their projects and are allowed to carry over unspent reserves from year to year. The new framework introduced in the U.K. brings together a strategy for raising quantity, quality, and stability of public investment (HTM, 1998). Although it is still too early to evaluate the success at this reform, the Report of Accounts for 2002-03 indicates a nominal 12 percent increase in public investment from the previous year, reflecting the government's determination to address the historical under investment in public services (HMT, 2003).
3. There are also unsuccessful experiences that provide lessons. Brazilian States suffer from inflexible budgets because committed expenditures to pension, interest, and wages represent most of their current expenditure. In an effort to tackle the fiscal distress in the country, the Government introduced the Fiscal Responsibility Law in 2000 which includes rules and limits for government debt, wage bill, golden rule, and other fiscal indicators. The limit for personnel expenditure for the states is 60 percent of net revenues, and 13 percent on interest payments. However, in an effort to tackle the issue of high committed expenditures and debt, there has been a negative impact on capital investment, namely public infrastructure. While most states have been successful at meeting limits on committed expenditures and the golden rule, they have achieved this success by sacrificing important public investments. The challenge for Brazil will be for the states to provide the necessary public investment. One possible strategy would be setting a floor on capital expenditures in the FRL that is consistent with other fiscal rules such as the golden rule.

Lessons for India

1. To protect capital investment in needed infrastructure, it is necessary to adopt the golden rule. However, the golden rule does not in and of itself guarantee sound and sustainable public investment. Capital expenditure may need to be planned separately from current expenditure and, more importantly, protected through separate capital budgets.

ISSUE 6: LOW QUALITY OF SOCIAL SERVICES

The quality of social services in India is rather low, resulting in poor performance indicators in many states, namely, high illiteracy rates, high infant mortality rates and malnutrition, and low access to education. In some parts of India, government schools lack textbooks, other school supplies, and teachers (or the teachers fail to show up to work); schools do not provide access to proper toilets for students and teachers, which is known to affect attendance particularly among female students; health clinics lack medicines and doctors (or they fail to show up to work); clean water is very often unreliable or unavailable; and roads and transport are inaccessible to many areas.[6] In summary, the delivery of most economic and social services is fraught with all sorts of problems, which are compounded by limited accountability for performance and poor management.

We proceed by briefly reviewing the success stories of other countries at improving the quality and management of social services. Given the breadth of issues, the discussion focuses mainly on the delivery of education services.

International Experience

1. *Reassignment of expenditure responsibility and decision-making:* Most countries have taken decentralization to lower level bodies under the assumption that these arrangements lead to a closer match between services and the needs and preferences of the beneficiaries; increase accountability of local decision-makers; and use localized information in decision-making. Decentralization of education and health services has characteristically proceeded through the devolution/delegation of key functions or responsibilities to different government levels, including institutions (i.e., schools and hospitals), rather than decentralization of the whole set of functions to subnational governments or to a facility. In fact, countries such as Canada, Germany, Spain, and the US among others have devolved most functions in education and health to the local and institutional level, especially those related to personnel management (i.e., compensation, hiring, firing, etc).
2. *School-based management* (SBM): The most radical form of educational decentralization involves the transfer of decision-making to the school level. Variations of SBM generally are defined by which stakeholder group holds decision-making authority. Generally there are four distinct forms of SBM: principal control, professional control (teacher majority), community control (community majority), and balanced control (teacher and community equally represented). SBM reforms have been implemented in a variety of countries, such as autonomous schools in Nicaragua, community-managed schools (EDUCO) in El Salvador, self-managed schools in New Zealand, the District Primary Education Programme (DPEP) in India, and local school council in Chicago.[7] These reforms have contributed to improvements in access to education, for example in El Salvador and Nicaragua; student learning, again in El Salvador and Nicaragua; student attendance in India and Chicago; teacher attendance in El Salvador, India, and Nicaragua; and parental involvement (all cases).
3. Nicaragua's autonomous school (AS) model offers an interesting lesson. In contrast to reforms in New Zealand and Chicago, Nicaragua's AS reform has been implemented gradually, starting with those schools that

[6] See Peters (2000), Kremer et al (2004), Ferro et al. (2002), Filmer (2001), and Keefer and Khemani (2004).

[7] See Jimenez and Sawada (2000), Pandey (2000) and World Bank (2000b).

have the strongest capacity. To become an AS school, teachers at the school must vote in favor of AS status. Then, the principal files an application with the municipality. The application is then reviewed and approved by the Ministry of Education (MoE), which evaluates the capacity of the applicant to undertake the responsibility of being an AS. AS schools are required to establish self-governing councils composed of the school director, teachers, and parents. The council has broad authority over a wide range of school issues, including hiring and firing school staff; salary incentives, and training support; setting student fees; and establishing and administering school budgets. In the AS model, rural schools use a different decentralization structure. The new rural model involves the creation of a cluster of schools (*Núcleos Educativos Rurales Autónomos)* in which the largest one acts as the nucleus. The group acts as one autonomous school with a shared school director and local school council (*Consejos Directivos*), which is based at the largest school. This means that urban school councils operate at the school level, whereas in rural areas they operate at the municipal level (King and Ozler, 1998).

4. *School grants* have been used in countries such as Chile, Guinea, Indonesia, and Nigeria as a means to improve efficiency, quality, and equity. School grants are transfers of decision-making authority and financial resources from governments to schools or small networks of schools. These can be managed by an individual or organization with the legal authority to receive and spend public funds, usually the school director, a governing board council of the school, or a parent-teacher association. School grants are used in numerous developing countries and are often supported by education development projects, such as community-managed schools and school-based management (discussed below). The scope of a grant's activities include, among other things, training of teachers and administrative staff, new organization of school management with community and teacher participation, and integration of children with special needs into the educational process.

5. Corporatization and/or privatization reforms of hospitals are being implemented in different countries in order to improve performance of publicly run health services. This allows hospitals to be operated by a variety of public and private organizations, based on hospital specific contracts that would define each hospital's mission, guarantee public funding, and ensure accountability. Reforms include various degrees of autonomy of ownership (i.e., fully public to fully private ownership), and management functions (i.e., governance, management, and financing) of hospitals. These reforms have recently been implemented to various degrees in California, Denmark, France, Holland, Italy, New Zealand, and the UK and among developing countries in Indonesia, several Latin American countries, the Philippines, and Singapore. While there are mixed results, most success stories relate to increased accountability, lower staff absenteeism, and better allocation of funds towards materials and equipment (Chawla et al, 1996).

Lessons for India

1. According to India's Constitution, education and health are primarily state responsibilities. The international best experience suggests

that devolving more functions related to education and health care delivery to local bodies and institutions can substantially improve access, accountability, and quality monitoring.

2. Many case studies involving devolution of decision-making power to local bodies, communities, and schools provide evidence of improvements in access, enrolment, and attendance. In particular case studies regarding devolution of personnel management decisions (i.e., compensation, hiring, and firing) report a decline in teacher absenteeism.

3. Nicaragua's AS reforms provide an example of a decentralization strategy where local bodies and schools may be empowered according to administrative capacity and providing an option for greater autonomy to rural schools, too. One of the advantages of this reform is that it provides an incentive for schools to improve their administrative and technical capacities in order to obtain autonomous status.

4. School grant designs in other countries provide good examples that complement reforms involving the devolution of decision-making attributes. The international experience suggests that school grants should feature sufficient flexibility for the schools to spend the funds. A well-designed transfer can be helpful in the implementation of minimum national standards, providing incentives for local effort, and improving accountability.

Revenue Assignments and Policies

It seems clear that the States of India need to augment revenues due to the large share of committed expenditures and persistent revenue deficits. This can be accomplished in any number of ways, including increasing own source revenues, improved tax administration, and increasing intergovernmental transfers. Enhancing the revenue autonomy of subnational governments would have the added advantage of tightening the Wicksellian link between costs and benefits which would help foster greater fiscal discipline. We begin with an evaluation of India's proposed subnational VAT in light of international experience. Then, we turn to a discussion of subnational revenue assignments in other federal countries.

ISSUE 1: INDIA'S PROPOSED SUBNATIONAL VALUE-ADDED TAX

India's current reform agenda includes a proposal to introduce a subnational VAT and abolish the existing system of state sales taxes. The problems with the state sales taxes are well-known and will not be repeated here. The State of Haryana has already implemented a VAT with good results in terms of revenue growth. On April 1, 2005, as this report was nearing completion, 21 of India's 28 States implemented a VAT. We proceed below by briefly reviewing international experience with VATs.

International Experience

1. Generally speaking, the VAT is a major source of revenue in many countries, including Australia, Brazil, Canada, Russia, and the member countries of the European Union ("EU") among others. It is considered to be an efficient and buoyant source of revenue when properly designed and administered.

2. Brazil's dual VAT most resembles the system of consumption tax currently underway in India, although some contend that the resemblance is superficial because there is no rebate of Central Sales Tax paid in the importing state. Brazil's federal VAT (IPI) applies to industrial

goods; the state VAT (ICMS) taxes the circulation of goods in general and some services (i.e., interstate and inter-municipal transportation and communication services); and municipalities levy charges (ISS) on a specified list of services. It is noteworthy that the IPI is fully creditable against the ICMS.

3. Although the States of Brazil obtain nearly 85 percent of their own-source revenues from the ICMS, there are a number of complex, technical, and administrative problems concerning the application of different VATs in different states. In addition, the tax bases of these three taxes overlap, leading to confusion and inefficiency. A detailed description of Brazil's VAT system is provided in the Annexure to this report for the interested reader.

4. Generally speaking, the ICMS is a poorly conceived and inefficient tax. The major problems with this tax include the following: (i) complexity of each of the 27 states having its own VAT law, resulting in more than 40 rates and different rules for assessing tax credits; (ii) evasion associated with the complexity and treatment of interstate trade; and (iii) fiscal wars, with states offering tax exemptions and refunds. Current proposals to reform the ICMS are currently under consideration. Among the proposals being considered is a national VAT (Goncalves, 2004).

5. In Canada, there is a federal VAT that is imposed throughout the country. In contrast to Brazil, the provinces of Canada levy a variety of consumption taxes. Quebec levies a VAT and administers both the federal VAT and the provincial VAT. In three other provinces, the federal government administers a joint federal-provincial VAT, which is levied at a uniform rate. Alberta does not have a broadbased consumption tax, and the remaining five provinces apply some form of final retail sales tax (RST). As in Brazil, Canada's VAT is fully creditable. A detailed description of Canada's consumption tax system is provided in the Appendix to this report for the interested reader.

6. Although the Canadian system is complicated, lacks clarity, and violates some efficiency and administrative criteria of a good VAT; it works. Canada is an example of a federal country where greater harmonization of VAT between the Centre and states has been achieved (Bird and Gendron, 2000).

7. For illustrative purposes, the EU can be regarded as a federation running state-level VATs by the member countries. Coverage of the VAT includes both goods and services. Broad guidelines have been established (i.e., common set of rules, exemptions, and definitions), and there is a main floor rate of 15 percent. Despite the efforts to harmonize rates, actual rates vary among member countries from 15 to 25 percent. The EU requires that any country wishing to be part of the Union adopt a VAT and must refrain from levying any effective tax on intra-community transactions. Thus, sales between member states are zero-rated. Although this arrangement was intended as a transitional arrangement, agreement on alternative regimes for tackling interstate trade still continues (World Bank, 2004; Howes et al, 2003; and GoI, 2005).

8. In Australia, there is a federal VAT levied throughout the country, which is distributed to the states through an equalization grant. This arrangement greatly simplifies or eliminates many of the complexities surrounding the design and administration of subnational VATs, such as harmonization of tax

Table 2.1: Comparison of Sales Tax Regines

	Canada GST-QST	Canada HST	Brazil	Argentina	India
Good Federal VAT	Yes	Yes	No	Yes	No
Federal VAT Revenue to States	No	No	Yes by revenue-sharing formula	Yes (part of general revenue-sharing)	Yes (CST)
State Taxes on Destination Basis	Yes	Yes	No	No	No
State Rate Setting Autonomy	Yes	No	Yes (except for interstate trade)	Yes	Yes
Good Administration	Yes	Yes	No	No	No
Good Cooperation between Central and State Governments	Yes	Yes	No	No	No

Source: Bird and Gendron (2000)

rates, the need for border adjustments on interstate trade, and administration of tax credits for input tax paid and zero-rating of international exports.

9. As part of Australia's tax reform of 2000, the federal government introduced a goods and services tax (GST) or a VAT. The proceeds from the GST are used to fund a Centre-state equalization grant pool. In return for giving the states access to a more buoyant source of transfers, the Commonwealth abolished financial assistance grants and revenue replacement payments to the states and reduced federal income tax rates. For their part, the states agreed to give up a range of state taxes and to reduce tax rates on gambling. This political bargain has proven to be very popular with the states and the public.

10. As a transition measure, the Commonwealth was required to provide 'budget balancing assistance' for a number of years to ensure that no state was financially worse off under the GST-related changes. Due to the moral hazard of allowing the Commonwealth to collect a tax from which they receive no revenue, the VAT arrangements are subject to overview by a federal-state ministerial council. The council ensures proper administration of the VAT by the Commonwealth, and the council must unanimously approve any rate changes.

11. The experiences of Australia and other federal countries, such as Argentina, Germany, Mexico, Russia, and Spain, show that international best practice is a national VAT administered by the central government and shared, if so desired, with regional governments on a formula basis (e.g., population or estimates of consumption shares). This arrangement avoids various complexities common to subnational VAT designs, such as tax rate harmonization, unifying the taxation of domestic trade, reducing administrative and compliance costs, and tax enforcement.

Lessons for India

1. India's subnational VAT is likely to be a more efficient and buoyant source of revenue than the system of state sales taxes. It is likely to be less costly to administer and enforce, as well. Taken together, these advantages recommend India's subnational VAT relative to the system of state sales taxes and the surcharges, entry tax, turnover tax, and the like that have cropped up over the years.

2. To prevent tax competition and reduce administrative and compliance costs with a VAT requires tax rate harmonization. This means that the States of India should coordinate on tax rate setting.

3. Canada's experience and, indeed, India's more limited but nonetheless successful experience in the State of Haryana demonstrate that a dual VAT can accommodate states that do not even levy VAT as well as some differences in VAT bases with respect to both zero-rating final services and crediting input tax paid. In other words, these experiences show that tax rate and tax base harmony are not required to operate a buoyant VAT.

4. Regarding transition relief, Australia and Canada's experiences show the importance of providing compensatory budgetary assistance to states (provinces) that experience revenue losses during the transition period of a major structural reform of the tax system. Such assistance helps allay the concerns of policy-makers regarding the uncertainty about projected revenues under the regime. It also helps states get through the difficult period of learning to administer a new tax. Finally, such assistance insures that states will not have to cut back on essential services due to unexpected revenue short falls or experience a further deterioration in their fiscal condition.

5. All case studies of subnational VATs present lessons on interstate trade, but none of the arrangements in place are regarded as fully satisfactory. Brazil's system is open to manipulation, and it benefits the better-off states. The Quebec and EU zero-rating systems have the advantage of preserving a common market, but they break the VAT chain and give incentives to evade by making intrastate sales appear to be interstate sales, which are zero rated in these systems. Although various suggestions have been offered to solve these problems (i.e. clearing house proposal, CVAT, VIVAT, prepaid destination VAT), these mechanisms have their own drawbacks.

6. The experience with the dual VAT in Brazil suggests that the cure can be worse than the disease. The EU experience suggests that agreements on floor rates are more stable than agreements to harmonize rates.

7. India's subnational VAT certainly has advantages over the current state sales tax system. International experience would suggest that the sooner India moves to the Kelkar Proposal the better.

ISSUE 2: ENHANCE OWN-SOURCE TAX REVENUE OF THE STATES

A distinctive feature of India's intergovernmental fiscal system is the adherence to the constitutional principle of separation of tax bases in the assignment of revenues. Some federal countries allow at least some concurrent taxes. For example, many countries allow subnational governments, regional and local, to levy taxes on income. International practice shows that the arrangement of concurrent tax bases has more advantages than disadvantages, in contrast to the exclusivity principle. We turn now to international experience with piggyback income taxes as a prime example of how to enhance tax autonomy at the state level.

International Experience

1. Several levels of government often levy tax on exactly the same tax base. Multiple use of the same base, if properly coordinated, is found to simplify administration and reduce compliance costs. Canada, the US, and many

European countries have concurrent powers to levy income taxes at the federal, provincial/ state, and local levels.

2. In Australia, the federal government has retained the exclusive power to tax income. Although this arrangement has ensured that the tax system has a high degree of uniformity in tax rates and tax bases, there is a high rate of transfer dependency in Australia. In Australia, however, this high transfer dependency has not led to fiscal profligacy, in part, perhaps because there is a remarkable consensus on the need to maintain fiscal discipline at all levels of government. Further, the States of Australia face hard budget constraints.

3. In Canada, tax collection agreements between the federal and provincial governments provide for joint use of the same income tax base. The provinces, with the exception of Quebec and Ontario, set their own personal and corporate income tax rates as a proportion of the rate charged by the Centre. The taxes are collected by the central government and then remitted directly to the provinces in a piggyback approach. In most Canadian provinces, a local surcharge is levied at a flat, locally-established rate as a percentage of the national tax liability rather than the national tax base, and collected by the central government. This arrangement is known as "tax supplementation." Similarly, in Switzerland, most cantons allow local governments to levy surcharges at locally-established rates on the cantonal income taxes.

4. In the US, many states piggyback on the federal income tax, but the piggybacking does not extend to central collection, only to reliance by states, if they wish, on federal tax definitions, structures, and reported amounts. Most states levy income taxes separate from, but coordinated with, the federal income tax. There are two major coordination mechanisms in the US These mechanisms are complementary not mutually exclusive. First, states may choose to cooperate on tax administration with the higher level government through a regular exchange of information. Work by one level of government can generate revenue for another level at little or no additional cost. For example, at the federal level, the Internal Revenue Service may inform a state of an audit finding regarding an individual residing in that state. Second, states may choose to coordinate their tax base with the higher level government. For example, several US states levy their state individual income tax on a taxpayer's amount of federal adjusted gross income, so that the state income tax form simply begins with a number extracted from the federal income tax form. Coordinating tax bases reduces administration and compliance costs and fosters greater coordination on tax enforcement between levels of government.

5. Other examples of countries with piggyback income taxes include Belgium, Denmark, Norway, Spain, and Sweden (CoA, 2001; Timofeev, 2002). Piggybacking arrangements provide subnational governments with considerable revenue autonomy because they can set the tax rate, administer the tax, and even limit the ability to define the base. Piggybacking arrangements allow the states and the Centre to exchange information which can increase the effectiveness of enforcement activities. A drawback of piggybacking arrangements is that there are fiscal externalities across different levels of government; a simple form of fiscal externality is that state revenues may change whenever

Table 2.2: Subnational Government Personal Income Taxes

Country	Tax Base	Subnational Government's Tax Rate Schedule		Tax base between localities	Assessment and Collection
		Single Rate*	Separate progressive rate schedule		
Canada (excluding Quebec)	Central gov't income tax paid before allowance	38.5 - 59.0 (Av = 47)	–	Residence	Central Govt.
Japan	Centre's tax base and separate tax relief structure	–	4 to 18 + fixed amount	Residence	Local Govt.
Spain (excluding Extremadura, Castilla-La Macha, and Andalucia)	Centre's tax base and separate tax relief structure	Not available	–	Not available	Central Govt.
Sweden	Centre's tax base and separate tax relief structure	26.4 - 33.2 (Av = 30)	–	Residence	Central Govt.
Switzerland	Separate base in each canton	–	5 to 34	Residence	Canton
United States	Separate tax base in most states	–	2 to 14	Residence	States

Source: Timofeev (2002).
Notes: * Minimum and maximum rates levied among subnational governments. Although a given subnational government uses a single rate, subnational governments are free to levy different rates. That different rates are applied by different subnational governments in a given country illustrates the advantage of greater revenue autonomy that can be achieved with a piggyback income tax.

the federal government changes the income tax base.

Lessons for India

1. Several levels of government often levy tax on exactly the same tax base, such as the personal income tax. Providing rate setting authority on a broadbased tax is an efficient way to provide subnational governments with a buoyant source of revenue and adequate revenue autonomy.
2. Multiple use of the same base, if properly coordinated, is found to simplify administration and reduce compliance costs. Coordinating tax bases reduces administration and compliance costs and fosters greater coordination of tax enforcement among levels of government.
3. A drawback to sharing tax bases across different levels of government is the existence of fiscal externalities. For example, some piggybacking arrangements changes subnational revenues whenever the federal tax base is changed.

ISSUE 3: THE ASSIGNMENT OF THE PROPERTY TAX

For reasons that are not well understood, Asian countries tend to collect less revenue from property taxes as a share of GDP than countries in other regions of the world, particularly European and North American countries. In India, the low revenue yield of the property tax appears to be largely due to problems with tax administration.

The property tax is a difficult tax to administer and often meets with considerable resistance from taxpayers. To the extent that states have retained administration of the property tax, India is out of step with current international best practice. Reassigning the property tax to local bodies has several advantages, which are discussed below.

International Experience

1. In Australia, Canada, Brazil, Germany, Russia, and the US the property tax is assigned to local governments. There are several reasons for assigning taxes on land and buildings to the local level. First, if local governments are going to play a meaningful role and adjust expenditures to local preferences, then they need a reliable source of own-tax revenue. Given the mobility of capital, employment, and consumption, local governments have very few viable options. Since land is immobile, though the improvements clearly are not, the value of unimproved land is generally believed to be a good revenue source for local governments. Second, it is believed that there may be advantages to local administration of the property tax because local officials have better knowledge of local conditions and the ownership of properties. Therefore, assignment of property taxes to local government is likely to lower the costs of administration.
2. Since the administration of property taxes is difficult, the assessment and billing of the tax may be charged to a regional or even central tax administration until local capacity is developed. This is the approach currently taken in Russia. But local governments can retain the right to change the tax rates even if the administration and collections are performed by a different level of government.

Lessons for India

1. Property taxes are the most obvious candidate for providing local governments with their own significant source of revenues. Besides being stable sources of revenue, generally nonexportable, and nondistortionary, property taxes provide a significant Wicksellian link between services received and taxes paid. The accountability of local elected officials to their constituencies also tends to be enhanced through property taxation. If local governments provide services that are valued by residents of the jurisdiction, then property values should increase, which in turn increases the tax base. Thus, the property tax creates an incentive for local government officials to behave in a manner that is consistent with the interests of the residents.

ISSUE 4: DISUSE OF OTHER TAXES

The States of India have access to a number of other taxes, including electricity tax, entertainment and hotel tax, luxury tax, professional tax, and transportation taxes. In many cases, the states do not fully utilize the taxes at their disposal. In part, this may be symptomatic of a soft budget constraint, which is discussed in greater detail below. Another contributing factor may be inappropriate tax assignments. We review other taxes, in addition to the three discussed above (consumption, income, and property taxes), that are commonly assigned to state and local governments, according to international best practice.

International Experience

1. In most countries, special excise taxes are levied on all manner of transportation fuels, beverage alcohol, tobacco products, vehicle

registration, and automobile tires. In Australia, these special excises are levied by both the Commonwealth and the states. In Brazil, there are no special excise taxes on these products, except for a tax on vehicle property which is levied at the state level. In Germany, there are special excises levied on tobacco, coffee, tea, salt, petroleum products, and beverage alcohol, excepting beer, by the federal government. The States of Germany levy special excises on motor vehicles, gambling establishments, and beer; local governments levy taxes on beverage alcohol. In Canada, the federal and provincial governments levy taxes concurrently on all manner of transportation fuels, beverage alcohol, and tobacco products. The provincial governments levy a tax for motor vehicle registration. In the U.S., the federal and state governments levy taxes concurrently on all manner of transportation fuels, beverage alcohol, and tobacco products. In addition, the states and local governments levy vehicle registration fees.

2. Special excises are a reliable source of revenue because the demand for these commodities is typically relatively inelastic. In developing countries, high income people may spend a greater share of their income on these luxury items, and therefore these taxes may increase the progressivity of the tax system. These taxes can be used to discourage the consumption of harmful commodities (i.e., tobacco products and alcoholic beverage), and polluting commodities like transportation fuels. Often the revenues from transportation fuels, tires, and the like are earmarked for building and repairing transportation infrastructure (e.g., airports, railroads, highways, and urban transportation). Similarly, taxes on tobacco products and beverage alcohol can offset the added burdens that heavy consumers of these commodities often place on the health system.

3. In the U.S., entertainment and hotel taxes, electricity taxes, and transportation taxes are assigned to local governments. In the case of entertainment, hotel taxes, and rental car taxes, these are viewed as a means to get tourists to help pay for the costs that they impose on local governments. Similarly, electricity and transportation taxes may be levied by states and/or local governments. Tolls, bus fares, and levies on the transportation of goods are often used to finance transportation infrastructure in Australia, Canada, and the U.S.

Lessons for India

1. In addition to being a source of significant revenue, special excise taxes or sales tax on beverage alcohol, transportation fuels, tobacco products, and vehicles can play an important regulatory function. Special excise taxes can be used as quasi-user fees, especially in the case of transportation fuels. They can also be used to compensate the government for the added health care costs that consumers of beverage alcohol and tobacco put on the public sector. This practice is already being used by the GoI and some of the states.

Intergovernmental Transfer System

Generally speaking, intergovernmental fiscal transfers are used to correct for vertical and horizontal imbalances, interjurisdictional spillovers, and promote national objectives. Most federal countries, the U.S. appears to be the lone exception, use equalization grants to address horizontal fiscal disparities among jurisdictions. All countries, the U.S. included, use special purpose grants of one type or another to promote national priorities and address interjurisdictional spillovers. Equalization grants and special purpose transfers also help reduce vertical imbalances or the mismatch between expenditure responsibilities and own sources of revenues for subnational governments. Often different forms of revenue sharing, in themselves a type of transfer, are used to address vertical imbalances. However, the only fail proof way to address vertical imbalances is to provide subnational governments with an adequate level of revenue autonomy. In summary, a system of transfers is needed for many good reasons, but it can easily be misused, and transfers are not a substitute for a healthy degree of tax autonomy. We proceed with a discussion of international experience with transfer dependency; then we discuss international experience with equalization grants, special purpose grants, and capital grants.

ISSUE 1: HIGH TRANSFER DEPENDENCY

The size of a country's vertical imbalance is largely a function of expenditure and revenue assignments. Generally speaking, central governments retain control over the most productive tax bases because they have an inherent advantage in administering broad based taxes on income and consumption. Consequently, it is common for there to be an imbalance between the expenditure responsibilities of subnational governments and their revenue assignments. India is not unusual in this regard, however, high transfer dependency may be contributing to fiscal profligacy among the States of India.

International experience

1. There is no best way to measure the vertical gap. One approximation is to compute the percent of total expenditures of subnational governments that are *not* financed with own revenues: taxes and others sources of revenue over which subnational governments have discretion. An important caveat with this approach is that the revenue statistics reflect actual receipts, and not the potential yield of the assigned revenue autonomy to local governments. At any rate, this measure indicates that countries like Canada and the U.S. have relatively small vertical gaps; countries like Australia, India, and Russia have larger ones.
2. The smaller vertical gap in Canada, for example, can be attributed to the fact that the Provinces of Canada have access to all the major broadbased taxes: there are no constitutional rules on exclusive use of certain bases by different levels of government. The provinces are also able to set their own rates. Currently, provinces raise most of their funds from own-source revenues, and overall federal transfers account for only 13 percent of total revenues of the provinces. However, transfer dependency varies greatly among the provinces, from 10-12 percent in the high-income provinces to nearly 40 percent in the low-income provinces.
3. There is no consensus on the optimal vertical gap. On the one hand, economic intuition suggests that allocative decisions are likely to be more efficient if subnational governments internalize the full costs of providing services. The result of a greater reliance on own revenues, at least at the margin, is greater accountability to local residents, improved creditworthiness, and so on. The surest way to make subnational governments internalize costs is to give subnational governments as much revenue autonomy as feasible and make them responsible for raising the necessary revenue to fund services, especially at the margin. Also the surest way to reduce vertical gaps is to assign subnational governments

with adequate revenue autonomy. Brazil, Canada, and the U.S. provide subnational governments with considerable revenue autonomy. In Brazil, increasing revenue autonomy and decreasing transfer dependency is seen as an important means of fostering greater fiscal discipline among subnational governments. However, tax autonomy is not a sufficient condition for reducing the vertical gap. Subnational governments have to feel the need to use the provided revenue autonomy. For this to happen, subnational governments need to operate under a hard budget constraint. For example, the conventional vertical fiscal gap is quite pronounced in Spain despite the fact that subnational governments have been provided with substantial revenue autonomy. The problem in Spain is that subnational governments have been able to convince the central government to increase their revenue sharing any time they have needed more revenues; i.e., they have been operating under a soft budget constraint. Elected officials, of course, find it much more attractive to receive transfers than to tax their own constituencies.

Lessons for India

1. There is no consensus on the optimal vertical gap. On the one hand, economic experience suggests that allocative decisions are likely to be more efficient if subnational governments internalize the full costs of providing services. The surest way to make subnational governments internalize costs is to give subnational governments as much revenue autonomy as feasible and make them responsible for raising the necessary revenue to fund services, especially at the margin.

2. Tax autonomy is not a sufficient condition for reducing vertical imbalances. Subnational governments have to feel the need to use the assigned revenue autonomy. For this to happen, subnational governments need to operate under a hard budget constraint.

ISSUE 2: LACK OF ADEQUATE EQUALIZATION

Requiring subnational governments to rely too heavily on own revenues to close vertical imbalances may give rise to economically and/or politically unacceptable differences in the quality and quantity of critical social and economic services among jurisdictions. However, a well-designed equalization grant is often used in many countries to reduce horizontal fiscal disparities among subnational governments arising from differences in expenditure needs and fiscal capacity. However, in practice countries differ in how, and if, they use measures of expenditure needs and/or fiscal capacity in their equalization formulae (See Tables II.3 and II.4).

International Experience

1. Australia, Germany, and Russia have chosen to use equalization grants to close vertical imbalances and reduce horizontal fiscal disparities among subnational governments. Germany, in particular, achieves considerable uniformity of service levels among the states, but German States have exhibited signs of fiscal profligacy. In fact, Germany recently had to bailout two states that were in fiscal distress. The initial signs of fiscal indiscipline are attributed to design flaws in Germany's intergovernmental fiscal system, specifically the combination of high transfer dependency, high expenditure autonomy, low revenue autonomy, extremely high levels of equalization, and finally high borrowing autonomy of subnational governments. Like Germany, Australia also achieves a considerable degree of uniformity in

Table 2.3: Equalization Goals and Allocation Factors

Goals	Factors	Country Examples
Enable Similar Levels of Service Affordability	*Expenditure needs indicators: Population*, school-aged children, elderly, illiteracy, poverty, infant mortality, and land area or National expenditure standards	India Italy Spain
Enable Similar Levels of Fiscal Resource Availability	*Fiscal capacity indicators: Gross* Regional Product per capita or Representative revenue system	Canada
Enable Similar Levels of Service at Similar Levels of Taxation	Fiscal gap or Some other combination of need and capacity	Australia, China Germany, Japan, Korea, Latvia, Russia, and the United Kingdom
Distribution on an Equal per capita Basis	Population	Some transfers in Canada, Ecuador, England, Estonia, Germany, and Hungary.
Filling the Budget Gap	Transfer is the difference between budget expenditures as determined by norms and the sum of own and shared revenues	Some countries of the former Soviet Union and Eastern Europe

Source: Boex and Martinez-Vazquez (2004).

Table 2.4: Summary of Equalization Arrangements in Six Federal Countries

Australia	Since 2000, a stand-alone federal equalization transfer is based on application of relativities of expenditure needs (18 categories) and revenue capacity (41 categories). The size and source of the fund is based on revenues from the centrally administered Goods and Services Tax (GST). The Commonwealth Grants Commission is charged with designing the grant formula. There is a body of state representatives that monitors the efficiency and efficacy of GCT administration
Brazil	Distribution of state participation fund (state share of three major federal taxes) is based a participation coefficient for each state. The formula for calculating the participation coefficient is based on primarily on redistributive criteria. As a result, 85 percent of the fund goes to the low-income regions in the North, Northeast, and West
Canada	A stand-alone federal equalization transfer is based on assessing provincial revenue capacity in terms of 33 provincial tax and nontax revenue sources against a middle range five-province standard. This transfer is unconditional and represents approximately 42 percent of all transfers
Germany	The equalization transfer is primarily based on interstate transfers (62 percent). High-income Länder contribute and low-income Länder draw according to a formula; plus federal transfers (38 percent) of 1.5 percent of VAT receipts; and the distribution of the VAT on a per capita basis also has an equalizing effect
Russia	Equalization transfer is based on normalized potential revenues. Revenues are normalized according to three composite indices of expenditure need
United States	There is no generalized equalization scheme. Some equalization occurs from cumulative effect of provisions in specific federal grants-in-aid schemes as approved by Congress

Source: Watts (2004).

subnational service levels; but, unlike Germany, the States of Australia show no signs of fiscal profligacy. In fact, the States of Australia are in outstanding financial condition. One reason may be a better designed transfer system. Finally, Russia is making progress in fostering greater fiscal discipline at the subnational level. Australia and Russia show that transfer dependency and equalization need not give rise to fiscal profligacy, but the key may be a well designed transfer system.

2. In Australia, the gap between state own-revenue and spending is filled by Commonwealth grants in the form of general purpose payments and specific purpose payments (SPPs). The Commonwealth Grants Commission (CGC) allocates transfers to the States of Australia based on a calculation of revenue capacity and expenditure needs from comparisons of 18 revenue categories and 41 expenditure categories. Since 2000, the equalization fund has been financed by receipts from the central government's GST. The transfers from this fund are based on relativities or disabilities (differences in the costs of service provision, higher incidence of dependent populations, etc.), which are used to achieve greater horizontal equalization. To put things another way, the equalization transfers are meant to provide the states with the means to achieve greater uniformity of service levels, though there is no requirement that they actually provide a uniform level of service delivery. The Australians are very keen on making this distinction. More specifically, equalization transfers provide states with the means to provide uniform service levels, though there is no mandate that they do so. In contrast, Germany creates mechanisms to ensure that resource transfers have the intended result: more uniform service levels.

3. In Brazil, the equalization transfer represents a very large allocation of resources. These include the State and Municipal Participation Funds (FPE and FPM, respectively), which are funded from centrally collected income taxes and the national VAT (IPI), with 21.5 and 22.5 percent, respectively, going into these funds in aggregate. The distribution of state participation funds (state share of three major federal taxes) is based on a participation coefficient for each state. The formula for calculating the participation coefficient is based primarily on equalization or redistributive criteria. As a result, 85 percent of the fund goes to low-income jurisdictions in the North, Northeast, and West.

4. The primary goal of intergovernmental fiscal transfers in the Canadian system is to maintain minimum national standards in provincial-local public services, thus compensating for vertical and horizontal imbalances between provinces. Accordingly, unconditional block transfers are made to low-income provinces to provide a minimum national standard of public services. The major two are the Canada Health and Social Transfer (CHST) and Equalization Transfer. While the equalization program focuses on horizontal imbalances, the CHST is the primary means for closing the vertical fiscal gap. The Equalization Transfer is based exclusively on tax capacity: Canada does not take into account differences in expenditure needs in the equalization grant. As such, the equalization formula is based on the province's tax base relative to the national average, which provides an incentive to provinces to design policies that affect the tax base to attract more equalization transfers. The CHST is provided to fund health, post-secondary education, and social services according to provincial priorities. Equalization

transfers are under constitutional provision, and they are aimed at reducing the horizontal imbalances among provinces; thus, only the low-income provinces are eligible to receive them based on tax capacity.

5. In Germany, the fiscal equalization scheme is rather complex. We review Germany's transfer system in some detail in order to illustrate the potential perils of too much of a good thing. Fiscal equalization of tax receipts among the German States proceeds in three stages. At the first stage up to 25 percent of the value-added tax receipts of the states is redistributed in favor of the states which are endowed with relatively low-tax revenues on a per capita basis after the primary tax allocation. Equalization at the second stage is conditional on the states' revenue allocation after stage one, including half of its local government revenues. For each state, the resulting revenues per capita are compared to average revenues per capita. Revenues are redistributed from states whose revenues per capita or 'financial endowment' exceed average per capita revenue or 'financial need' to the states with revenue per capita below the average.[8] For contributing states, the surplus of financial endowment over financial needs is transferred to the receiving states at a progressive rate which increases up to 80 percent. At this stage the financially weaker states reach 95 percent of their 'financial needs.' At the third stage of the horizontal equalization system, the fiscal endowment of the financially weaker states is lifted up to at least 99.5 percent of their 'financial needs' by supplementary grants of the federal government. In addition, there are supplementary grants to compensate states for special burdens: new states due to unification, small states to compensate for higher administrative costs per capita, and western states to compensate for the fiscal burden of unification. Finally, two states receive special supplementary transfers as federal aid for their debt servicing obligations, which is discussed in greater detail below.

6. The fiscal equalization system in Germany produces rather strange incentives. First, states that run a sound fiscal policy leading to an increase in the tax base (tax rates are fixed by the federal government) lose a considerable share of any additional tax revenue due to the fraternal (also known as "Robin Hood") rule for funding equalization: contributions or negative transfers from states with excess fiscal capacity to states with weak fiscal capacity, as discussed above. In fact, the highest marginal rate is 80 percent. For individual states, an additional DM one million in income tax receipts – either personal or corporate – generates only between DM 80,000 and DM 290,000 in extra tax revenue, depending on the state. The remainder is allocated to the Centre due to revenue sharing, and the other states due to horizontal fiscal equalization transfers. Second, the fiscal equalization system yields a substantial redistribution of income in favor of the financially weaker states. For example, in 1996, the per capita tax revenues of the poorest states, including local governments, amounted to 80.1 percent of the average prior to redistribution. After redistribution and supplementary transfers, it exceeded the average by 8.7 percent. By design the horizontal fiscal equalization system should leave the ranking of the states by per capita

[8] The effective population is regarded as 35 percent higher for than actual population for the three city-states: Bremen, Hamburg, and Berlin.

revenues unchanged. After taking into account special transfers, however, Germany's transfer system changes the ranking of states in terms of per capita revenues.[9] For example, in 1996, the State of North Rhine-Westphalia had the highest revenue per capita prior to redistribution (DM 5,132), excluding the City-State of Hamburg, but fell to 8th place after redistribution (DM 4,753). The high marginal rate on additional revenue in financially strong states and substantial redistribution through fiscal equalization kills any incentive for a state to run a growth oriented economic policy. Low rates of tax auditing by the states, which administer the joint taxes, may also be attributable to the fact that although they bear the cost of administration, only a small fraction of additional tax revenues accrue to them, so that it hardly pays for the individual states to strengthen audits. Indeed, tax competition, driven by the political incentive to seek to increase employment, could take the form of differential enforcement of the tax code by individual states.

7. In the Russian Federation, the equalization transfer (Fund for the Financial Support for the Regions) is based on an index of expenditure needs which is used to normalize or adjust per capita potential revenues. Potential revenues are estimated using a modified representative revenue system. The formula assigns equalizing transfers to regions for which the normalized per capita potential revenue falls below some threshold. Starting in 2005, the index of expenditure needs is calculated as the weighted sum of three sub-indices for relative differences in wages, housing, utility costs, and the price level. Each of the three sub-indices is calculated as an additive and/or multiplicative aggregation of 3-4 different indicators. The current system does a decent job in preserving incentives for tax effort at the regional level and for discouraging inefficient expenditure policies, such as, hoarding unused infrastructure capacity, which had been a problem in Russia in past years. After the practical elimination of ad hoc nonbudgeted transfers to the regions (known as "mutual settlements"), Russia has considerably hardened the budget constraints of subnational governments, enhancing fiscally responsible behavior.

Lessons for India

1. An effective equalization grant system is a key element in the design and performance of a decentralized system. Providing subnational governments with revenue autonomy is only admissible if there is an equalization system that corrects for the differences in fiscal capacities across jurisdictions. Equalization formulae in general should attempt to equalize differences in fiscal capacity and also disparities in expenditure needs. The definition and quantification of expenditure needs and fiscal capacity must avoid the introduction of perverse incentives in the equalization formula, for example, to exercise low tax effort or conduct inefficient expenditure policies.

2. Equalization grant systems should in general pursue the single objective of achieving the desired level of equalization taking into account all other elements of the fiscal system (expenditure assignments, revenue assignments, and other transfers). Other

[9] Germany's Supreme Court recently ruled unconstitutional any transfer system that changes the rankings across the states in terms of resources per capita before and after the transfers.

objectives should be pursued with different tools for example, conditional grants.

ISSUE 3: CENTRALLY SPONSORED SCHEMES CURB STATE AUTONOMY

Centrally sponsored schemes (CSSs) are an important source of revenue for the States of India, and they are justified on the same bases as conditional grants are in other countries: addressing externalities, pursuing national objectives, and so on. It is generally recognized, however, that there are too many schemes in India. In other countries, the problems associated with the proliferation of conditional grants generally has led to calls for (or effective) simplification and consolidation into a much smaller number of block grants. In India, in contrast, the trend has been in the opposite direction with a continued growth in the number of schemes. These schemes provide a backdoor for the federal government to micromanage decisions that are ostensibly the responsibility of the states. Thus, CSSs burden the administrative capacity of the states and distort state decision-making and priorities. Furthermore, these schemes blur the lines of responsibility, particularly in the minds of voters.

International Experience

1. In Australia, the current system identifies over 120 separate specific purpose payments (SPPs), many of which contain sub-programs. Concerns are raised about the efficiency of maintaining a large number of small SPPs, and the involvement of the Commonwealth in determining priority areas where the states have exclusive responsibility under the constitution.
2. In Brazil, revenue is transferred to the states and municipalities by specific purpose transfers. There are five types, and three of them have no horizontal redistributive effects.[10] The first two revenue transfers represent the centrally collected taxes that the federal government gives back to the states as *devolution*, or for taxes that could have been collected as *compensation*. In these transfers, states are mainly compensated for the exemption of VAT from exports (states receive 75 percent and municipalities 25 percent). The third type is an intrastate redistribution of resources with criteria different than revenue collection capacity; thus they are horizontally neutral. Part of this transfer is the Education Fund (FUNDEF), which is ICMS revenue sent to the federal government and transferred to municipalities to invest in basic education and teachers training. The last type of transfer is a federal grant to states and municipalities for specific purposes. These discretionary transfers are not regulated by law and have generally been negotiated between governments. Thus, they are often provided to the most politically powerful and the wealthiest states.
3. In Canada, there is the Health and Social Transfer (CHST) scheme, which may be likened to India's CSSs. The CHST is a conditional transfer, as they require that certain conditions be met. Any province is eligible to receive them, and they allow the federal government to influence expenditure responsibilities assigned to the provinces and outside the federal government's constitutional jurisdiction. There is ongoing debate on the future of the CHST. Provinces fund the bulk of

[10] Horizontal redistribution refers to the purpose of equalizing revenues of richer and poorer states.

services from their revenues, and particularly face rising health care costs. Yet, this is the area where the most stringent CHST standards apply, and the only one with a financial penalty mechanism applicable to the use of provincial user fees and the threat of withholding CHST for noncompliance.

4. In the U.S., there are a plethora of federal-state conditional grants, although their number has been greatly reduced in the last twenty years. These grants influence the level and composition of spending by the recipient governments, and they are the main mechanism by which federal and state governments influence actions of lower level governments. There are federal grants to states and cities for primary education, low income health care, housing assistance for the poor, and so. Empirical research has found that matching grants stimulate more spending than nonmatching grants, suggesting that intergovernmental transfers are important in determining the level and the mix of public provision of goods and services in the U.S.[11]

5. A large portion of federal grants are transferred to local governments through the states, in addition to state own grants to local governments. While there is no system in place to equalize fiscal capacity across states, horizontal fiscal equalization occurs only indirectly and partially via grant-in-aid programs. Conditional grants can be block grants for health, social services, and other areas, while categorical grants require states to apply them to particular narrower areas of expenditure. These categorical grants act as federal mandates on the states receiving the federal assistance.

6. The federal government uses these specific purpose grants, although containing equalization factors in their formulas, to ensure minimum standards of service provision. The criteria of distribution include measures of need of the community, capacity of providing services, cost of providing services, and tax effort. The formulaes can be very simple or very complicated, but they are generally related to population and per capita income. Formula grants include matching and nonmatching grants. Medicaid is the largest matching program, and its distribution varies across states. Although the federal government has made efforts to decrease the number of grant programs in the past, there are still over 500 matching grants. Most of these grants are for education, social services, health, transportation, pollution abatement, and regional development.

Lessons for India

1. The international trend is to streamline the number of special grants into a small number of special purpose grants. In this manner the Centre does not over burden the administrative capacity of subnational governments or implicitly assume responsibility for the competencies of subnational governments.

2. A smaller number of block grants also allow the Centre to establish a clear set of national priorities, more easily monitor the disposition of the funds, and gauge state progress in achieving goals.

3. There is a growing practice of channelling funds outside the vertical structures of the

[11] See Craig and Inman (1982, 1986) and Stotsky (1991).

states and local bodies directly to parastatals and nongovernmental organizations. This practice weakens representative institutions and should be avoided.

ISSUE 4: PLANNING COMMISSION'S TRANSFERS AGGRAVATE FISCAL PROBLEMS

The Planning Commission in India is charged with the responsibility of enhancing productive public investments in the country. Increased public investments can contribute to the growth of the country's economy, the growth in productivity of existing investments, or both. However, the Planning Commission, under pressure from the Centre and State Governments, promotes increasing public investments even though they may be fiscally unsustainable. As a result, the Planning Commission pitches for higher "Gross Budgetary Support" for plan, irrespective of the level of national or state indebtedness. The inability of the states to rein in revenue expenditure and an increasingly higher proportion of revenue expenditure component of their plans has contributed to the states running very high and persistent revenue deficits. This is aggravated by the selection of plan schemes for states by the Planning Commission. Increasingly, most of the schemes financed from the central assistance recommended by the Planning Commission are revenue expenditure schemes. A stage has come where most of the borrowings undertaken by the states for plan are going for funding the nonplan or revenue component of the plan schemes.

The central assistance released through the Planning Commission is also in loan and grant form. The Gadgil formula 70-30 (10-90 in the case of special category states) loan-grant transfers create incentives for the states to assume debt in order to get the grant even though they otherwise may not have borrowed the funds because of their very high debt levels and for other reasons. The Planning Commission's development projects create budgetary obligations on the states (debt service, maintenance and operation costs, and personnel costs) that are many times now shifted to the nonplan side as the states in their misconceived interest continue to treat these as plan expenditure, which prevents the Finance Commission from taking these into account when they make their recommendations.

The present process tends to generate low rates of return on investments because there is a bias in favor of taking up new projects while projects that are underway are not fully funded and allowed to languish and remain unfinished for long periods of time. The longer periods for completion lower the rate of return on projects. Besides, the states are under funding maintenance and the current process does not provide any incentives to prevent this, which results in the faster deterioration in public infrastructure, and further lowering the rate of return. Finally, the existing procedures allow the states to divert Planning Commission loans to finance revenue deficits, which in part explains the decline in the share of GSDP that is going to capital investment activities.

International Experience

1. Capital transfers should address externalities across local governments, assist with financing constraints for lumpy capital, ameliorate significantly different infrastructure endowments when these are not the result of voluntary decisions, and pursue sectoral objectives. Two major policy biases need to be openly addressed. First, the belief by some central authorities that capital expenditures

are always more efficient than recurrent expenditures and second, the lack of maintenance of existing infrastructure. Conditional matching grant arrangements can help subnational governments to take ownership and more properly maintain infrastructure.

2. Capital grants vary by the degree of flexibility in the use of the funds. They can either be specific project-based grants, which tend to be closely administered and monitored by line ministries, and categorical or block grants. Capital grants also vary by the way funds are allocated. The approaches include *ad hoc* decisions and negotiations, use of a pre-established formula, and competition processes with defined application procedures. There is no single best approach to the design of capital transfers, but nontransparent, highly detailed, and discretionary procedures should be avoided. Formulas based on needs and clients are often quite feasible. In Australia, for example, funding for school buildings based on the number of students is available.

3. Although a few countries use a loan and grant combination for the implementation of capital grants, the vast majority of countries just use a grant formula often accompanied by matching arrangements. Matching arrangements can raise some liquidity problems for low income subnational governments, but the matching rate can also be adjusted for fiscal capacity.

4. The institutional set up for the implementation of capital transfers varies across countries, but there has been a significant trend to remove the implementation of capital grants and capital budgeting from ministries of planning or economy and to integrate them with the rest of the budget process in ministries of finance. This has been an imperative result from the need to coordinate all aspects of budgeting. Despite that trend, countries often retain the vehicle of a PIP (Public Investment Programme) but integrated into a Medium Term Expenditure Framework (MTEF) or multiyear budget that covers the entire budget.

Lessons for India

1. Although many countries make a distinction between development and nondevelopment budgets, most of these countries have done away with this distinction. Very few countries classify their budgets into plan and nonplan as is the practice in India.

2. No federal country attaches a loan component to transfers.

Revenue Deficit and Debt

The States of India have been running persistent revenue deficits since the mid-1980s. This has led to unsustainable debt accumulation and a growing share of expenditures committed to debt service. Diverting Plan Commission loans to cover revenue deficits has also led to a decline in the share of state government resources available for investment in economic development and social infrastructure. We turn, now, to a brief discussion of soft budget constraints before turning to a discussion of international experience with a variety of strategies for hardening subnational budget constraints.

Issue 1: Soft Budget Constraint

Subnational governments may engage in unrestrained spending and undisciplined borrowing when policy-makers fail to internalize the true resource costs of government programs.

For example, financing subnational government through intergovernmental transfers and loans breaks the Wicksellian link between the costs and benefits of government services. Furthermore, subnational governments may believe that the central government will bail them out of a fiscal crisis. In which case, subnational governments have no incentive to restrain spending or control borrowing. Soft budget constraints, as this set of problems is often called, typically arise when the intergovernmental fiscal system is characterized by high transfer dependency, low subnational revenue autonomy, high subnational borrowing autonomy, and weak commitment to a no bailout policy by the central government.

Generally speaking, countries control subnational borrowing through a mix of rule-based controls, administrative controls, and market discipline. In developing countries, fiscal rules are increasingly used as a key policy instrument in fostering fiscal discipline. Such rules can be an effective policy instrument when they are well-designed and strictly enforced (Braun and Tommasi, 2002). Latin American countries, in particular, have recently implemented fiscal rules both at the national and subnational levels. Although their experience is not sufficiently long to draw certain conclusions, preliminary evidence from these countries suggest that fiscal rules may help overcome problems with coordinating fiscal policy at different levels of government and improving budget management and transparency (Webb, 2004). Now, we turn to an evaluation of strategies to harden subnational budget constraints.

International Experience

1. *Formal deficit and debt rules*: The main examples of deficit and debt rules come from the countries of the EU which are bound by the Maastricht Treaty and the subsequent Stability and Growth Pact (SGP).

   Balanced budget or deficit rules:

   - Balance between government revenue and expenditure (i.e., prohibition on government borrowing), or limit on government deficit as a proportion of GDP;
   - Balance between structural (or cyclically adjusted) revenue and expenditure, or limit on structural (or cyclically adjusted) deficit as a proportion of GDP; and
   - Balance between recurrent revenue and expenditures (i.e., borrowing permitted only to finance capital expenditure).

   Debt or reserve rules:

   - Limit on stock of gross (or net) government liabilities as a proportion of GDP; and
   - Target stock of reserves of extra budgetary contingency funds (e.g., social security funds) as a proportion of annual benefit payments.

2. Facing a deteriorating budget balance and growing debt payments, Argentina enacted a Fiscal Solvency Law in 1999. Besides aiming at achieving budget balance by 2003, the law limited the growth of expenditures, stipulated the adoption of multiyear budgeting, created a countercyclical fiscal fund, and implemented transparency measures regarding public finances. However, the deficit ceilings for the nonfinancial public sector were broken every year. The Fiscal Solvency Law was modified by the Budgetary Law in 2001, which relaxed the deficit ceilings and extended the achievement of budget balance until 2005. Given the strong constitutional rights of Argentina's provinces, the law did not include conditions for

subnational governments. However, it encouraged the provinces to enact fiscal responsibility laws themselves. The long history of the national government bailing out provincial governments in fiscal distress emphasizes the importance of provinces adopting fiscal responsibility laws. Nevertheless, 10 out of 24 provinces have not passed a fiscal responsibility law, including Buenos Aires and other large provinces representing over half of the nation's economy (Webb, 2004). In 2000, only 5 provinces that promised to achieve budget balance by that time actually fulfilled their commitment. Argentina has a long tradition of not respecting rules. In fact, 16 of 24 provinces have limits on public borrowing in their constitutions; yet only 10 of the 16 provinces complied with these limits in 2000. Many analysts believe that Argentina would not have solved their fiscal problems, even with stronger enforcement of the fiscal responsibility laws, given the weak institutional framework within which the states are operating. They contend that the few provinces that passed their own fiscal rules, the lack of compliance by those that passed them, and the inadequate institutional design contributed to the inability of fiscal rules to foster greater fiscal discipline among subnational governments (Braunn and Tommasi, 2002; Webb, 2004).

3. In *Australia*, the states do not have any rules that prohibit them from running deficits. However, there is a broad political consensus that states should maintain fiscal balance. Such gentlemen's agreements provide the necessary flexibility for the states to run deficits during hard times. In the U.S., in contrast, state governments must compress expenditures and/or raise taxes during economic recessions when arguably states should cut taxes and increase expenditures on social services. On the other hand, it is generally agreed among fiscal experts that macroeconomic stabilization should be exclusively assigned to the central government. In short, the issue of using fiscal policy for macroeconomic stabilization speaks to the need, especially in federal countries, for the various levels of government to coordinate on fiscal policy.

4. During the 1980s, Australia prohibited subnational governments from accessing capital markets and centralized all loans through the Australian Commonwealth's Loan Council. This system of direct control was not effective as states started to utilize semigovernment or local government authorities to effectively borrow on their behalf. In fact, some of the resulting loan funds appeared as revenues in the consolidated accounts of the states, which is similar to the situation with contingent liabilities among the States of India. This brought about an increase in off-program-borrowing activities at all levels of government.

5. The Loan Council was reconstituted in 1993, and operates largely under voluntarily agreed upon arrangements rather than legislated provisions of the earlier agreement. States are now able to operate with more flexibility by the issuance of securities in their own name, and the greater reliance upon the market has diminished the Council's role and influence. Under the agreement, the Commonwealth would not only cease borrowing on behalf of the states, but the states would make accelerated sinking fund contributions such that all federal debt outstanding to the states would be fully redeemed by 2005-06 (James, 1994). The Loan Council traditionally meets

annually in March to consider a jurisdiction's Loan Council allocation nominations for the forthcoming year. As part of these arrangements, the Loan Council considers these nominations, having regard to each jurisdiction's fiscal position and the macroeconomic implications of the aggregate figure. The Loan Council Allocation is a headline measure of a government's call on financial markets.

6. As part of the reform, jurisdictions are also required to improve the frequency and openness of their financial reporting, not only to permit monitoring of their financial activities but also to provide more reliable information to the financial markets. For example, the State of Victoria requires that the State Treasurer include a statement of risks in its annual and semiannual budget reviews presented to parliament and the public. This statement describes the factors that could have a significant impact on the fiscal outcome of the state.

7. Many states have greatly reduced their levels of general government net debt over the past decade. Aggregate, general state government net debt is forecast to be —1.7 percent of GDP by 2006-07. An increasing number of states are expected to be in a positive net financial asset position by 2006-07 (CoA, 2001).

8. In *Austria*, the SGP requires that all levels agree to internally allocate the Maastricht Treaty deficit limit. It also established proportional contribution of the federal and state governments to sanction payment in case of an excessive deficit. Local governments in a state would collectively share the responsibility for the deficit, which would be deducted from their share of federal revenues. The monitoring and enforcement system includes fines subject to unanimous decision of all interested parties.

9. Brazil is an interesting case, which we describe in some detail. Brazil enacted an FRL (2000) after a history of repeated fiscal crises and a long history of the federal government bailing out subnational governments. Brazil's fiscal responsibility law sets a general framework for budgetary planning, execution, and reporting for the three levels of government, all under one law. The law calls for sustaining the structural adjustment of public finances and constraining public indebtedness. It comprises three basic rules: (1) general targets and limits for selected fiscal indicators; (2) a corrective institutional mechanism in case of noncompliance; and (3) institutional sanctions for noncompliance. Thus, Brazil's fiscal responsibility law applies *ex ante* rules and legal penalties to enforce fiscal prudence upon politically powerful governors.

10. More specifically, Brazil's fiscal responsibility law includes the following provisions:

    - *Limits on spending*: Outlays on payroll (including social security benefits, pensions, and payments to subcontractors) cannot exceed 50 percent of net revenues of the federal government and 60 percent in the case of subnational governments. Separate subceilings apply to personnel outlays in the executive, legislature, and the judiciary; and

    - *Ceilings on borrowing*: The actual ratios are set by the Senate for each level of government in a separate piece of legislation. The current ceiling for expenditures on debt service is 13 percent of total state and municipal revenues. The net debt ceiling is 1.2 times net revenue for local governments, and two times net revenue for state governments. If local governments exceed this ceiling, they are obligated to repay the portion above the ceiling within one year. Authorization for subnational borrowing is required by the Senate, subject to prior technical approval by the Central Bank. Borrowing is banned in the 180-day period before the end of the incumbent's mandate. The ban applies to all subnational jurisdictions, including the Federal District.

11. Brazil's fiscal responsibility law also requires multiyear budgets with three-year targets for revenues, expenditures, and indebtedness. The law does not set these limits. Rather, they are set by the Senate. However, it governs the procedures for monitoring compliance and sanctioning of noncompliant jurisdictions. Civil society participation is required in the budget process at all levels of government. Additional provisions include ceilings for borrowing in relation to the total capital expenditures approved by the budget law. Additional ceilings are also required by the law, subject to complementary legislation on debt service and outstanding debt stock in relation to revenues. The annual budget of each subnational government has to be consistent with its multiyear budget plan and with the federal fiscal and monetary program. Finally, debt and labor contracts in violation of the fiscal responsibility law are not legally valid.

12. There are five types of sanctions available for enforcement of the fiscal responsibility law: mollifications, fines, impeachment, and prison terms. These are provided in an accompanying Fiscal Criminal Law. The law has sanctions both at the institutional and individual levels. A State that does not comply with the law may be subject to limits on new credit operations, discretionary transfers, and federal guarantees. These apply to jurisdictions that fail to comply with personnel ceilings, debt ceilings, and transparency requirements. Nullifications apply to contracts or administrative decisions that violate the fiscal responsibility law, such as exceeding debt ceilings established by the Senate. At the individual level, a government official may be subject to fines. For example, exceeding mandated ceilings on borrowing or personnel expenditures may result in a fine equal to 30 percent of the annual salary of the responsible official. Other violations may subject a governor or mayor to impeachment. He/she can also lose the right to hold a public sector position for five years, and even be arrested and fined. Such criminal sanctions apply to violations of debt ceilings. Any violation of these laws, especially in regards to the hiring and firing of personnel, can result in prison terms for periods ranging from three months to four years (Guardia and Sonder, 2004).

13. Despite all the important fiscal changes promoted in Brazil through the Fiscal Responsibility Law (FRL), arguably one of the most important is the prohibition against future bailouts of state and local governments by the Centre. This strategy has forced subnational governments into a fiscal consolidation program. According to the law, if debt repayment exceeds 13 percent of net revenue, state and local government finances must be balanced. After four years of implementation, the FRL seems to have contributed to fiscal adjustment in Brazil, as evidenced by declining debt and deficit ratios (Webb, 2004). By 2001, only 21 out of 27 states are out of compliance with their deficit ratios, and most of them have made major efforts to adjust their personnel expenditures, including

pensions. However, the pressure on the states to compress expenditures is having a negative impact on infrastructure and social investments in some states because of the high committed expenditures on personnel expenditures. Despite these weaknesses, Brazil's FRL is expected to increase fiscal prudence among the states and municipalities.

14. Countries that have adopted the euro have to commit themselves to prudent fiscal policy. The Maastricht Treaty specifies that countries must keep general government deficits within 3 percent of GDP, except for exceptional and temporary reasons, and gross general government debt must be below 60 percent of GDP. Countries joining the European Monetary Union with debt above the threshold must first make substantial progress in reducing their debt. Countries that violate the Maastricht Treaty ceilings may be subject to pecuniary sanctions. Successive council regulations and resolutions have further strengthened the treaty by committing members to a fiscal position "close to balance or in surplus" in the medium term and establishing monitoring procedures (SGP). As part of the monitoring mechanism, countries must present their fiscal policy plans each year for the subsequent four years to the Council of Ministers of the European Union (ECOFIN). The council issues an opinion on whether the plans are consistent with the SGP and with sound public finance. These programs contain only indicative targets and sometimes few specifics. For instance, they may not specify how the path of the balance breaks down between revenues and expenditures. In contrast with the Maastricht Treaty, there is no process to sanction deviations from the "close to balance or in surplus" target. Within the boundaries of both the Maastricht Treaty and the SGP, a country can set fiscal policy according to its own national framework. However, the SGP has been under attack during the last two years because some large countries (e.g., France and Germany) hope to get exceptions or to ease the rules.

15. In *Germany,* the Internal Stability Pact (ISP) reinforces the role of the Financial Planning Council. The ISP specifies that all levels of government are responsible for avoiding the excessive deficit procedures and proclaims the overall aim of deficit reduction to meet the close-to-balance target. However, there is a lack of sanctions for a government's noncompliance with the Financial Planning Council's recommendations.

16. In *Italy*, an ISP was introduced in 1999 requiring regional and local governments to reduce their deficits and debt. The three-year total adjustment was divided among the different levels of subnational governments — regions, provinces, and municipalities — in proportion to their respective levels of total expenditure. A previous ceiling of debt service payment not more than 25 percent of own revenues remained in place. Finally, it established that if Italy were sanctioned under the Maastricht Treaty, fines would be levied on entities failing to meet their targets.

17. *Mexico* is a case of a federal country that has managed to achieve a higher degree of subnational fiscal discipline without resorting to fiscal responsibility laws. The States of Mexico, as with subnational governments in Argentina, Australia, Canada, India and the U.S., have strong constitutionally based guarantees of independence from central government control. These constitutional guarantees prevent Mexico's central government from imposing top-down fiscal responsibility laws,

as was done in Brazil for example. Thus, Mexico uses financial sector regulations to achieve state-level fiscal discipline and has issued public decrees regarding federal-level fiscal procedures which are monitored through a politically autonomous congress (Webb, 2004).

18. Following the financial crisis of 1995 and several episodes of subnational bailouts, Mexico passed legislation to limit bailouts of subnational governments by the national government. In 2000, the administration established *ex ante* market-based mechanisms in order to prevent excessive subnational borrowing, while at the same time, conveying credible no bailout signals.

19. Mexico's financial regulatory framework as it applies to state borrowing has four key components: (i) elimination of discretionary transfers from the federal government, at least those at the discretion of the executive; (ii) elimination of the federal government's role in securing debt with payments from the revenue sharing arrangement, thus requiring the states and their creditors to assume the financial risks for collateralization of debt; (iii) subnational debt is subject to normal credit exposure ceilings limiting the extent of financial-sector damage that can occur when a single state cannot meet its debt service obligations, thus signalling that state debt must be evaluated on a similar basis as other debt; and (iv) a bank's capital-risk weighting of loans to subnational governments is linked to international ratings of creditworthiness, giving commercial and development banks *ex ante* signals about the financial risk borne by particular states.

20. To the extent that it is enforceable, Mexico's approach seems to provide *ex ante* and *ex post* controls. Although Mexico does not have a top-down fiscal responsibility law, state governments now have an incentive to make their balance sheets and budgets attractive to credit rating agencies, lenders, and voters. This is similar to the measures expected of an effective top-down fiscal responsibility law. Even so, such features as transparency and medium-term fiscal management of a fiscal responsibility law would benefit all levels of government in Mexico.

21. In *Spain*, the new Law on Budgetary Stability first implemented in 2003 requires that all levels of government formulate, approve, and execute a budget in balance or in surplus. It also strengthens reporting requirements, especially at the regional level.

22. In the *U.S.*, there are several different types of laws requiring balanced budgets among the various states. Some states require that the governor submit a balanced budget to the legislature; some states require the legislature to pass a balanced budget; and some states require a balanced budget at the end of the fiscal year. Those states that require *ex post* balance show greater fiscal discipline and faster fiscal adjustment than those that only impose some form of *ex ante* balance.

Lessons for India

1. Some countries impose fiscal discipline through the market; others impose fiscal discipline through fiscal rules; and others combine market discipline and fiscal rules. The advantage of market discipline is that self-interest compels jurisdictions to comply and lenders to enforce discipline. However, market discipline requires relatively sophisticated and well-regulated financial markets.

ISSUE 2: SUBNATIONAL GOVERNMENT DEBT BAILOUTS

International experience shows that bailouts are often used to resolve fiscal crises at the subnational level. In fact, bailouts have occurred in developed countries such as Australia, Germany, Italy, Spain, and Sweden as well as emerging countries such as Argentina, Brazil, and Mexico.

International Experience

1. In Argentina, provincial authorities behaved as if they anticipated the *ex post* assistance from national sources. Overrepresented provinces have benefited from irregular transfers, debt assumption by national government, and exporting of overspending via provincially owned-banks (Wibbels, 2003). In Brazil, states have relied on state-owned banks for deficit financing where the federal government has ultimately assumed the debt of failing banks. In Germany, two states in fiscal crisis received transfers to reduce their debt burdens. However, analysis shows that in the German case the states did not reduce their debt; they simply increased expenditures in response to the transfer of resources intended for debt relief. In Russia, the federal government rewards the regions with the most vociferous separatist claims with preferential fiscal agreements. Thus, examples of bailout in federations and the recent significant reforms in the past decade suggest that addressing soft budget constraints is indeed a challenge.
2. According to analysis, bailout expectations can arise from a variety of conditions such as lack of limits on borrowing, low revenue autonomy couped with high expenditure autonomy, unclear allocation of spending responsibilities, lack of rule-based grants, subnational governments that are too weak or too strong, undisciplined state political parties, and lack of central government commitment to a no bailout policy (Lago-Peñas, 2004). The above show that bailout cases are attributable to the lack of a well-designed intergovernmental system and the need for a rule-based approach to enforce political discipline and a credible no bailout law. Bailout expectations often create incentives for subnational governments to engage in profligate spending and borrowing in the belief that in the event of a fiscal crisis, the central government will bail them out.
3. One approach to bailout policy is to make the terms and conditions of a bailout so onerous that subnational governments will not pursue it, except in the most difficult of circumstances. During the fiscal crisis in New York City in the early 1980s, for example, an administrative board was appointed by the Governor of New York. This administrative board had broad powers to make tax and spending decisions on behalf of the state. In this manner, the State of New York, which guaranteed the debt of New York City (no bailout was given during this episode) was able to guarantee that the City took the necessary steps to put its fiscal house in order.

Lessons for India

1. Bailout expectations can arise from a variety of conditions, such as lack of limits on borrowing, lack of revenue autonomy coupled with high expenditure autonomy, unclear allocation of spending responsibilities, lack of rule-based grants, subnational governments that are too weak or too strong, undisciplined state political parties, and lack of central government commitment to a no bailout policy.
2. An approach to bailout policy is to make the

terms and conditions for a bailout so onerous that subnational governments will not pursue a bailout, except in the most difficult of circumstances. This provides an opportunity for the Centre to restructure state finances, through privatization of state-owned enterprises, eliminating subsides, and other measures that are politically unpopular at the state level.

Economic Reforms

In many Indian States, the economic and financial performance of many SOEs is poor, especially in the power and transportation sectors. These SOEs often incur losses, and even when profitable the rates of returns are usually very low. In addition, there is lack of commercial orientation, lack of competition, lack of autonomy and accountability, low cost recovery, and the quality of services is very poor. Although various state governments have initiated actions to establish regulatory commissions in the power sector, the progress achieved so far is not satisfactory.

ISSUE 1: POOR PERFORMANCE OF STATE-OWNED ENTERPRISES

Studies of SOEs in developing countries generally show similar issues as those of India. There is a wide array of international experiences regarding SOE reforms.

International Experience

1. Governments have taken many actions to address the problems of SOEs, including external environment reforms to provide the right incentives by promoting competition and commercialization; corporate governance; restructuring of organization and operations; some privatization without changing SOE ownership; and transferring of ownership through privatization (Kennedy and Jones, 2003).
2. Tariff policies based on the principle of full cost recovery are a way to lead towards commercialization and prepare the ground for privatization. Services provided by SOEs (e.g., power, water, and transportation) should be appropriately priced through user charges. In Argentina, for example, municipal governments are restricted to imposing fees for services as their most important source of revenue. In Australia, Canada, and the U.S., user charges and cost recovery are used to finance all locally-provided services to identifiable agents ranging from public utility charges to admission charges to recreational facilities (Bird, 2001).
3. International experience with corporatization of functions calls for establishing an appropriate governance structure, contracting out management, and providing autonomy to exercise their managerial skills. Certain functions and responsibilities have been transferred to generating companies, transmission companies, and distribution companies in the case of the power sector.
4. International experience shows that governments have moved control of state enterprises to the private sector. The global wave of privatization started in the United Kingdom in 1979 with the privatization of major state enterprises in gas, petroleum, power, telecommunications, transportation, and water. Other countries have emulated the British model of privatization including Argentina, Canada, Chile, France, Germany, Italy, New Zealand, and Spain. The U.K. offers a case study of power industry restructuring, privatization, and regulatory reform. It was one of the first countries to embark on

privatization of its power utilities, and a growing number of countries have privatized electricity or are currently undertaking such efforts (e.g., Australia, Argentina, and Brazil).

5. Privatization among countries has taken many forms, including the transfer of ownership of an SOE to private owners, public/private combination of ownership and management, and contracting out certain functions. Evaluations of privatization of SOEs in Chile, Malaysia, Mexico and the U.K. indicate that there are significant gains in efficiency.

Lessons for India

1. The States of India should evolve a reform program keeping in mind the specific characteristics and developmental needs of its power supply industry as well as the policies of the government. While such exercises are already underway. For example Andhra Pradesh, Haryana, and Orissa have already enacted legislation outlining a reform plan for their power sectors; other states should also design reform programs best suited to their requirements.
2. As international experience suggests, states should take steps to corporatize and commercialize generating companies, transmission companies, and distribution companies so that they are able to operate on commercial principles, generate the required fiscal resources, and ensure availability of reasonably priced power. Various segments of the power sector should be run by smaller, more manageable, and commercially oriented entities to prepare the way for privatization.
3. In view of the urgent need to reduce transmission and distribution losses, facilitate higher investments in system improvement, and ensure availability of reliable power to consumers, reforms in the distribution sector need to be initiated by establishing distribution companies in different regions of each state. The entry of private investors should be encouraged, wherever, feasible.
4. International experience shows that tariff rationalization is a key element of economic reform. Tariff rationalization should be based on full cost recovery, progressively reflecting the cost of supply, while safeguarding consumer interests and reducing cross-subsidization as well as encouraging competitive, efficient, and economical use of resources.

Local Governments

International experience shows that most countries around the world, (i.e., developed, developing, transition, federal, unitary) are involved in some type of decentralization to local governments, or at least are considering it. The fundamental reason is that these countries expect that decentralization leads to a closer match between services provided and the preferences and needs of service beneficiaries or greater allocative efficiency. Decentralization permits localized information to be used in the decision-making process, thus increasing efficiency and accountability of local decision-makers. The modalities for local government decentralization differ depending on the heterogeneity of the populations, differences in regional economic situations, differences in the sizes of large urban areas and small rural areas, and different administrative capacities.

Given the population size of many of India's States, the general lack of effective decentralization to local bodies is a serious shortcoming of the current system, affecting the quality and level of services and overall accountability in the system. However, the task ahead will not be an easy one. Two states, Karnataka and Kerala, have moved forward with decentralization to local governments, but their experiences suggest that there is still a long way to go before local bodies are self-functioning (World Bank, 2004).

ISSUE 1: LACK OF FULL DECENTRALIZATION AT THE LOCAL LEVEL

Although decentralization is no panacea, the experience of many countries shows that moving political, fiscal, and administrative decision-making closer to the people achieves efficiency gains, improves service delivery, and increases political accountability. However, there is no consensus on the degree of autonomy that should be devolved to local governments. The answer lies in finding the right balance between devolution of responsibilities according to economies of scale, the internalization of costs, and available administrative capacity. The available evidence also shows that the gains from decentralization can be significantly enhanced by decentralizing authority to the actual units in charge of delivering public services, such as schools and hospitals.[12]

International Experience

1. In most federal and unitary but decentralized countries, decentralization reaches local governments quite fully, with these entities having different degrees of revenue autonomy and exclusive responsibility for an array of functions and services. This status for local governments is the result of explicit legislation in unitary decentralized countries. In the case of mature federal systems, such as Australia, Canada, and the U.S., local governments are creations of the states or provinces, and local governments are not even mentioned in their constitutions. However, through traditions of self-governance and practice, local governments in these countries have achieved significant levels of autonomy and self-governance. It also is important to note that in these countries, although states define and govern the local level, federal governments still have direct programs for local governments. In the case of other federal countries, such as Brazil, Mexico, and Russia, state governments have been reluctant to decentralize to the local level, which in turn has led federal governments to intervene. In Brazil, for example, the political drive for decentralization led to the 1988 Constitution granting municipalities constitutional status as a third tier of government with equivalent status as the states. At present, therefore, states cannot compel or prohibit actions of municipalities within their jurisdictions. In Russia, several laws in the late 1990s, and very definitely the Budget Code of 2002, structured in the law many of the relationships between regional and local governments. While the Budget Code provides exclusive expenditure assignments to local governments, the Tax Code of 2002 also provides separate revenue assignments to local governments.

Lessons for India

1. The two approaches to achieving meaningful administrative and fiscal decentralization among federations are as follows: (i) a voluntary approach, letting the states do it; and (ii) legally forcing the states to do it or otherwise removing them from this task. India needs to reassess whether the voluntary

[12] See Burki et al (1999).

approach now present in the constitution is actually working. Otherwise, a mandatory approach may be required. Although some action has taken place in states such as Karnataka and Kerala, the pace toward meaningful decentralization to local governments has been slow.

ISSUE 2: ASYMMETRICAL FISCAL AND ADMINISTRATIVE DECENTRALIZATION

Many countries recognize the diversity of local governments and their variations in scale, tax bases, poverty levels, and administrative capacity. Accordingly, some countries have taken an asymmetric approach to local governments in terms of differentiating among them in assigning spending, taxing, and borrowing authority as well as reporting requirements. Asymmetric approaches to decentralization are relevant to India because the argument is often used that local governments lack the capacity, in the many different dimensions of this word, to take on more responsibility and autonomy for service delivery. In reality, however, capacity varies widely among local governments of India. International experience with asymmetric decentralization, namely those of Colombia, the Russian Federation, and Spain are reviewed next.

International Experience

1. International experience in Latin America demonstrates that when responsibilities are not explicitly differentiated according to effective fiscal/management capacities, *de facto* differentiation takes place, often in *ad hoc* chaotic ways (Giugale et al, 2000). When differentiating between local units according to capacity, it is important to categorize local units explicitly while concurrently establishing the standards to move from one category to another. Colombia has introduced a process of certification for municipalities which not only categorizes but also stimulates regional and local governments to qualify themselves to assume responsibilities in education and health. In order to be certified, departments (states) are required to demonstrate to the national government that it is capable of assuming the new responsibilities in health and education, through required capabilities in planning, financing, monitoring, and reporting capacity. After a department (state) is certified, its municipalities may apply to the department for certification.
2. The comprehensive review of Russia's fiscal federalism undertaken by the Kozak Commission in 2002-03 resulted in a set of legal changes which, among other things, introduced a rather comprehensive set of asymmetrical designs for subnational governments. In particular, separate packages of functions were assigned to each tier and type of local government (i.e., rural, urban).
3. In Spain, there are also large asymmetries on the expenditure side. There is a "large responsibility" group of five regions that are assigned many more responsibilities that the general "small responsibility" group of regions. Over the past two decades Spain has gradually increased the number of responsibilities to the rest of the regions with the goal that at some point all communities would develop the same capacities and take on the same responsibilities.

Lessons for India

1. Regarding symmetric and asymmetric approaches, the international experience is mixed. Both approaches are successfully used. India should take note of it for their circumstances.

ISSUE 3: EXPENDITURE RESPONSIBILITIES FOR LOCAL GOVERNMENTS

Setting appropriate expenditure assignments for each tier of government is a crucial component in any decentralization policy, since the design of the other important pieces of the system, notably revenue, transfers, and borrowing, depends on it. Both theory and international experience suggests that it is important to specify expenditure responsibilities as clearly as possible in order to enhance accountability and reduce unproductive overlap and duplication of authority. International best practice shows that empowering communities and even institutions in the delivery of services increases accountability. In the education sector, for example, there is evidence that community managed schools lower teacher absenteeism, as is the case of the EDUCO program in El Salvador and Nicaragua's SBM (Sawada, 2002; King and Ozler, 1998). Madhya Pradesh, where the para-teacher scheme has been more widely used, has one of the lowest teacher absence rates (Kremer et al, 2004). Whether the low absenteeism rate in Madhya Pradesh is attributable to the fact that para-teachers are employed and monitored locally is still to be evaluated. However, an evaluation of Community Based Primary Schooling Initiatives in Madhya Pradesh have already proven successful at providing the critical immediate inputs that contribute to universal primary schooling as well as an increase in enrolment and retention rates (Shrivastava,1998).

International Experience

1. Local governance in some federal countries is reinforced by institutions that facilitate the involvement of civil society in the delivery of public services. For example, in Canada, Local Boards are not-for-profit, community-based organizations comprised of volunteers from business, labor, education, and community groups which support local governments in a variety of ways. Similar institutions exist in the U.S.

2. Highly decentralized and successful federal countries such as Canada and the U.S. have taken years to reach their current responsibility distribution across different levels of government. For example, most local governments in the U.S. have been devolved functions in provision of education, health, and roads as well as exclusive local services such as drinking water, waste management, public transportation, police and fire services, parks, and the like. As previously discussed, other federations have long dealt with instability and controversy in the practice of decentralized systems especially due to unclear competencies and expenditure obligations of different levels of government. The principle lesson from these varied experiences being the importance of clearly delineating the exclusive competencies of each government tier and in the case of concurrent assignments clearly delineating each tier's area of competency: establishing policies, financing, service deliver, and so on.

Lessons for India

1. To take full advantage of the benefits associated with decentralization, local governments need to be empowered with their own exclusive expenditure responsibilities and where concurrent responsibilities are needed, it is very helpful to clarify the attributes of different levels of government over regulation, financing, provision, and production of the public service. This could be accomplished through a revision of the 11th and 12th Schedules of the Constitution.

ISSUE 4: REVENUE AUTONOMY

International experience suggests that local governments are more efficient and effective in implementing their responsibilities when they are also responsible for raising the revenues that they spend.[13]

International Experience

1. Most federal systems provide local governments with their own sources of revenue, with autonomy to change at the margin, tax rates or other elements of the structure of the tax. A tentative list of the most widely used local taxes across countries would include property taxes, user charges, business license fees, permits and excise taxes, motor vehicle taxation, income taxes, and sales taxes. In countries such as the U.S., revenues collected from the property tax using modern appraisal and billing techniques represent a major source of revenue for local governments. In Brazil, the property tax represents a substantial source of revenue, although its application is through simplified forms of mass appraisal, using a few readily observable and measurable characteristics of each property. A piggyback, flat-rate income tax is a tax instrument with considerable potential, as the experience of Canada and the U.S. demonstrate as well as the experience of Japan and many European countries.
2. User charges and fees play an important role at the local level in mature federations. For example, local user charges in Australia, Canada, and the U.S. include highway tolls, public transportation charges, park and recreation charges, water provision, charges and so on. Besides creating a Wicksellian connection between the costs and benefits of service delivery, user fees improve cost recovery and provide strong incentives for conservation, not wasting supply of the service, particularly in the case of water provision.

Lessons for India

1. Greater revenue autonomy must be considered an important reform in putting decentralization to work at the local level in India. It will not be an easy task, but the various lessons from international experience show that it can be done. Brazil's approach to property taxation (i.e., field surveys, use of a highly simplified form of mass appraisal, and use of construction cost data) can be implemented by rural and urban governments to address the current weaknesses of the administration of the property tax system in India.
2. An asymmetric approach can be explored as a means to allow major cities and other local governments with more developed capacity to introduce piggyback income taxes and other forms of local tax autonomy.
3. User charges can be more often updated and more widely used as in other countries for highway tolls, parks and recreation centres, and the like. Local bodies should be empowered to establish user charges in order to increase accountability at the margin and to improve cost recovery of these services.

ISSUE 5: INTERGOVERNMENTAL TRANSFERS TO LOCAL GOVERNMENTS

The design of transfers is of critical importance for efficiency and equity of local service provision,

[13] Many examples of this exist, but a striking one is provided in Jimenez and Paqueo (1996) for local financing of education in the Philippines: primary schools that rely more heavily on local sources are more accountable to their constituents and operate more efficiently.

autonomy, and fiscal health of local governments. As in the case of state governments, a transfer system to local governments is designed to address vertical and horizontal disparities and allow upper level governments to address externalities and pursue policy objectives of their own interest through local government activities and budgets. The fact is that even in mature federations such as Australia, Canada, and the U.S., local governments rely heavily on transfers from federal and state governments.

International Experience

1. An ideal transfer system to local governments entails a combination of general-purpose and specific-purpose transfers, and the composition of this combination depends on the service mix provided by local governments. Local governments in other federations rely heavily on general purpose grants with relatively few conditions. Often, formula-driven systems are used to equalize horizontal fiscal disparities at the local level. In Australia, for example, general purpose, recurrent grants to local governments are determined using a discretionary growth factor each year. Canadian Provinces use different formulaes: (i) some provinces recognize needs and fiscal capacity; (ii) others just recognize tax base deficiencies, in some cases just on the basis of property taxes; (iii) others do it by classes of municipalities, (e.g., urban and rural); (iv) others equalize on the basis of a few expenditure categories (i.e., mandatory expenditures such as police, fire, water and sewer, leaving out expenditures such as parks, culture, and recreation; and (v) others include all expenditure categories. The U.S. emphasizes conditional or categorical grants more than other federations, where money is distributed according to factors to measure the needs of the community, capacity to provide public services, cost of providing public services, and tax effort made by the community to provide public services.
2. In Australia, local governments receive financial assistance and SPPs from the Commonwealth to cover both recurrent and capital expenditures. They are generally passed through the states on the basis of recommendations of independent State Grants Commissions on the basis of fiscal equalization. They help local governments to meet the general cost of major areas of service delivery, realize service outcomes for the community beyond those that could otherwise be achieved through other revenues, and support special assistance to targeted groups. In Canada, conditional transfers to local governments vary across the country but are generally used mainly for social services (where there is a local role), roads and transport, and water and sewers. Specific purpose grants are used in other federations to pursue national policy objectives. In the U.S., the federal government transfers conditional funds to local governments, sometimes directly and other times through state budgets, for a wide variety of programs.
3. In Brazil, tax-sharing is the main source of revenue at the local level. The states now transfer to municipalities more than they receive from the federal government through revenue sharing. As a result, municipalities have been the main beneficiaries of the ongoing revenue reforms. The federal government now transfers funds to municipalities for education, which until recently had been transferred to the state government. In the Russian Federation, regional-local government transfers are

through the assignment of discretionary intergovernmental transfers (as "regulated" revenue sharing or subventions) or through long-term entitlements of local governments to a fixed portion of the yield from regional taxes to equalize disparities across their local governments.

Lessons for India

1. Transfers to local governments should be clear, transparent, and formula-based. It is possible for the states to create clear and transparent methodologies for transferring funds to urban and rural local governments. The methodologies should be simple and use available measures, such as population and property taxation. With time, as data on reliable developmental indicators are compiled, transfers could also be related to other proxies of revenue capacity and expenditure need. Given the types of services that are provided at the local level (i.e., water supply, sanitation, and street lights) a simple formula with population could be initially used.

ISSUE 6: BORROWING POLICIES FOR LOCAL GOVERNMENTS

International experience suggests that local borrowing has the potential to generate significant benefits for local governments by allowing them to finance public capital projects. However, local government access to credit markets is riddled with potential moral hazard problems. In some cases, federal intervention in the form of a bailout has been required even in mature federations, such as Canada, Germany, Sweden, and the U.S. To curb the moral hazard problem, the U.S. has introduced explicit bankruptcy procedures through financial control boards.[14]

International Experience

1. Countries rely on different approaches to control local borrowing, and in some cases a variety of approaches is employed. A typology of approaches follows:
   - *Market discipline*: In this type of control, higher level governments typically stay out of any direct involvement with local borrowing, and instead the system relies on market forces to ensure that local debt is managed, controlled, and disciplined. For this system to operate well certain conditions are required, including: free and open financial markets, easy availability of information on local debt and repayment capacity, and no bailout expectations. Countries that rely on this approach include Finland, France, Portugal, Spain, and the U.S.. Nevertheless, some of these conditions are often not met in developing countries;
   - *Direct administrative controls*: Higher level governments directly control the borrowing of local governments with limitations on debt, restrictions on external borrowing, and approval of specific investment projects. This approach is found in developed countries, such as Austria, Canada, Ireland, Japan, Spain, U.K., and many developing countries, such as Argentina, Bolivia, Brazil, Chile, Colombia, India, and Mexico. The advantage is that higher level governments have a better

[14] Following he conditional bailouts of the 1930s, the Federal Municipal Bankruptcy Act of 1937 revised in 1988, remains the norm for conditional bailouts today in the U.S. (Inman, 2000).

Table 2.5: Local Borrowing Restrictions in Different Countries

Type of Restrictions	Description	Country
Affordability Formulae	Ceilings on: (i) debts service/local revenues; and (ii) debt service/local current saving	Argentina, Brazil, Italy, Japan, Spain, Colombia
Indebtedness Formulae	Limit on outstanding debt/net revenue	Brazil, Colombia, Italy
"Golden Rule" Provision	Borrowing for capital expenditures	Brazil, Canada, USA, South Africa, India
Balanced Budget	Local councils required to pass balanced budgets	Brazil, Canada, Germany, USA
Local Approval	Local councils required to approve loans for individual projects	Canada, USA
"No bailout" Provision	Higher-level government does not guarantee local debt	Brazil, Colombia, Mexico

Source: Weist (2002)

handle on coordinating the overall country debt, including external borrowings. The disadvantage is that this strategy diminishes local government autonomy to make investment decisions according to local circumstances;

- *Cooperative controls*: Limitations on local borrowing are negotiated between higher level governments and local governments. An agreement is reached regarding overall deficit targets, revenue and expenditure growth, and controls on local government debt. Examples include developed countries, like Canada where municipalities are bound by provincially set rules and processes of approval administered directly by a provincial ministry or agency. However, this requires effective cooperation and fiscal discipline. In the absence of cooperation and fiscal discipline, this approach is unable to prevent excessive debt, as the experiences of Brazil and Colombia demonstrate; and
- *Rule-based control*: Actions of local governments are prescribed in various rules written in the constitution, law, or regulations. These may establish limits on the level of allowable debt, limits on debt-service capacity, stipulate limitations on the type of borrowing (e.g., capital projects), and the like. This approach is transparent, and it treats all local governments equally. However, it gives local governments an incentive to devise schemes that attempt to avoid or evade the rules, such as reclassifying current expenditures as capital expenditures, creating off-budget agencies and even government-owned enterprises, and relying on payment via arrears. Its success depends on the ability to monitor compliance with the rules.

2. International experience also suggests that sole reliance on one of these controls may not be sufficient. For example, in the U.S., all local governments require balanced budgets, but the effective borrowing constraint imposed by such requirements, even when written into the state's constitution, is often limited. Often the requirement only applies to the budget, excluding social security and capital spending; in some cases, the requirement only refers *ex ante* to the formulated rather than the realized

budget; and there may be other escape clauses, including extra budgetary sources of funds. Effectively, therefore, market discipline plays an important role in achieving borrowing discipline (Ter-Minassian and Craig, 1997). In Germany, the budget laws specify the conditions under which subnational borrowing can be undertaken. Local authority borrowing is limited to cash flow needs and is subject to approval by the Länder (state) authorities. In practice, there are weaknesses in both the formulation and application of the *Länder* laws. The investment requirements are specified *ex ante* rather than *ex post* and the interpretation of what constitutes investment is flexible. Spain is another example where multiple approaches are used to control local borrowing, including a market approach, legal rules, and cooperative controls. In addition, MoF approval is generally required for domestic borrowing, but there are some exceptions, including for those local authorities covered by Autonomous Communities.

3. Besides the problem of controlling the demand for borrowing funds by local governments, there is often a problem with the supply of available funds for lending to local governments. International experience considers two models of fund supply: the bank lending model of Western Europe, and the municipal bond model of North America (ADB, 1998).

    - *Municipal bank lending*: This approach is founded on three principles: (i) municipal banks establish lasting and stable relationships with the local government, which is helpful to small municipalities that need assistance with project preparation, financing, and implementation; (ii) municipal banks perform the function of delegated monitoring, however, this may be inefficient, except in the case of a large loan; and (iii) municipal bank operations are characterized by bundled services and bundled pricing. In some cases where municipal banks have had little or no history of relationship banking, financial deregulation has forced them to lend like commercial banks, and municipalities are constrained to accessing short-term loans.
    - *Municipal bond market*: This model contrasts the three principles of the previous model, as follows: (i) instead of a banking relationship, this model is based on competition. Each bond is subject to competitive bidding which results in large savings for large and established municipal issuers. However, this is deficient in serving the lending needs of smaller and inexperienced local governments. Although credit pooling has proven to be partially successful in meeting the financing needs of less creditworthy local governments, such as the state bond banks found in the U.S., where a special state intermediary with a superior credit rating raises funds through bond issuances and on-lends to local governments by purchasing their bonds. (ii) The municipal bond model is based on public monitoring as opposed to delegated monitoring. The creditworthiness depends on the public disclosure of municipal financial information.
    - The bundled services received from a municipal bond are typically unbundled in a municipal bond market. Municipalities can decide to receive advisory services from various institutions other than the

municipal bank. These can be purchased on the basis of a competitive bid thereby lowering project costs.

Lessons for India

1. International experience suggests that a rules-based approach to local borrowing with effective controls is a good way to avoid moral hazard problems. These rules should include at a minimum a balanced budget rule, golden rule, statutory limit on borrowings, ceilings on debt, a *credible* no bailout rule, and provisions for noncompliance. However, international experience also shows that it may be a good idea to rely on more than one type of control. Thus, in states where local governments fall behind on reporting and repayment capacity, borrowing rules can be complemented by hierarchical controls. The experience in Spain with asymmetrical decentralization of borrowing authority suggests that in states where local governments have better public disclosure of financial information, especially urban local governments, a municipal bond market could be developed. In addition, the experience of failing municipalities in the U.S. suggests that municipal bankruptcy laws may be a good way to further curb moral hazard issues.
2. On the supply side, both the bank lending model and the municipal bond model could be promoted. In the long-run, however, as local governments develop the public monitoring and disclosure practices required for efficient bond market operations, the municipal bond market model could become more prominent. The advantage of this second model is that it will endogenously generate transparency in local government finances.

Part 3: Options for Reform of India's Subnational And Intergovernmental Fiscal System

Overview

The fiscal deterioration and imbalance of subnational governments and suboptimality and design issues with India's intergovernmental fiscal system have been reviewed in Part 1 of this report. In this Part, the group offers a discussion of credible and serious reform options to address these problems taking on board international experience reviewed in Part 2. In making our recommendations, we have not been constrained by major structural limitations usually associated with implementing reforms of this kind, such as Constitutional limits, difficulties of administration, political acceptability, and the like. We further believe that a successful reform of this magnitude will have to be a joint effort of the states and the Centre. Designing such a reform will be a great challenge. The structure of the recommendations follows the structure and order of presentation of the two previous Parts of this report.

Objectives of the Reform

There is no one magic simple way to optimally reform India's intergovernmental fiscal system. GoI should begin the reform process by developing a policy stance on the overall goals of its intergovernmental reform. The best intergovernmental fiscal reform for India will depend on a clear statement of what government most wants to accomplish. As such a reform process should begin with a set of general goals or objectives. The group offers the following five general reform objectives.

1. Improve the Quality of Public Services

The basic objective of fiscal reform by the States of India and reform of India's intergovernmental fiscal transfer system is to improve the quality of public services offered to the people. Clearly, a major element of the problem is inadequate resources at the subnational level, including local governments. GoI transfers to state governments have fallen over the past two decades as revenue mobilization at the State level has flagged. The TFC has called for an increase in the tax to GDP ratio to 17.6 percent. While many Indian States are poor, the level and quality of services delivered to the public with the available budgets are well below where they ought to be with the money spent. There is much evidence of inefficiencies in delivering services.

A large share of subnational government budgets is spent on employee salaries, pensions, and interest charges which are uncontrollable in any given year. Pre-emption of revenues on payment of these costs results in nonprovision or under provision of operation and maintenance costs, consumables, and the like, which adversely affect the quality of public services. In part, this situation is a result of past, unwise decisions that have come back to haunt the states. However, subnational governments are hamstrung by mandates, conditional grants, and restrictions of various kinds on the pricing of publicly provided services. Nor can they rely on broadbased taxes to mobilize much revenue from their own sources. In short, they are unable to respond to the demands of their constituents.

Another plausible explanation for the failure to deliver quality basic public services is the failure fully to decentralize and empower local governments. Rather than empowering communities to deal with their own problems, state governments and the central government have created substitute institutions in the form of specialized agencies for water provision, housing, and so on. These parallel government institutions have served to further weaken development of local governments and to reduce local government accountability.

Objective 1:
The reform should strive to increase the level and quality of subnational public services by increasing the level of subnational government revenue mobilization, provision of operation and maintenance costs and other necessary costs, increasing the rate of cost recovery, and introducing policies that guarantee more accountability of government officials for the quality of service delivery.

2. Impose Aggregate Fiscal Discipline on the States

Many States in India run large fiscal and revenue deficits. In some cases, these deficits reach 50 percent of the budget or even more, and revenue expenditures are routinely financed through borrowing. Some states are beginning to bring their revenue budgets into balance. However, there are no consequences to fiscally prudent behavior just as there are no consequences to fiscal irresponsibility. In fact, irresponsible fiscal behavior at the subnational level is facilitated, if not encouraged, by institutions and practices that impose a soft budget constraint on subnational governments and sometimes by perverse incentives fostered by the transfer system.

Besides the macroeconomic issue of the long term sustainability of debt accumulation by the public sector, the current arrangements for state financing have introduced a "tragedy of the commons" problem leading to the inefficient and wasteful use of scarce resources. This reform direction would be in keeping with the recommendation of the TFC to reduce the level of debt as well as the size of the recurrent deficit of the states.

Objective 2:
The states should be fully accountable for their fiscal behavior. Consequently, the reform should impose a hard budget constraint and remove any perverse incentives to irresponsible fiscal behavior. This would force better expenditure decisions, would likely result in a greater rate of revenue mobilization, and lead to lower revenue deficits. The reform package ought to be structured to achieve this outcome.

3. Extend Decentralization to the Local Government Level

For the most part, the process of decentralization in India has stopped at the state level despite a constitutional imperative to push fiscal decision-making down to the lowest level. Particularly, the rural local governments remain weak, under financed, and lack administrative capacity. Urban local governments are also under financed relative to their service delivery responsibilities and have too little discretion in deciding their budgets. Some of the fundamental failures in

India's intergovernmental system to deliver adequate levels of basic services to the people can be traced to the absence of strong and accountable local governments.[15]

Decentralization in India currently translates into having intermediate level governments, the states (many of which are very large), in charge of delivering many local services. To realize the potential gains in efficiency and accountability associated with moving government closer to the people, India will need to take the next step of decentralizing more fiscal powers to the local bodies. The TFC recommends getting more resources in the hands of local governments but stops short of recommending increased revenue raising powers.

Objective 3:
The reform should be consistent with the spirit of the 73rd and 74th Constitutional amendments and encourage and assist the states in developing a workable system of local self-government. This will include the removal of overly restrictive mandates, the pruning back of some of the state sponsored schemes, the full funding of local government transfer entitlements, the granting of exclusive expenditure responsibilities to local bodies, and the granting of some degree of revenue raising powers to local bodies.

4. Get the Intergovernmental System in Synch with the Economic Reforms

Since it was launched in 1991, India's economic liberalization has given the private sector and the states much more discretion in shaping the flow of investment. However, the states continue to occupy and run several commercial services on a monopoly basis, such as the provision of electricity and bus services. Still worse, some states have directed large amounts of their revenue resources toward subsidizing enterprises that are not self-sustaining, hence exacerbating the weak fiscal position of the states. The absence of a commercial orientation of the enterprises, with user charges set well below cost recovery levels, and in some cases, an unwillingness on the part of the states to let loss making enterprises fail or be sold off, has led to significant and recurring fiscal losses at the state level. An objective of the intergovernmental reform must include putting public enterprises producing merit goods on a selfsustaining basis, divorcing others (mostly private goods producing) from the public sector, and putting an end to the practice of financing their current account deficits with revenues from state borrowing.

Objective 4:
The reform should put the states in a position where they are incentivized or forced to take more calculated decisions about continuing and/or subsidizing failing SOEs, or where they begin questioning the responsibility of government for continuing subsidies, as for example, to the power sector. A key to forcing state governments into taking a harder stance about what services general revenues should finance is the imposition of a hard budget constraint. Judging from history, problems such as inadequate public utility user

[15] For example, many states have failed to provide adequate education services, among other reasons, as we have seen, because a large share of school teachers fail to show up to work on a daily basis. In many countries, part of the solution to this problem has proven to be empowering local governments and even parents association to monitor performance and transferring budget authority for compensation and hiring and firing employees to these local institutions.

charges will not be legislated away as part of a general rate increase at the state level, because there is not strong political will to support this policy. Possibly a hard budget constraint will generate the political will to do so.

5. Redesign the Institutions to Match the New Realities of Indian Federalism

An underlying objective of intergovernmental reform of the Indian federal system will be to redesign institutions to match the intention to give state and local governments more fiscal autonomy and requiring them to be more accountable for their fiscal decisions. Institutions are difficult to move in most countries, and India is no exception here, but some degree of institutional reform would appear to be important.

A major component of institutional reform might be a rationalization of the system of intergovernmental transfers. At present, Centre-state transfers are based upon recommendations of the Finance Commissions administered by the MoF and Planning Commission allocations for both conditional and unconditional grants, which are administered by line ministries (in the case of grants classified as state plan assistance, releases are made by the MoF). These are programs that are not adequately coordinated, tend to have offsetting effects, and are not fully transparent. There are now conditional grant programs which encourage economic and fiscal reforms, but still many programs encourage subnational governments to behave in ways that are not consistent with the goals of a well-functioning, transparent, and incentive-compatible intergovernmental fiscal system. This is a major area where institutional reform would seem necessary to support a viable intergovernmental reform.

Objective 5:
The reform should remove those institutional barriers to good reforms and improve the overall level of coordination and directions for federal policies. This will require, amongst others, reexamining the future role of the Planning Commission and whether the Finance Commission should be a permanent body.

Options for Reform

The challenges facing India's decentralized system of finance run wide and deep. Many of the key problems with the current system have their roots in the design of the constitution and legal system. These problems will be difficult but necessary to address. Other problems can be addressed through fine tuning of current institutions and processes. Therefore, addressing subnational government fiscal imbalances and reforming the system of intergovernmental fiscal relations needs to be developed at two different levels. At the first level, all aspects of the system are put on the table under the assumption that there will be no restrictions on the types of reform that can be undertaken, including reforms requiring changes to the constitution. At a second level, and perhaps as a transition strategy, there are many changes that can be carried out to improve the current system of decentralized finance within the framework provided by the constitution and other fundamental laws.

Expenditure Assignments and Policies

Introduction of several CSSs on subjects which are constitutionally the responsibility of the states and incorporation of Panchayat Raj Institution (PRI) and Urban Local Bodies' Schedules in the Constitution, without granting autonomous authority to these bodies has created tremendous role confusion. This confusion over "who is responsible for what" is present at both the Centre–state level and the state-local level. The central government has introduced major schemes in sectors like agriculture, cooperatives, primary education, rural roads, rural electrification, water supply, irrigation projects, police modernization, district administration, repair and rejuvenation of local tanks, land records, agriculture records, and so on. More often than not, whenever a CSS gets introduced in an area, the states stop or reduce financing of such expenditure from their resources. Or, they start implementing a scheme as central funds become available for that very purpose, when they may have never wanted the scheme in the first place. As CSSs have central design, local priorities are lost and all states start implementing the schemes with similar financing and administrative arrangements. Whenever, such a CSS stops, the states are left with the liability of paying the salaries and wages of those employed for the schemes. The National Common Minimum Programme (NCMP) of the present government calls for closure of all CSSs, except those which represent large national priorities.

We deal with segments of the problems offering some options for consideration to clarify expenditure assignments, which would perhaps eliminate role confusion and unnecessary duplication and inefficiency in public spending.

ISSUE 1: CONCURRENT LIST OF EXPENDITURE ASSIGNMENTS

The concurrent list of the constitution and de-facto concurrent implementation on account of various CSSs weakens transparency and accountability.

Option 1:

The Indian Constitution was framed with explicit division of expenditure responsibilities, as part of exclusive executive and legislative powers for Centre and states in the Seventh Schedule. However, over the years, the concurrent list has expanded. Some entries in the Union List have been used to override roles assigned to states in the State List and gross use of Article 281 which allows the Centre to provide grants to anyone irrespective of the subject have altered the clear division of competencies. Technological and economic changes since 1950 have also necessitated a fresh look at these lists. Accordingly, a thorough review of expenditure responsibilities, with each class of expenditures unbundled by subfunction, wherever needed, could be carried out for the division of Centre-state responsibilities and state-local division of expenditure assignments. Insofar as possible, an exclusive list of expenditure responsibilities should be assigned to each level of government, and the concurrent list either eliminated or reduced to a minimum number. Exclusive assignment of legislative and executive power should be further clarified in specifying clearly in the law, passed under such authority, which level of government has competence for each responsibility, for example, (i) regulating and establishing norms for provision; (ii) financing the service; and (iii) actual delivery of the service for each level of government that shares the responsibility.

Option 2:

Another option to clarify expenditure assignments could be to review CSSs and Additional Central Assistance (ACA) schemes, which also has been called upon by NCMP and simultaneously examine Article 281, afresh. There are too many, duplicative and small CSSs and ACAs. The Central government can first consider outlays under state plan assistance including ACA schemes, CSSs, and grants under Finance Commission awards, as together constituting the transfers from the Centre to the states, in conditional and unconditional forms. The pool of this fund should be broadly divided into two parts: unconditional and conditional block assistance. An option is to further divide unconditional assistance into those for states and those for local bodies and to divide conditional assistance in a similar manner. Only the conditional part should be reorganized under ten major national programs, adopted with the consent of the states. These programs can have a time-frame of at least five years so that expenditure assignments there under are clearly understood for a longer period of time by all concerned. Article 281 can be amended to stipulate that the Centre would provide grant funding for subjects included in the State List or Local List only upon such CSSs having been considered and approved by the National Development Council (NDC). The states would then be exclusively responsible for the subjects assigned to them.

Option 3:
Another option could be to create a national coordination arrangement by strengthening the role of NDC for intergovernmental dialog and coordination. Even with the most explicit and clear statement of expenditure responsibilities, situations can be encountered in delivery of services. Rather than including more and more detail and complexity in the law, this option can provide a forum for effective coordination among agencies at different levels of government that share a particular expenditure responsibility. Holding regular meetings and providing information at all levels facilitate coordination for clarifying an effective assignment of expenditure responsibilities. The practice of allowing higher level governments to circumvent expenditure assignments with backdoor arrangements — the “schemes”-should be discontinued. CSSs can then be introduced and allowed only if the coordination forum agrees to it after due examination and analysis.

Recommendation 1
It is recommended that the GoI make it mandatory that no new CSS can be introduced unless this is specifically approved by the NDC, after a detailed proposal in this respect is placed before the public for discussion and comment for a reasonable period of time. Similarly, cost-benefit analysis should be done for each existing CSS and approval of NDC sought for the same. It is further recommended that the existing CSS should be consolidated into a small number of CSSs, reflecting major national priorities as conditional block grants. All existing schemes must be subject to periodic evaluation for regarding its continued relevance. Whichever existing CSS is not approved by the NDC, funds equivalent to the average of the last three most recent years expenditure on such CSS should be transferred to an unconditional block grant to be distributed to the states. Options 1 and 2 should also be examined by an appropriate commission or authority as well.

ISSUE 2: COMPRESSION OF EXPENDITURES

Although the level and the economic composition of expenditures vary considerably among the States of India, most states are running persistent revenue deficits. As a result, they need to compress expenditures.

Option 1
The GoI could encourage the states to pass balanced budget laws and follow the golden rule for capital expenditures. To encourage the states to pass such laws, the Centre can exercise its authority under Article 293 of imposing borrowing ceilings and also incentivize it. Recommendations of the TFC in this regard can be used with great effect by the central government to nudge the states into enacting fiscal responsibility laws. To deal with the problem of passing budgets with unrealistic forecasts of expenditures and revenues also requires *ex post* budget balance. This also could include limiting pay increases to government employees based on affordability.

Option 2
The Centre and states could enter into a fiscal responsibility pact. This pact could, for example, place ceilings on total debt, debt service payments, wages, and subsidies as a percent of the revenue budget for both the Centre and subnational governments. In addition, floors as a percentage of revenues could be placed on expenditures on education and health in order to maintain a certain minimum standard in the face of expenditure compression. Monitoring compliance with these norms should be assigned to an autonomous body in order to insulate it from political influence in contrast to the practice in Brazil where a political body is charged with enforcing the norms. The pact can provide for developing a mechanism for reporting these data in a timely manner and auditing the accounts to insure the quality of the information.

Option 3
The states could come together under their own initiative, along the lines of the VAT Empowered Committee, to coordinate on drafting and adopting fiscal responsibility laws, sharing of resources, capital borrowing laws, and so on. This collaborative arrangement can also discuss the borrowings of the states and Centre as well as central institutions that currently lend to the states.

Option 4
Leave it to the states to adopt fiscal responsibility laws on their own, with the Centre exercising control only on borrowings by states to enforce a hard budget constraint.

Recommendation 2
It is recommended that the GoI encourage the states to pass balanced budget laws and follow the golden rule for capital expenditures, by using the leverage and incentives provided by the TFC and by exercising its authority under Article 293 to impose borrowing ceilings. Fiscal responsibility laws should have procedures and penalties that discourage the practice of passing budgets with unrealistic forecasts of expenditures and revenues. This could include limiting pay increases to government employees based on affordability, as mandated in the Financial Emergency provisions of the Constitution of India.

ISSUE 3: PENSION REFORM

The pension issue has severe implications for state finances and has several dimensions: existing employees, new employees, and existing pensioners. For existing pensioners, there are both wage and price indexation, but no reforms are currently underway. For new employees, reforms have been initiated by the central government with introduction of a DC scheme with eight states following the lead of the Centre.

For existing employees, there are very little reforms, with only some states introducing some minor parametric changes. The current pension obligations of the states are completely unassessed and unfunded.

New Employees

Option 1

Some people argue that it is not appropriate to segregate and introduce the DC scheme only for new employees. It is felt by such people that the Centre and some states have been able to introduce this scheme for new employees as their strength is very small. As the number of such employees increase in number, there may be organized opposition from them on the ground of unequal treatment. Accordingly, one option is to leave it as is for them also and introduce pension reforms for all employees together.

Option 2

The existing and new employees form two separate classes, and therefore, they can be treated differently. While the governments are bound by their contractual obligation to provide pensions as per the existing rules to existing employees, there is no such obligation to new employees. The demographic dynamics are very uncertain. Nor is there long-term clarity about the continuance of the public sector role in everything which governments do today. Any Pay As You Go scheme runs the risk of underfunding in such situations. Leaving pension obligations to be entirely funded from the revenues of future budgets is clearly unfair to future generations. A pure DC scheme takes away the intergenerational equity issue and also protects budgets from unknown dynamics. It is therefore advisable to adopt a pure DC scheme.

Option 3

A possible way to harmonize the interests of both individuals and the State is to adopt a multipillar scheme. The new employees will get part of the pension as a defined benefit and part would be funded out of individual accounts based on defined contributions. This option sounds better emotionally, but it leaves fiscal uncertainty to the extent of the DB scheme. However, if it is possible to fund the defined DB pension on regular actuarial valuation, this can provide a possible meeting ground.

Existing Employees

Option 1:

Several retirement-related benefits have been introduced for employees over the last two to three decades. Initially to address the strains caused by an expanding public sector and socialistic pattern of society and subsequently as largesse by some of the Pay Commissions and weak governments. Development of financial markets and savings-investment gaps in the economy have also impacted several underlying assumptions, such as the discount rate for pension commutations, percentage of commutation, and so on. Providing leave encashment in a situation of surplus manpower does not make much sense. Parametric aspects of the pension schemes for employees need to be therefore revisited and rationalized. This would bring about some fiscal benefits.

Option 2:

The other option is to convert the existing accrued rights of existing pensioners into lump-sum investments and switch them over to a DC scheme for the remaining period of their service like new employees. This would bring about complete fiscal certainty and bring equity in treatment of existing as well as new employees.

Existing Pensioners

Option 1:
As pensions of such employees have crystallized, reworking them on the basis of parametric changes would not be fair. However, pensioners in India enjoy both wage and price indexation. There is no reason for wage indexation to be provided to them. Their pensions should be protected in real terms, which are ensured by price indexation. It would not be advisable to revise their pensions on the basis of the pay revisions granted to existing employees.

Recommendation 3:
For new employees, the better course is to adopt a DC scheme or a multipillar scheme with full set apart funding of defined benefits based on yearly actuarial evaluation. For existing employees, the pension obligations should be assessed and parametric changes, such as using a market rate as the discount rate should be brought about. If a satisfactory assessment of the accrued rights is done, it should be possible to require employees whose term of service does not exceed a certain number of years to move over to the DC scheme for the remaining term of their employment. For existing pensioners, there should be exclusively price indexation, and no further wage indexation should be provided.

ISSUE 4: SUBSIDIES TO STATE-OWNED ENTERPRISES
Not only are the explicit subsidies a drain on state budgets, but the lack of transparency in implicit subsidies and the contingent liabilities contribute to the financial risks borne by the states. The issue of subsidies to SOEs needs to be approached from the point of first ascertaining what kind of goods/services are being provided by any particular SOE. There are many enterprises at the state level which are providing pure private goods, which need not be provided at all by the public sector. However, one has to structure the policy carefully for private goods provided by the public sector if such public sector enterprises happen to be operating under a monopoly situation. For example, all important highways are nationalized by the states and only State Transport Undertakings can provide bus services on such roads. Bus services are clearly a private good.

Private Goods — Natural Monopolies

Option 1:
Being private goods, there cannot be any justification to keep such enterprises in the public sector, but the Government has to put in place a very strong regulatory mechanism to ensure that private monopolists do not abuse their monopoly power. Accordingly, India should continue with sectoral reforms, especially in power and irrigation, to improve commercial discipline and move ahead with privatization of such entities, with strong regulatory mechanisms. In short, the states should be encouraged to privatize such SOEs that are producing private goods in monopoly situations and regulate them to prevent unfair pricing policies.

Private Goods — Competitive Industries

Option 1:
Privatize profitable SOEs that are producing private goods in competitive industries. In the case of loss-making SOEs, it is better to close them down as long as private industry is providing such services/goods. In case, there is no private provision of such goods/service for the time being, the Government should encourage

private players to provide such services and ensure that Public Sector Enterprises (PSEs) are managed efficiently and charge full cost recovery as long as such PSEs have to continue.

Public Goods

Option 1:
There is no alternative to public financing of public goods. The Government should be concentrating on efficient management of such enterprises and ensure delivery of quality services.

Merit Goods

Option 1:
In the case of merit goods, such as electricity to poor farmers, primary education, and primary health services, there should be better targeting of such subsidies. Accordingly, state budgets should clearly show the amount of each subsidy, the intended beneficiaries, and the economic and/or social rational for each subsidy. Bringing greater transparency to subsidies will provide the necessary information for an informed debate about the efficacy of these subsidies. This policy would have the added benefit of bringing greater transparency to state and SOE relations and accounts.

Recommendation 4
There should be transparency in the state of affairs of the SOEs, which the GoI can help bring about. Privatize profitable SOEs that are producing private goods in competitive industries. In the case of loss-making SOEs, it is better to close them down as soon as private provision of such services is ensured. In the meantime, such PSEs should be managed with full cost recovery to prepare them for privatization. There should be better targeting of subsidies for PSEs providing merit services. Accordingly, state budgets should clearly show the amount of each subsidy, the intended beneficiaries, and the economic and/or social rational for each subsidy. There is no alternative to public financing of public goods. The Government should be concentrating on efficient management of such enterprises and ensuring delivery of quality services.

ISSUE 5: DECLINING EXPENDITURES ON CAPITAL OUTLAYS

Capital outlays are declining as a share of GDP because state borrowings are being diverted to finance persistent state revenue deficits.

Option 1:
Reform the fiscal laws to mandate the golden rule at all subnational levels so that borrowings are only used for capital investment purposes. A golden rule can ensure that state governments do not borrow to finance revenue deficits, and a fiscal responsibility law can set limits on committed expenditures.

Option 2:
An expenditure management framework as in the U.K. ensures that the quantity, quality, and stability of capital investment are not jeopardized by other rules. The DIS strategy of capital management could be applied at the local level, thus providing local governments with more autonomy and flexibility in the implementation of capital funds and an incentive to maintain and operate according to established performance targets. Local bodies could determine their own priorities for capital spending and manage the funds according to what they judge to be the most cost-effective and efficient way possible.

Option 3:
Expenditures on capital outlays could be protected by mandating floor thresholds as a percentage of overall expenditures at the subnational level for public investment. Brazil's experience with declining public capital investments suggests that the design of fiscal rules or any attempt to implement expenditure limits should include a floor threshold for public investments. In India, similarly, public investments have declined because of the high commitment of expenditures to wages, pensions, and interest. In India, a floor limit on capital investment could be instituted as a budget policy or in the states' fiscal responsibility laws, aiming at ensuring that current expenditures or debt reduction attempts do not sacrifice capital investments. However, this approach would limit the discretion of subnational governments.

Recommendation 5
States should adopt the golden rule. Allow the states to decide their capital expenditures. Do not limit the opportunities for creative financing. Where the assets are revenue producing, the better course is to issue revenue bonds or specific loan financing. In the case of nonrevenue producing projects, use of general obligation bonds should continue as at present.

Revenue Assignments and Policies

A comparison of the intergovernmental fiscal system in India with the major federal countries visited by the group calls for enhanced revenue raising autonomy at the state and local levels. The following list of options is not a complete package but presents components of a revamped and decentralized federal financing system.

In Chapter 1, we have described the complex and suboptimal goods and services tax regime in India. Chapter 2 documents the reforms in Australia from 2000 onwards which resulted in a fully harmonized integrated goods and services tax system which provides a model for integrated goods and services tax regime for India. Canada's experience in bringing excellent coordinated arrangement when both the Federal Government and provinces have jurisdiction in levying taxes on goods and services shows that coordination can work when different tiers of government have overlapping taxing powers. Brazil's experience in running an origin-based VAT provides an opportunity to study the negative consequences of such a regime.

A great deal of coordination work has been done in India by the Empowered Committee of State Finance Ministers in bringing about agreement among most of the states on a "uniform" VAT on goods in India. The Kelkar Committee has proposed a national goods and services tax arrangement by proposing to do away with central excise, service tax, and state sales taxes which is very close to the Australian system. In the light of these experiences and proposals in India, the following options emerge for India.

ISSUE 1: IMPLEMENTING A GST TO REPLACE THE EXISTING STATE SALES TAX REGIME

Option 1:
India could continue to move towards a "uniform destination based VAT on goods" as a replacement of the state sales tax regimes. This would require replacing the existing central sales tax by a prohibition on taxation of interstate sales by the origin states or zero rating interstate sales; completing the integration of Central VAT at manufacturing stage and service tax by introducing a central goods and services tax law; accepting the recommendations of the Kelkar

Committee report; amending the Constitution if required; and bringing about a national goods and service tax law, with appropriate collection and sharing arrangements.

Option 2:
Institute separate state and central GSTs with concurrent taxation on the destination basis. Such concurrent taxation in a federal country has been modelled with a Clearinghouse arrangement, CVAT, and VIVAT basis. Except for the limited experience with the Clearinghouse arrangement in Israel and the West Bank and Gaza, these designs have not been attempted in any country to the best of our knowledge. Alternatively, subnational governments could apply VAT on top of the central VAT on an origin basis.

Option 3:
The GoI could institute an exclusive, centrally administered GST, with specified proceeds shared as grants to the states. India could adopt either (i) Australia's approach by enacting a centrally administered VAT at a uniform rate on a destination basis and use the revenues, in whole or part, to fund an equalization grant fund; or (ii) the approach used by Canada, Germany and Spain of collecting the VAT centrally and distributing the funds across the states according to population or estimates of shares in aggregate consumption.

Recommendation 6
International experience suggests that a centralized GST/VAT with a portion shared with the states based on a formula is the most simple, prevalent, and successful model for indirect taxation. Given the constitutional position and processes at work presently in India, however, it would be advisable for all states to switch over to a uniform VAT using the platform provided by the Empowered VAT Committee and for the Centre to fully integrate manufacturing stage VAT and services tax into a Central GST, with the objective of integrating the two in a national GST with a common tax base with both Centre and the states levying taxation thereon along the lines suggested by the Kelkar Report.

ISSUE 2: ENHANCE OWN-SOURCE TAX REVENUE OF THE STATES

Supposing reform of indirect goods and services taxation as recommended above, there would still be a significant need to augment the tax revenues of the states. Augmenting their revenue autonomy would have the added benefit of helping the states to balance their revenue budgets, improve the quality of public service offerings, and live under a hard budget constraint. So, we consider below alternative approaches of augmenting the states own-tax revenue raising autonomy.

Other Tax Revenues

Option 1:
The states have several other sources of tax revenues like transport taxation, agriculture income tax, stamp duty on conveyances, professional tax, etc. However, these taxes are not being fully exploited even though the states are running persistent revenue deficits. The states should be encouraged to use their existing taxes optimally; achieving that goal will depend to a large extent on imposing a hard budget constraint on the states. In addition, the GoI can help in reforms of these taxes as well as enhancing their revenue yields.

Option 2:
Realign some of the taxes, which have wider

economic implications for their effect on the production of goods, services, and financial market efficiency, such as stamp duty. The Centre could follow the Australian example by bringing about a compensation scheme to encourage the states to shed these taxes. For example, these taxes could be designed and administered centrally, and the states could be compensated for the resulting revenue loss by increasing resource transfers from the Centre in an offsetting amount or by providing adequate substitute tax instruments to the states.

Enhanced Revenue Autonomy

Option 1:
With goods and services taxation moving in the direction of a national GST, the states are necessarily foregoing their revenue autonomy for a major source of their tax revenues. The time has come to think of improving the revenue autonomy of state governments by allowing them to tax personal income, but not corporate income. An optimal way to do this is through a piggyback personal income tax, where the states basically use the same base as the Union's personal income tax but choose a flat rate between a minimum and a maximum set in the federal law. Tax proceeds of such additional tax would accrue only to the states which levy such taxes. Increasing the revenue autonomy of the states in this manner would also correct the lack of efficiency aspect of current tax sharing arrangements between GoI and the states.

Option 2:
A certain part of the personal income taxes could be shared with the States according to the origin principle. This would give the states a stake in the collection of personal income tax in their states.

Option 3:
The states could be encouraged to levy and collect special excises and VAT on beverage alcohol, transportation fuels, and tobacco products. Several states are doing so in India by levying additional sales tax on transportation fuels and special excise on alcohol.

Modernization of Tax Administration

Option 1:
States, with the assistance of programs sponsored by the Centre and bilateral and multilateral donors, could begin upgrading the administration of their revenue collection systems in order to make better use of the revenue autonomy they already have and the autonomy they may get in future.

Recommendation 7
The states may not be fully using available taxing authority because available tax assignments are poorly conceived. In addition, the lack of a hard budget constraint undermines the incentives for the states to utilize their own tax revenue raising authority more fully. The GoI also should examine the taxing powers of the states in terms of revenue sufficiency. However, this examination must take place in the light of analysis of the desired vertical gap and the transfer system. The states should be encouraged to use their existing taxes optimally. The GoI can help in reforms of these taxes as well as enhancing their yields. An optimal way to enhance the revenue autonomy of the states is through a piggyback personal income tax. The states would use the same base as the Union's personal income tax, but each state would choose a flat rate between a minimum and maximum set in the federal law. Tax proceeds of such additional tax would accrue only to states which levy such taxes. This would also correct the

'lack of efficiency' aspect of the current tax sharing arrangement between GoI and the states. It also should be possible to refer the issue of allowing states to levy additional income tax on personal income taxes to the next Finance Commission. States, with the assistance of programs sponsored by the Centre and bilateral and multilateral donors, could begin upgrading the administration of their revenue collection systems in order to make better use of their existing revenue autonomy and the autonomy they may get in future.

ISSUE 3: WEAK ADMINISTRATION OF THE PROPERTY TAX

The property tax is not being adequately exploited as a source of subnational revenues. The property tax is a notoriously difficult tax to administer and often meets with considerable resistance from taxpayers. However, a property tax is the ideal tax for local bodies as there is a very clear link between property taxation and the services provided by the local bodies. The link may be weakened when the property tax is administered by the states. To the extent that the States of India have retained complete responsibility for all aspects of the administration of the property tax, India is out of step with current international best practice.

Option 1:

The best choice is to empower local governments with the development of a modern real estate property tax, with an updated fiscal cadastre, fair and efficient valuation or appraisal methods, and a fair and transparent administration of the tax, including efficient appeals procedures. For those local governments with weaker administrative capacity some of the administrative functions, such as updating the fiscal cadastre, could be entrusted to the state government. It would be advisable to amend the Constitution to confer this taxation power along with power to levy professional taxes to local bodies. Within the broad regime of unit area method or some other objective basis, the local bodies should be able to decide on the rates to be charged and should collect and appropriate these taxes.

Recommendation 8

It is recommended that the authority to levy and administer the property tax be truly decentralized to local bodies. The cities and rural areas should be assisted in developing the capacity to develop and administer a modern real estate tax. The GoI and the states should provide technical assistance, especially to rural local bodies, to improve administration of a simplified property tax.

ISSUE 4: GREATER EXPLOITATION OF NONTAX REVENUES

Inadequate user charges are being levied for the private and merit goods delivered by the Government. Likewise, the investments made by state governments are not yielding meaningful returns. It is very important that departmental commercial enterprises run by the Government like bus services, electricity, and irrigation yield returns.

Recommendation 9

It is recommended that the states be encouraged to do a critical analysis of all merit and private goods delivered by them departmentally and the present rate of recoveries for such services. The states should then take up a well designed and publicly shared program to manage the costs of delivering these services and levy user charges at appropriate levels and gradually close the cost-recovery gap. Similarly, the states should critically examine the returns accruing to them from their investments. Investments must be made to perform and yield market returns, privatized, or written off.

Intergovernmental Fiscal Transfer System

Intergovernmental fiscal transfers are used to correct for vertical and horizontal imbalances, interjurisdictional spillovers, and promote national objectives. As such, a system of transfers is needed for many good reasons, but they can easily create perverse incentives, and they are not a substitute for a healthy degree of tax autonomy.

ISSUE 1: LACK OF ADEQUATE EQUALIZATION

Although India has an equalization system, the formula mixes too many objectives, does not distinguish well between fiscal capacity and expenditure needs, and creates negative incentives for the states. The current equalization system needs to be overhauled. Various mechanisms are used in India in an attempt to cover vertical and horizontal imbalances, most important of these are tax sharing by Finance Commission, grants from the Finance Commission, and NCA from the Planning Commission. The tax sharing formula for horizontal distribution to the states takes several equity principles into consideration like income (distance method), land area, and so on. There is no clear and demonstrable link between fiscal capacity and expenditure needs, and the distribution of shared taxes. Finance Commission grants like revenue deficit grants are supposedly based on assessment of the fiscal needs and fiscal capacity on normative bases. However, these computations are never shared with the public, and there is a resulting lack of transparency. The TFC has sought to introduce explicit equalization principles in a limited way in recommending education and health grants. The Planning Commission's NCA, distributed according to the Gadgil formula, is the least equalizing. It is, therefore, necessary to reexamine all the unconditional block grants, tax sharing included, and to treat them as a single large pool of equalization grants.

Option 1:

The objective of equalization could be exclusively pursued by an equalization grant system, which would distribute a pool of equalization funds via a formula based on the difference between expenditure needs and fiscal capacity of the states. This equalization grant system, should be designed, reviewed, and recommended by Finance Commissions every five years and implemented by the MoF. The pool of funds could be fixed by formula as a percent of general government revenues, or it could be fixed in an ad hoc manner every five years. However, the latter is generally less desirable. The formula used for the distribution of the equalization funds would capture the gap between estimated expenditure needs and fiscal capacity. Those states with a negative fiscal gap would not receive equalization grants, and the available funds would be distributed to each state with a positive fiscal gap in proportion; for example, to that state's share in the total sum of positive fiscal gaps. Other options are available for the final distribution of available funds, for example, by bringing up the worse off states to minimum desired disparity level. Expenditure needs could be based either on a weighted index of proxies for needs including population, poverty, and population profiles (school age and the elderly), and so on. Alternatively, they could be based on a set of financial per capita norms for the main expenditure responsibilities of the states. The fiscal capacity measure could be based on a representative revenue system methodology that captures the revenue potential of the state from the taxes assigned to them and their respective tax bases.

Recommendation 10
Equalization should be exclusively pursued by an improved and explicitly dedicated equalization grant system by merging the present tax share, Finance Commission's grants, and Planning Commission's NCA. The equalization grant will be funded by a stable formula as a share of dedicated central government revenues. The measurement of expenditure needs would be based on a weighted index of need proxies, and fiscal capacity would be measured by a modified representative revenue system that takes into account the revenue potential of the taxes assigned to the states. The Finance Commission should be entrusted with this job, and the MoF would be responsible for implementation. It may be necessary to make the Finance Commission a regular body in order to implement this recommendation.

ISSUE 2: CENTRALLY-SPONSORED SCHEMES

As far as conditional grants, normally referred to as CSSs and ACA schemes, are concerned, the MoF provides the envelopes; the Planning Commission allocates the same amongst various ministries and schemes; and the respective ministries implement them. According to international experience, no autonomous body is responsible for conditional grants. Although CSSs are an important source of revenue for the States of India, these schemes burden the administrative capacity of the states and provide a backdoor for the federal government to micromanage decisions that are ostensibly the responsibility of the states.

Option 1:
A simplified, rationalized, and streamlined (very few in numbers) set of block grants could be established to replace the existing central schemes. This also has been called for by the NCMP. As such, these conditional grants would be distributed as specific purpose grants, with very few rules and mandates, by the Union's line ministries. These would be very different from the current scheme-based programs in that they would be fully administered by the recipient subnational government, with some discretion as defined by the specific nature of the transfer. These programs would be restricted to support those functions where increased state and local government spending are viewed as being in the national interest (i.e., improved fiscal management, tax administration, and restructuring the finances of SOEs, improving social service delivery, and the like).

Recommendation 11
The existing CSSs should be rationalized and simplified into a small number of specific purpose conditional grants. The Centre should indicate the broad mandate and objective of these grants, rather than issuing detailed guidelines which micromanages state affairs and uses a one size fits all approach among the states, with different on the ground realities. The states should be free to design their programs and projects with the grant consistent with the objectives of the grant. The Centre should focus on evaluating the efficacy of these state programs and projects as well as the sufficiency and timeliness of funding.

ISSUE 3: PLANNING COMMISSION'S LOAN GRANTS CREATE DISTORTING INCENTIVES

The state plan schemes are substantially loan funded, even when the program and project is not meant to create any capital assets. This results in severe fiscal problems for the states. The Gadgil formula 70-30 (10-90 in the case of special category states) loan-grant transfers create incentives for states to assume debt in order to get the grant even though they otherwise may not have borrowed the funds for such a purpose because of their very high debt levels and for other reasons.

The distinction between plan and nonplan is also no longer relevant and could be dropped in favor of a formula-based allocation of capital grants. More specifically, the GoI could create a set of conditional matching grants for capital infrastructure purposes based on viability gap analysis, without any borrowing component, distributed to the states according to a formula based on population, land area, and an index of infrastructure deprivation. These transfers could be administered by the Planning Commission or the MoF.

Recommendation 12
GoI should establish conditional matching grants for capital infrastructure purposes, after assessing the viability gap by way of grants, (i.e. without any borrowing component). These grants would be distributed to the states according to a formula based on population, land area, and an index of infrastructure deprivation. These transfers could be administered by the MoF.

ISSUE 4: COORDINATION BETWEEN THE FINANCE AND PLANNING COMMISSIONS

The Planning Commission's development projects create budgetary obligations for the states (i.e., debt service, maintenance and operation costs, and personnel costs) that the Finance Commission may or may not take into account when they make their transfer recommendations.

Option 1:
The intergovernmental transfer functions of the Finance Commission and the Planning Commission could be merged into a single autonomous body.

Option 2:
In light of the economic and intergovernmental fiscal reforms underway in India, the role of the Planning Commission could be refocused. More specifically, the distribution of block grants by the Planning Commission in the form of NCA could be transferred to the Finance Commission. Additional Central Assistance schemes, being very similar to the CSSs, could be integrated with the CSSs. The Planning Commission's resource allocation role could be limited to CSSs. The Planning Commission could concentrate on appraisal, evaluation, and monitoring of these programs.

Recommendation 13
The Planning Commission should be given a new set of responsibilities that is consistent with the economic and intergovernmental reforms underway in India. These new responsibilities should include appraisal, evaluation, and monitoring of the programs and schemes; evaluating the creditworthiness of the states; and reporting to the nation about the success or failure of the projects. The distribution of block grants by the Planning Commission in the form of NCA should be transferred to the Finance Commission.

Revenue Deficit and Debt

The States of India have been running persistent revenue deficits since the mid-1980s. This has led to unsustainable debt accumulation and a growing share of expenditures committed to debt service. Diverting Planning Commission loans to cover revenue deficits has also led to a decline in the share of state government resources available for investment in economic development and social infrastructure. A fundamental reason behind this fiscally irresponsible behavior is the existence of soft budget constraints.

ISSUE 1: SOFT BUDGET CONSTRAINT

Soft budget constrains typically arise when there is a high vertical gap, low subnational revenue autonomy, high subnational borrowing autonomy, and a history of debt forgiveness by the central government. In India, soft budget constraint has been institutionalized by central government providing autonomous borrowing through small savings, lending by the Centre to the states, lending by the GoI owned institutions to the states without insistence on debt servicing capacity, ways and means advances from the Reserve Bank of India and MoF and the like. Neither the Centre, nor the states, passed any law placing limits on their borrowing as envisaged in the Constitution of India. GoI has been providing substantial loan funding knowing fully well that the states are using the same for funding their revenue deficits. GoI in 2003 decided to adopt a fiscal responsibility law. Some states have also done so. Now, the TFC has recommended a fiscal responsibility law that places statutory limits on both revenue deficits and fiscal deficits. The soft budget constraint have resulted into enormous build up for loans and other liabilities of the states. The financing framework of the states now needs to be brought within a regime of hard budget constraints.

Option 1:

Either through the creation of a federal-state pact resulting in a federal budget code and/or the adoption of "Fiscal Responsibility Acts" by all states independently, borrowing practices should be brought under control by imposing the golden rule (state borrowing can only be used to finance capital investment spending) and ceilings of total debt and debt service payments as a percent of the revenue budget. Overseeing and enforcing these provisions may require personal liabilities and prosecution under federal laws of state government officials, as in Brazil. Monitoring compliance with these norms should be assigned to an autonomous body in order to insulate it from political influence, in contrast to the practice in Brazil. The Union Government must also assist in developing a mechanism for reporting these data in a timely manner and auditing the state accounts to insure the quality of the information provided by the states.

Option 2:

The Centre could impose strict control and limits on state borrowing using its authority under Article 293(3) and disband providing loans from Union sources. State borrowing could be based on creditworthiness rather than need or an artificial sense of no-default. The Centre could take measures to eliminate any form of interbudgetary payment arrears, and prohibit state governments from borrowing from public enterprises of any sort. The Centre could require the states to maintain at arms length the operation of existing public enterprises. The Centre could require the inclusion of all contingent liabilities as part of the published quasifiscal deficit. The failure to repay debt as scheduled should carry significant consequences.

Option 3:

Borrowing sources could be streamlined and borrowing limits reimposed. All borrowing from special sources (required holdings of state government bonds by commercial banks, borrowing from pension funds, and shares of rural small savings, etc.) are examples of financial repression and should be phased out in a preannounced manner over a two or three year period. Over the longer term, there should be a plan to phase out all Union Government lending to the states (including small savings) and substitution of (consensual) private market lending. Imposing market discipline on state borrowing should be a long-term goal of the GoI and needs to be fully coordinated with financial sector reforms.

Recommendation 14

States should be encouraged to adopt fiscal responsibility laws imposing a strict hard budget constraint. The centre should simultaneously use its authority under Article 293(3) to impose prudent borrowing control. Following recommendations of the TFC, loans from the Centre should be discontinued. Gradually all borrowing from special sources (required holdings of state government bonds by commercial banks, borrowing from pension funds, and shares of rural small savings, and so on) should also be eliminated.

ISSUE 2: SUBNATIONAL GOVERNMENT DEBT BAILOUTS

International experience shows that bailouts, which are often used to resolve fiscal crises at the subnational level, create a culture of soft budget constraints and lead to more fiscally irresponsible behavior down the road. There have not been serious subnational debt bailouts, but occasionally the Finance Commissions have recommended certain debts of the Centre to the states be written off. Occasionally, the central government has also done so on its own. More often than not, Finance Commissions have recommended debt consolidation at lower rates of interest, or debt waiver linked to fiscal improvement. There is, however, a feeling amongst the states that there business would not come to a standstill even if they did default on GoI loans or loans taken from the finance sector.

Option 1:

The experiences of Brazil and Mexico with fiscal adjustment through debt-rescheduling and debt forgiveness, respectively, followed by a regulatory framework, and a credible no-bailout commitment may present a reasonable option for stabilizing the most fiscally distressed subnational governments. In India, this could be an option to stabilize budgets in the most indebted states, such as Rajasthan and West Bengal, in exchange for strict control, at least for a reasonable length of time. The TFC calls for rescheduling of existing central government debt of the states and debt waiver linked to states adopting fiscal responsibility laws and eliminating their revenue deficits by 2008-09.

Option 2:

The GoI could immediately enforce a hard budget constraint.

Option 3:

If a state becomes fiscally insolvent, which is a real possibility, the Centre may not be able to hold to a no bailout policy. If so, it may be wise to have a clear set of policies regarding the circumstances under which debt forgiveness will be granted to a state. Such provisions are enshrined in the Financial Emergency provisions of the Constitution, but have never been invoked. It may be advisable to bring a law under the financial emergency provision of the Constitution to define the conditions under which a state may be declared to be in financial emergency and rules for its resolution mandating states to undertake politically difficult reforms, such as restructuring and privatizing SOEs, eliminating subsidies, cutting down on salaries, and undertaking pension reforms to name just a few.

Option 4
Capping the size of contingent liabilities assumed by state governments, and including all contingent liabilities as part of the published quasifiscal deficit.

Recommendation 15
Establish a clear set of policies regarding the circumstances under which debt forgiveness will be granted to a state in the case of fiscal insolvency. It may be advisable to bring a law under the financial emergency provision of the Constitution to define the conditions where a State may be declared to be in financial emergency and rules for its resolution, such as restructuring and privatizing SOEs, eliminating subsidies, cutting down on salaries, and pension reforms to name just a few

Economic Reforms

ISSUE 1: POOR PERFORMANCE OF STATE-OWNED ENTERPRISES

Reforming the management practices and restructuring the finances of SOEs, particularly in the power, irrigation, and transportation sectors is vitally important for improving the fiscal condition of the states and sustaining the performance of India's national economy.

Option 1:
The states could be required either to privatize SOEs or establish an arms-length relationship between the state and the SOEs. In particular, the SOEs must be required to maintain a separate and proper set of books that are subject to annual audit by an independent body or private firm. The Union Government could agree with the states to develop SOE rationalization and/or privatization plans, which would be executed over a period of several years. Incentives and significant penalties should be attached to these agreements.

Option 2:
Impose a hard budget constraint on SOEs and bring greater transparency to SOEs' accounts. This may create the political will to address the problem of insufficient cost recovery and poorly targeted subsidies. Accordingly, SOEs should be subject to a hard budget constraint, meaning that revenues should balance costs. The practice of allowing SOEs to incur operating losses should be immediately discontinued. SOEs should achieve budget balance by increasing tariffs and/or through explicit transfers from state budgets. Electricity boards should end the practice of retaining revenues from the electricity tax and running arrears. Any subsidy from the state to SOEs, implicit or otherwise, could be made explicit. The cost of such subsidies, the intended recipients of the subsidy, and the rationale for the subsidy could be clearly documented in state budgets.

Option 3:
Rationalizing the operations of SOEs along commercial lines and imposing a hard budget constraint may result in one or more states becoming financially insolvent. The Centre should have in place an explicit, transparent, and detailed regime to deal with states that default on loans, accumulate arrears, or otherwise become financially insolvent. They could not be allowed to mask insolvency through such well-known and frequently practised artifices and subterfuges. The proposed regime to restructure state finances in case of loan default should lend credibility to the Centre's determination to achieve its stated objectives, penalize bad behavior by states that are not pursuing genuine reform, and reward good behavior by proactive states that are successfully and earnestly pursuing reforms.

Recommendation 16
The states should be required either to privatize or establish an arms-length relationship with SOEs producing private goods/services. The Union Government should agree with the states to develop SOE rationalization and/or privatization plans, which would be executed over a period of years. Incentives and significant penalties should be attached to these agreements. In the meantime, the SOEs should be required to maintain a separate and proper set of books that are subject to annual audits by an independent body or private firm. Any subsidy from the state to SOEs, implicit or otherwise, should be explicit in state budgets, clearly documenting their cost, intended recipients, and economic and/or social rationale.

Local Governments

Given the population size distribution of the States of India, the lack of greater decentralization to local bodies is a serious shortcoming of the current system. The full benefits of decentralization will not be achieved until local governments are empowered with their own resources and exclusive competencies.

ISSUE 1: LACK OF FULL DECENTRALIZATION TO THE LOCAL LEVEL

Although decentralization is no panacea, many countries have proven that moving political, fiscal, and administrative decision-making closer to the people achieves efficiency gains, better service delivery, and greater accountability.

Option 1:
Each state could be entrusted with the specifics of intergovernmental fiscal relations within the state, as is now the case. However, the institutional arrangements could be monitored to determine that fiscal decision-making power was being passed though according to the intent of the constitutional amendments.

Option 2:
The GoI could legislate a much more defined structure for the relationship between the states and the local governments. This is, for example, the solution adopted by the Russian Federation with the approval of a comprehensive Budget Code in 2002.

Option 3:
The Union Government could get directly involved in fiscal activities (e.g. transfers, with local governments), as is now the case in Australia, the U.S., and several other federal countries to provide local governments with their own resources and allow them to pursue their own objectives more independently from state governments.

Option 4:
Recognizing the diversity of local governments and their variations in scale, tax bases, poverty levels, and administrative capacity, India could take an asymmetric decentralization approach to local governments as far as categorizing them to determine spending, tax, and borrowing authority, as well as reporting requirements. The approach could be augmented by requiring local bodies to prove that they have established the necessary administrative capacity before they are allowed to assume new authority.

Recommendation 17
The GoI could legislate a much more defined structure for the relationship between the states and the local governments. Recognizing the diversity of local governments and their variations in scale, tax bases, poverty levels, and

administrative capacity, India could take an asymmetric decentralization approach to local governments as far as categorizing them to determine spending, tax, and borrowing authority, as well as reporting requirements.

ISSUE 2: EXPENDITURE RESPONSIBILITIES

Setting appropriate expenditure assignments for each tier of government is a crucial component in any decentralization policy, since the design of the other important pieces of the system (notably, revenue, transfers, and borrowing) depend on it.

Option 1:

As previously discussed, a commission or authority could be seated to review the State and Local Body Lists and make recommendations for change. In which case, the focus could be on assigning exclusive assignments to each tier. In a very limited number of cases, there is a need for concurrent assignments. However, such cases could be unbundled into subfunctions which are explicitly assigned to a particular government level. Coordinating bodies could be strengthened or created to deal with the inevitable coordination issues that will arise among the tiers of government.

Option 2:

Administrative capacity may be developed through training and capacity development programs sponsored by the states and the central government. In addition, it would be desirable to introduce an asymmetric treatment whereby only those local governments that can demonstrate sufficient administrative capacity would be delegated additional budgetary autonomy. This may be an incentive for those with lower capacity to take advantage of available training and capacity development programs. To the extent that local governments (particularly urban local governments) are entrusted with more fiscal discretion, the capacity training should be extended to policy areas such as forecasting and general fiscal planning.

Recommendation 18

Designate exclusive subfunction expenditure assignments, insofar as possible and develop the administrative capacity of local governments.

ISSUE 3: REVENUE AUTONOMY

International experience suggests that local governments implementing expenditure functions are more likely to do so responsibly the more they are responsible for raising the revenues they spend.

Option 1:

The best choice to develop tax autonomy at the urban local government level is a modern real estate property tax, with a well-developed fiscal cadastre, fair and efficient valuation or appraisal methods, and a fair and transparent administration of the tax, including efficient appeals procedures. Another way to enhance local tax autonomy associated with the real estate tax is to regulate the voluntary introduction by municipalities of betterment or improvement levies. These are surcharges to the property tax that local governments may approve within their jurisdictions, as one-time or multiyear charges, for improvement directly benefiting certain homeowners, such as improvements in street lighting, sidewalks, and so on. These levies have become common in many developing countries and in some cases represent a significant source of revenue for local governments. Another possibility is to develop a piggyback flat rate payroll tax. Local governments could be given the option of introducing or not their piggyback flat-rates also up to a nationally legislated maximum rate. A final possibility for promoting local tax autonomy is the assignment at this level of some tax on motor vehicles.

Option 2:
Rural local governments are a more difficult case. The need for some autonomy is important to reinforce the GoI's objective of local self-governance. Yet administrative capability at the gram panchayat level is very weak. Still, it is possible to strengthen the property tax, in the form of a rudimentary levy, and to encourage greater reliance on user charges, licenses, and fees. Other forms of taxation, such as presumptive taxes on agricultural income could be explored. States will need to build incentives into their transfer systems to promote increased revenue mobilization by rural local governments.

Option 3:
Certain taxes currently assigned to the states (e.g., electricity tax, entertainment tax, and so on) could be assigned to local bodies.

Option 4:
Local bodies could levy a piggyback tax on wages.

Option 5:
The Central government could issue a model Municipal Act with a minimum revenue assignment for local governments. This minimum revenue assignment to local government should differentiate between urban and rural local governments and go beyond current assignments from states to local governments, which include low revenue yield taxes, such as the property tax, or highly distortionary levies, such as octroi.

Recommendation 19
Provide urban local governments with revenue raising autonomy by allowing them to levy a modern real estate property tax, introduce betterment or improvement levies, and introduce some form of tax on motor vehicles.

ISSUE 4: INTERGOVERNMENTAL TRANSFERS TO LOCAL GOVERNMENTS

The design of transfers is of critical importance for efficiency and equity of local service provision, autonomy, and fiscal health of local governments.

Option 1:
The State Finance Commissions (SFCs) could be required to report on designated features of the state fiscal system. The work of the SFCs could be monitored and evaluated by the Centre.

Option 2:
The Centre could provide direct transfers to local bodies. However, this is not practical given the number of local bodies, particularly rural local bodies.

Option 3:
The states could be required to distribute full entitlements of transfers to the local governments, rather than failing to distribute them in order to preserve the fiscal position of the state.

Recommendation 20
Reform the system of state-local government transfers by phasing out the state-based schemes in favor of block grants and allocate them according to formulae. The Central government should monitor and evaluate the performance of the SFCs

ISSUE 5: BORROWING CONSTRAINTS ON LOCAL GOVERNMENTS

International experience suggests that local borrowing has the potential to generate significant benefits by allowing them to finance public capital projects. However, local government access to credit markets has proven to create significant moral hazard problems.

Option 1:

Local bodies should be subject to a strict golden rule. The Centre and/or states could provide grants for capital projects. Local bodies could be authorized on an application basis to borrow funds on a creditworthiness basis if the following two conditions are satisfied: (i) a local body has the revenue capacity to repay loans; and (ii) a local body demonstrates that it has sufficient administrative capacity.

Recommendation 21

The Centre and/or states should provide conditional grants to local governments for their capital projects. Local bodies should be authorized on an application basis only, subject to statutory limits, to borrow funds on a creditworthiness basis for capital infrastructure projects subject to the following two conditions: (i) the local body has the revenue capacity to repay the loan; and (ii) the local body has sufficient administrative capacity to monitor the proper disposition, management, and repayment of the loan funds.

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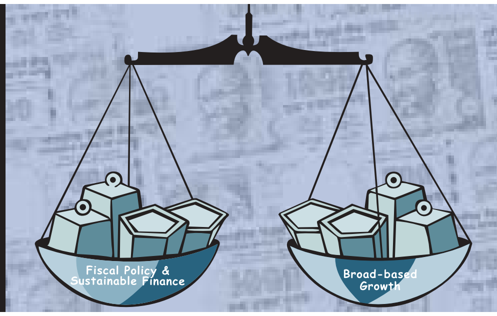


Annexures

Table A.1: Centre: Profile of Fiscal Imbalance (percent of GDP)

Year	Fiscal Deficit	Revenue Deficit	Primary Deficit	Ratio of Revenue to Fiscal Deficit (%)
1990-91	6.61	3.26	2.83	49.36
1991-92	4.72	2.49	0.65	52.72
1992-93	5.33	2.76	0.72	51.73
1993-94	6.43	3.81	2.15	59.21
1994-95	4.74	3.06	0.39	64.60
1995-96	4.23	2.50	0.02	59.16
1996-97	4.11	2.38	-0.24	58.01
1997-98	4.81	3.05	0.50	63.45
1998-99	5.14	3.85	0.67	74.78
1999-00	5.41	3.49	0.75	64.55
2000-01	5.69	4.08	0.93	71.74
2001-02	6.18	4.39	1.47	71.06
2002-03	5.87	4.37	1.10	74.36
2003-04 RE	4.77	3.60	0.27	75.59

Sources:
- Report of the Twelfth Finance Commission (2005).
- Figures for 2003-04 are revised estimates.
- Fiscal deficit figures exclude States' share against small savings.
- Primary deficit is derived by netting interest payments from fiscal deficit.

Table A.2: Major Taxes of the Centre: Performance since 1990-91 (percent of GDP)

Year	Corporation Tax	Income Tax	Customs Duties	Union Excise Duties	Total Central Tax Revenues (Gross)
1990-91	0.94	0.95	3.63	4.31	10.12
1991-92	1.20	1.03	3.41	4.30	10.31
1992-93	1.19	1.06	3.18	4.12	9.97
1993-94	1.17	1.06	2.58	3.69	8.82
1994-95	1.36	1.19	2.65	3.69	9.11
1995-96	1.39	1.31	3.01	3.38	9.36
1996-97	1.36	1.33	3.13	3.29	9.41
1997-98	1.31	1.12	2.64	3.15	9.14
1998-99	1.41	1.16	2.34	3.06	8.26
1999-00	1.58	1.32	2.50	3.20	8.87
2000-01	1.71	1.52	2.28	3.28	9.03
2001-02	1.60	1.40	1.76	3.18	8.20
2002-03	1.87	1.49	1.82	3.33	8.76
2003-04r	2.27	1.45	1.78	3.33	9.20
Year As Percentage of Centre's Gross Tax Revenues					
1990-91	9.27	9.34	35.85	42.58	-
1991-92	11.66	9.99	33.04	41.73	-
1992-93	11.92	10.58	31.86	41.31	-
1993-94	13.28	12.04	29.30	41.85	-
1994-95	14.98	13.03	29.02	40.46	-
1995-96	14.82	14.02	32.15	36.13	-
1996-97	14.42	14.16	33.28	34.95	-
1997-98	14.38	12.28	28.87	34.45	-
1998-99	17.06	14.08	28.28	37.03	-
1999-00	17.87	14.94	28.19	36.04	-
2000-01	19.93	16.84	25.21	36.33	-
2001-02	19.57	17.11	21.53	38.79	-
2002-03	21.35	17.04	20.74	38.06	-
2003-04r	24.71	15.80	19.36	36.24	-

Source: Report of the Twelfth Finance Commission (2005).

Table A.3: Trends in Central Government Expenditures (percent of GDP)

Year	Revenue Expenditure	Interest Payments	Pensions	Subsidies	Capital Expenditures	Total Expenditure
1990-91	12.93	3.78	0.38	2.14	5.59	18.52
1991-92	12.60	4.07	0.37	1.88	4.46	17.06
1992-93	13.76	4.61	0.45	1.78	4.44	18.20
1993-94	12.59	4.28	0.39	1.35	3.92	16.51
1994-95	12.06	4.35	0.36	1.17	3.81	15.87
1995-96	11.77	4.21	0.36	1.07	3.23	15.01
1996-97	11.62	4.35	0.37	1.13	3.08	14.69
1997-98	11.84	4.31	0.45	1.22	3.40	15.24
1998-99	12.43	4.47	0.58	1.36	3.61	16.04
1999-00	12.86	4.66	0.74	1.26	2.53	15.39
2000-01	13.30	4.75	0.69	1.28	2.29	15.58
2001-02	13.21	4.71	0.63	1.37	2.67	15.88
2002-03	13.75	4.77	0.59	1.76	3.02	16.77
2003-04 RE	13.09	4.49	0.55	1.61	4.02	17.11
Average (1990-93)[A]	13.09	4.15	0.40	1.93	4.83	17.92
Average (2000-03)[B]	13.42	4.74	0.64	1.47	2.66	16.08
B-A	0.32	0.59	0.24	-0.46	-2.17	-1.85

Source: Report of the Twelfth Finance Commission (2005).

Table A.4: Explicit Subsidies Relative to Centre's Revenue Receipts (percent of GDP)

Year	Food	Fertilizer	Others	Total
1990-91	4.45	7.98	9.67	22.11
1991-92	4.32	7.85	6.39	18.56
1992-93	3.78	7.82	3.01	14.60
1993-94	7.31	6.02	1.99	15.31
1994-95	5.58	6.32	1.08	12.98
1995-96	4.88	6.12	0.50	11.50
1996-97	4.80	6.00	1.47	12.27
1997-98	5.90	7.41	0.54	13.85
1998-99	6.09	7.76	1.94	15.78
1999-00	5.20	7.30	1.00	13.49
2000-01	6.26	7.16	0.51	13.93
2001-02	8.69	6.26	0.55	15.50
2002-03	10.43	4.75	3.59	18.78
2003-04 RE	9.58	4.48	2.93	17.00

Source: Report of the Twelfth Finance Commission (2005).

Table A.5: Aggregate State Finances: Alternative Deficit Indicators (percent of GDP)

Year	Revenue Deficit	Fiscal Deficit	Primary Deficit	Rev. Def./ Fiscal Def	Debt/GDP
1993-94	0.45	2.35	0.52	19.05	21.79
1994-95	0.69	2.72	0.79	25.55	21.40
1995-96	0.73	2.59	0.76	28.06	21.00
1996-97	1.31	2.77	0.90	47.37	21.00
1997-98	1.23	2.94	0.93	42.01	21.73
1998-99	2.61	4.31	2.24	60.48	23.02
1999-00	2.82	4.64	2.34	60.87	25.20
2000-01	2.61	4.16	1.69	62.60	27.42
2001-02	2.68	4.09	1.41	65.49	29.37
2002-03	2.29	3.94	1.14	58.09	31.15
Averages					
1993-96 [A]	0.62	2.55	0.69	24.22	21.79
2000-3 [B]	2.53	4.07	1.41	62.06	31.15
[B]-[A]	1.90	1.51	0.72	37.84	9.36

Source: Report of the Twelfth Finance Commission (2005).

Table A.6: Aggregate State Finances: Main Fiscal Indicators (percent of GDP)

Year	Own Tax Revenues	Own Nontax Revenues	Finance Commission Transfers	Nonfinance Commission Transfers Revenues	Total Revenue
1993-94	5.30	1.59	3.05	2.02	11.96
1994-95	5.31	1.55	2.86	1.55	11.27
1995-96	5.20	1.51	2.90	1.30	10.91
1996-97	5.01	1.47	2.94	1.29	10.71
1997-98	5.14	1.43	2.90	1.33	10.80
1998-99	4.93	1.26	2.44	1.17	9.31
1999-00	5.09	1.38	2.50	1.29	10.26
2000-01	5.46	1.37	3.02	1.20	11.04
2001-02	5.32	1.19	2.84	1.28	10.63
2002-03	5.52	1.23	2.80	1.22	10.77
			Averages		
1993-96 [A]	5.27	1.55	2.94	1.62	11.38
2000-3	5.44	1.26	2.88	1.23	10.81
[B]-[A]	1.90	1.51	0.72	37.84	9.36
[B]	0.17	-0.29	-0.05	-0.39	-0.57
[B]-[A]					

Source: Report of the Twelfth Finance Commission (2005).

Table A.7: Aggregate State Finances: Expenditure Indicators (percent of GDP)

Year	Revenue Expenditure	Interest Payments	Pension	Plan Revenue Expenditure	Nonplan Revenue Expenditure
1993-94	12.41	1.82	0.61	2.22	10.19
1994-95	11.96	1.92	0.63	2.06	9.91
1995-96	11.63	1.83	0.66	2.01	9.63
1996-97	12.02	1.87	0.72	2.10	9.93
1997-98	12.03	2.01	0.77	1.93	10.10
1998-99	12.41	2.07	0.93	1.99	10.43
1999-00	13.08	2.30	1.16	1.87	11.21
2000-01	13.65	2.48	1.24	1.91	11.74
2001-02	13.31	2.63	1.26	1.85	11.46
2002-03	13.06	2.80	1.24	1.81	11.24
			Averages		
1993-96 [A]	12.00	1.86	0.63	2.09	9.91
2000-3	13.34	2.65	1.25	1.86	11.48
[B]	1.34	0.79	0.62	-0.24	1.57
[B]-[A]					

Source: Report of the Twelfth Finance Commission (2005).

Table A.8: Comparative Performance of States: Revenue and Fiscal Deficits (percent of GDP)

	Revenue Account [Deficit(-)]			Fiscal Account [Deficit(-)]		
States	**1993-96[A]**	**2000-03[B]**	**[B-A]**	**1993-96[C]**	**2000-03[D]**	**[C-D]**
Arunachal Pradesh	24.28	1.76	-22.51	1.48	-12.70	-14.18
Assam	-0.01	-1.90	-1.88	-2.38	-3.73	-1.34
Himachal Pradesh	-1.56	-7.28	-5.72	-6.70	-11.41	-4.71
Jammu & Kashmir	4.56	-1.82	-6.38	-3.85	-8.28	-4.44
Manipur	6.07	-2.46	-8.53	-3.02	-6.06	-3.04
Meghalaya	3.32	0.84	-2.48	-3.20	-5.28	-2.08
Mizoram	7.53	-9.07	-16.60	-5.82	-17.79	-11.96
Nagaland	-0.19	-2.12	-1.93	-5.26	-7.97	-2.71
Sikkim	8.10	11.30	3.20	-8.26	-3.42	4.84
Tripura	2.57	-0.61	-3.18	-4.04	-7.20	-3.15
Total: SCS	1.96	-2.53	-4.49	-7.04	-3.64	-3.40
Andhra Pradesh	-0.51	-2.03	-1.51	-3.16	-4.57	-1.41
Bihar	-1.83	-1.87	-0.04	-2.85	-4.52	-1.67
Goa	1.44	-2.44	-3.89	-2.30	-4.68	-2.38
Gujarat	0.10	-4.66	-4.75	-1.82	-5.74	-3.93
Haryana	-0.75	-1.32	-0.56	-2.50	-3.69	-1.19
Karnataka	-0.07	-2.21	-2.15	-2.71	-4.37	-1.65
Kerala	-1.18	-4.17	-2.99	-3.32	-5.13	-1.81
Madhya Pradesh	-0.61	-2.05	-1.44	-2.16	-3.94	-1.78
Maharashtra	-0.09	-3.09	-3.00	-2.16	-4.12	-1.96
Orissa	-2.00	-4.91	-2.91	-4.63	-7.84	-3.21
Punjab	-1.88	-4.53	-2.66	-4.37	-6.14	-1.77
Rajasthan	-1.09	-3.87	-2.78	-4.51	-6.05	-1.54
Tamil Nadu	-0.71	-2.50	-1.78	-1.99	-3.75	-1.77
Uttar Pradesh	-1.77	-2.98	-1.21	-4.04	-5.07	-1.03
West Bengal	-1.53	-5.47	-3.95	-3.18	-7.31	-4.13
Total: GCS	-0.86	-3.19	-2.33	-2.93	-4.97	-2.04
All States	-0.72	-3.15	-2.43	-2.96	-5.08	-2.12

Source: Report of the Twelfth Finance Commission (2005).

Table A.9: Outstanding Debt Relative to GSDP: State-wise Position (percent)

States	1993-96[A]	2000-03[B]	Col.[B-A]
Arunachal Pradesh	36.48	54.82	18.34
Assam	31.40	34.75	3.35
Himachal Pradesh	41.95	61.79	19.84
Jammu & Kashmir	58.01	55.99	-2.02
Manipur	38.16	47.88	9.72
Meghalaya	24.12	38.68	14.56
Mizoram	53.05	85.29	32.25
Nagaland	42.71	49.91	7.20
Sikkim	53.65	63.24	9.59
Tripura	38.77	38.11	-0.67
Total: SCS	39.68	47.17	7.48
Andhra Pradesh	21.86	29.93	8.07
Bihar	36.80	44.35	7.55
Goa	41.64	33.54	-8.10
Gujarat	21.07	37.92	16.85
Haryana	19.85	28.02	8.17
Karnataka	19.62	27.27	7.65
Kerala	27.27	37.58	10.32
Madhya Pradesh	19.95	30.42	10.47
Maharashtra	15.63	27.11	11.48
Orissa	36.21	63.68	27.47
Punjab	34.55	46.66	12.10
Rajasthan	28.28	44.88	16.60
Tamil Nadu	18.87	26.16	7.29
Uttar Pradesh	33.94	46.94	13.00
West Bengal	23.26	42.73	19.47
Total: GCS	24.12	36.06	11.94
All States	24.86	36.65	11.79

Source: Report of the Twelfth Finance Commission (2005).

Table A.10: Own Tax Revenue: Comparative Performance of the States (percent)

States	1993-96[A]	2000-03[B]	Col.[B-A]
Arunachal Pradesh	0.55	1.47	0.91
Assam	3.69	4.58	0.90
Himachal Pradesh	4.87	5.08	0.21
Jammu & Kashmir	3.11	4.51	1.40
Manipur	1.44	1.21	-0.23
Meghalaya	3.02	3.26	0.23
Mizoram	0.59	0.97	0.38
Nagaland	1.18	1.19	0.01
Sikkim	3.44	4.58	1.15
Tripura	1.95	2.19	0.24
Total: SCS	3.30	3.96	0.66
Andhra Pradesh	5.90	7.30	1.40
Bihar	3.71	4.46	0.75
Goa	7.91	6.46	-1.45
Gujarat	7.51	7.71	0.20
Haryana	7.22	8.30	1.09
Karnataka	8.53	8.33	-0.19
Kerala	8.45	8.11	-0.34
Madhya Pradesh	4.91	6.45	1.53
Maharashtra	6.64	7.76	1.12
Orissa	3.93	5.81	1.87
Punjab	6.88	7.13	0.25
Rajasthan	5.50	6.48	0.98
Tamil Nadu	8.40	9.00	0.60
Uttar Pradesh	4.76	5.88	1.12
West Bengal	5.46	4.26	-1.20
Total: GCS	6.26	6.95	0.69
All States	6.12	6.79	0.67

Source: Report of the Twelfth Finance Commission (2005).

Table A.11: States: Comparative Trends in Expenditure (percent of GDP)

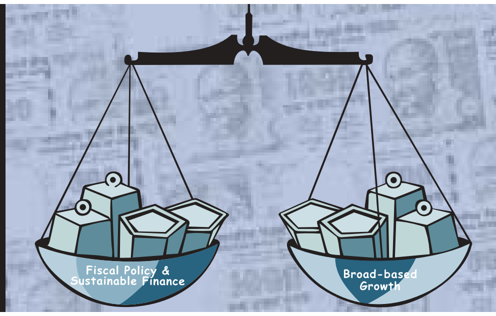
	Revenue Account			Fiscal Account		
States	1993-96[A]	2000-03[B]	[B-A]	1993-96[C]	2000-03[D]	[C-D]
Andhra Pradesh	13.47	15.56	2.08	3.87	2.93	-0.94
Bihar	16.50	18.11	1.60	1.04	2.67	1.63
Goa	17.11	17.25	0.13	3.86	2.33	-1.54
Gujarat	12.52	18.37	5.85	2.37	2.43	0.06
Haryana	13.06	13.45	0.39	2.33	2.52	0.18
Karnataka	13.96	15.33	1.36	3.08	2.44	-0.64
Kerala	14.93	16.11	1.18	2.23	1.07	-1.16
Madhya Pradesh	13.29	16.74	3.45	1.90	2.37	0.47
Maharashtra	10.68	14.10	3.42	2.56	1.47	-1.09
Orissa	16.49	22.22	5.74	2.83	3.23	0.40
Punjab	12.75	15.33	2.59	2.65	2.11	-0.54
Rajasthan	15.43	18.06	2.63	3.89	2.30	-1.59
Tamil Nadu	13.95	15.60	1.66	1.85	1.51	-0.34
Uttar Pradesh	14.28	16.78	2.50	2.63	2.23	-0.40
West Bengal	11.80	15.02	3.23	1.78	1.94	0.16
General Category	13.33	16.05	2.72	2.51	2.12	-0.38
Special Category	26.27	27.66	1.40	5.71	4.69	-1.03
All States	13.94	16.67	2.72	2.66	2.26	-0.40

Source: Report of the Twelfth Finance Commission (2005).

Table A.12: State Expenditure Trends: Comparative Profile (percent of GDP)

	Interest Payment/TRR			Pension Expenditure/GSDP		
States	**1993-96[A]**	**2000-03[B]**	**[B-A]**	**1993-96[C]**	**2000-03[D]**	**[D-C]**
Andhra Pradesh	14.07	22.37	8.30	1.01	1.49	0.48
Bihar	21.78	24.92	3.14	1.01	2.82	1.82
Goa	14.21	19.50	5.29	0.55	1.28	0.74
Gujarat	15.18	24.59	9.41	0.60	1.25	0.65
Haryana	15.26	23.35	8.09	0.54	1.10	0.56
Karnataka	12.08	18.07	6.00	0.92	1.42	0.50
Kerala	17.61	27.34	9.73	1.72	2.57	0.85
Madhya Pradesh	13.34	18.36	5.02	0.67	1.17	0.50
Maharashtra	11.93	20.75	8.82	0.36	0.88	0.52
Orissa	22.39	35.85	13.46	0.68	2.21	1.53
Punjab	32.13	38.51	6.38	0.64	1.62	0.98
Rajasthan	17.38	30.57	13.19	0.73	1.91	1.18
Tamil Nadu	11.98	18.61	6.63	0.93	2.11	1.19
Uttar Pradesh	22.30	28.27	5.97	0.54	1.21	0.67
West Bengal	20.34	44.33	23.98	0.61	1.44	0.83
General Category	16.70	25.40	8.70	0.72	1.51	0.80
Special Category	13.41	16.98	3.57	1.11	2.39	1.28
All States	16.37	24.57	8.20	0.73	1.56	0.83

Source: Report of the Twelfth Finance Commission (2005).



Annexure

Intergovernmental Fiscal Relations in Seven Large Countries

Annexure 1:

Fiscal Federalism in Australia

Table 1A.1: Australia's Descriptive Statistics

	2004
Total Pop. (in mill.)	19.91
Pop. Density per km^2	2.6
Number of Intermediate-level Government Units	8
Number of local-level Government Units (approx.)	774
Coefficient of Variation of Pop. Distribution (in %)	110.83
GDP (USD in Billion)	571
GDP per Capita (PPP in USD)	29,000
GDP Real Growth Rate (in %)	3.00

Sources: CIA, *World Fact Book 2004 (est.).* Retrieved on December 3, 2004 from Internet Web site http://www.cia.gov/cia/publications/factbook/; and the *Australian Bureau of Statistics, http://www.abs.gov.au/*

In Australia, there are currently six states and two territories, and approximately 774 local governments. Australia, and particularly its Commonwealth Grants Commission (CGC), has played a pioneering role in equalisation arrangements. Additionally, Australia has been successful at achieving negative net debt (the market value of financial assets exceeds the market value of state debts) for the aggregate states.

General Overview

In Australia, the share of subnational (state and local) expenditures is 46 percent of all government expenditures, while their share of revenue is only 31 percent of all government revenues (Watts, 2004). This gives rise to a vertical fiscal gap of 15 percentage points for subnational governments. Own-source tax revenue varies widely across states, accounting for 48 percent of total revenues in New South Wales and just 18 percent in the Northern Territory. Similarly, a large proportion of own-source tax revenue (mainly payroll, property taxes) in a state corresponds with a relatively low proportion of Commonwealth grant revenue to that state. New South Wales is the least reliant on Commonwealth grants with 32 percent of its total revenue coming from Commonwealth grants, while the Northern Territory relies on 67 percent of total revenue from Commonwealth grants (OECD, 1997a). Total federal transfers to SNGs are 45.3 percent of total subnational revenues (or 27 percent of total Commonwealth expenditures), while 21.3 percent of total subnational revenues are in the form of conditional transfers assigned for specific services such as health, education, roads and housing. Between 1990 and 1995, Australia's ratio of aggregate net debt to GDP grew from 10 to 25 percent. However, the figures have improved in recent years and state general government sector net debt is expected to be approximately—1.2 percent of GDP in 2004-05.

Expenditure Assignments

The Australian National Government has exclusive responsibility under the Constitution for the administration of a wide range of functions including defense, foreign affairs and trade, and immigration. State and territory governments (referred to as 'State' governments in tables in this Chapter) perform the full range of government functions, other than those the Constitution deems the exclusive domain of the Australian Government. The functions mainly administered by state and territory governments include public order, health, education, administration, transport and maintenance of infrastructure. Shared expenditure responsibilities between the national and state governments are mainly in education, health and transportation.

Local government authorities govern areas typically described as cities, towns, shires, boroughs, municipalities and district councils. Although the range of functions undertaken by local governments varies between the different jurisdictions, their powers and responsibilities are generally similar and cover such matters as: the construction and maintenance of roads, streets and bridges; water, sewerage and drainage systems; health and sanitary services; the regulation of building standards; and, the administration of regulations relating to items such as slaughtering, weights and measures, and registration of dogs. Local governments also provide transport facilities, hospitals, charitable institutions, recreation grounds, parks, swimming pools, libraries, museums and other business undertakings.

Revenue Assignments

The Constitution has been of little assistance in the assignment of tax powers in Australia. Section 51 of the Constitution assigns concurrent taxing powers to the Commonwealth and states, except in the imposition of duties of customs and excise, which are exclusive to the Commonwealth. Thus, the states can legally have access to any tax base, including income taxation. However, despite the taxing powers granted by Constitution, the Commonwealth has been able to rely on High Court rulings based on certain sections of the Constitution to effectively prevent the states from fully exploiting their tax autonomy potential. A distinctive feature of the Australian Federal System is that the Australian Government levies and collects all income tax, from individuals as well as from enterprises. It also collects a significant portion of other taxes, including taxes on the provision of goods and services such as the Goods and Services Tax (GST). The Australian Government distributes part of this revenue to other levels of government, principally the states and territories.

The revenue base of state and territory governments is narrower than that of the Australian Government and consists of taxes on property, on employers' payrolls, taxes on financial and capital transactions, taxes on gambling, insurance taxes, and motor vehicle taxes. This revenue base is supplemented by grants from the Australian Government, which includes an allocation of GST revenue. Local governments' own-source revenue is derived mainly from immovable property taxes. They also rely on grants from the Australian Government and their parent state governments. The Australian Capital Territory has no separate local government.

In a tax reform in 2000, the Federal Government created a new VAT tax, the Goods and Services Tax, where all proceeds would go to the states as unconditional equalisation transfers. The payments of financial assistance grants and revenue replacement payments to the states ceased at the same time. In addition, the states agreed to give up a range of state taxes and to reduce tax rates on gambling. Although the Commonwealth Grants Commission is responsible for making recommendations on the state relativities for transfers, the arrangements are subject to overview by a federal-state ministerial council, including any changes to the rates (Watts, 2000, p. 61). Moreover, the Commonwealth is now required to provide Budget Balancing Assistance for a number of years to ensure that no state is financially worse off under the GST-related changes.

Intergovernmental Transfers

The merits of vertical fiscal imbalance (VFI) have long been debated in Australia. The issue became more prominent with the introduction of the GST. This was associated with an increase in VFI since under the agreement that the states receive all GST revenue, the states agreed to abolish or reduce some taxes. The Federal Government controls about three-quarters of the total federal-state-local revenues. Since state and local governments are constitutionally responsible for nearly half the total public expenditures, the system depends heavily on transfers from the federal to the state governments to close the vertical fiscal gap. The gap between state own-revenue and spending is filled by Commonwealth grants in the forms of general purpose payments and specific purpose payments (SPPs).

Since 1933, Australia has been an influential model of equalisation arrangements, particularly through the evolution of equalisation arrangements through the Commonwealth Grants Commission (Watts, 2004). Since 2000, equalisation arrangements are based on relativities to distribution of the central GST tax. The CGC allocates transfers based on a calculation of revenue capacity and expenditure needs from comparisons of 18 revenue categories and 41 expenditure categories (Watts, 2004, p.102). Table 4 AI.2 shows the per capita distribution of the principal forms of grants to the states—unconditional allocations from GST revenues and Specific Purpose Payments .

From the Table 1A.2, three out of the eight states and territories receive less than the average per capita share of GST revenues. In addition, four states and territories receive lower than average per capita share of SPPs. The introduction of the GST and the associated arrangements provide that no state budget would be worse off as a result of the GST and related measures. However, total GST revenue received by the states is less than the sum of state revenue foregone and additional expenditure responsibilities. The Commonwealth is currently funding the shortfall through Budget Balancing Assistance. To date, there have been no changes to the extent or nature of SPPs or the arrangements for allocating general revenue assistance (CoA, 2001).

Table 1A.2: Distribution of GST Revenue and SPPs in Australia, 2001-02 (USD per capita)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Australia
GST	1267	1198	1422	1373	1688	2316	1737	6666	1410
SPPs	1007	1017	972	1152	1040	4060	1096	2122	1034

Source: Twelfth Finance Commission Report (2005).

On a practical level, there are some issues around the fiscal equalisation process in Australia. First of all, the CGC process is very complex, with documentation of up to two thousand pages. Despite many years of CGC and close examination by the states, there continues to be intense debate and analysis about the quantification of expenditure and revenue needs. Regardless of the '"policy neutrality" objective of fiscal equalisation, it has been suggested that states, in the long term, can influence their population's needs for services, and their capacity to raise taxes and royalties. The CGC treatment of SPPs also raises controversy. The current system identifies over 120 separate SPPs, many of which contain subprograms. Concerns are raised about the efficiency of maintaining large number of small SPPs, and the involvement of the Commonwealth in determining priority areas where states have exclusive responsibility under the Constitution.

Subnational Borrowing

In 1927, the Commonwealth and the government of the six states entered into a financial agreement to coordinate and centralize their borrowings. The Loan Council was then created which coordinated all subnational borrowing. However, some exceptions in the 1929 legislation allowed the states to utilize semigovernment or local government authorities to effectively borrow for them, with some of the resulting funds appearing in their consolidated revenues. The 1980s brought about an increase in "off-program-borrowing" activities at all levels of government. Thus, state budget constraints had been softened.

The Loan Council was reconstituted in 1993, operating largely under voluntarily agreed upon arrangements rather than legislated provisions of the earlier agreement (Courchene, 1999). States are now able to operate with more flexibility by the issuance of securities in their own name, and the greater reliance upon the market has diminished the Council's role and influence (Ter-Minassian and Craig, 1997). Under the agreement, the Commonwealth would not only cease borrowing on behalf of the states, but the states would make accelerated Sinking Fund contributions such that all Federal debt outstanding for the States would be fully redeemed by 2005-06 (James, 2001). The Loan Council traditionally meets annually in March to consider jurisdictions' Loan Council Allocation nominations for the forthcoming year. As part of these arrangements, the Loan Council considers these nominations, having regard to each jurisdiction's fiscal position and the macroeconomic implications of the aggregate figure. The Loan Council Allocation is a headline measure of a government's call on financial markets.

As part of the reform, jurisdictions are also required to improve the frequency and openness of their financial reporting, not only to permit monitoring of their financial activities but also to provide more reliable information to the financial markets (James, 2001). For example, the State of Victoria requires that the State Treasurer include a statement of risks in its annual and semiannual budget reviews presented to Parliament and the public. This statement describes the factors that could have a significant impact on the fiscal outcome of the State.

Currently, many states have greatly reduced their levels of general government net debt over the past decade. Aggregate state general government net debt is estimated to be -1.7 percent of GDP by 2006-07. This reflects that an increasing number of states are forecasting to be in a net financial asset position in their general government sector by 2006-07 (CoA, 2004).

Conclusion

The high degree of vertical fiscal imbalance that is evident in Australia can be attributed to the fact that the Commonwealth Government has captured all major tax bases. According to Watts (2004), however, the tax reform of 2000 and the new equalisation arrangements have delivered a reform that supports the financial security of the states, reduces the inefficiency in the tax system with the removal of some minor state taxes, and introduces an exclusive degree of codecision in fiscal arrangements and tax policy. From 2004-05 onwards, the Australian Government expects that no state will require Budget Balancing Assistance. In addition, all states forecast an increase in their fiscal balances, and the aggregate states have reached a negative net debt position. Most states are also set to continue the trend of reducing nonfinancial public sector net debt.

Despite all the improvements in the Australian States fiscal health, the changes in the tax reform increased an already high dependence of the states on the Commonwealth, and this dependence is likely to increase further as the GST is projected to grow faster than most state taxes (CoA, 2001). The current debate involving the Commonwealth and the states recognizes the need for some decentralization and revenue autonomy for the states.

Annexure 2:

Fiscal Federalism in Brazil

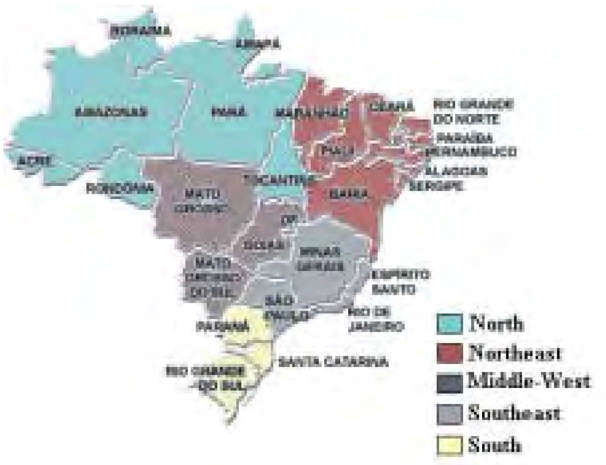


Table 2A.1: Brazil's Descriptive Statistics

	2004
Total Pop. (in mill.)	184.1
Pop. Density per km^2	21.6
Number of Intermediate-level Government Units	27
Number of Local-level Government Units (approx.)	5,559
Coefficient of Variation of Pop. Distribution (in %)	121.33
GDP (USD in billions)	1,375
GDP per Capita (PPP in USD)	7,600
GDP Real Growth Rate (in %)	-0.20

Sources: CIA, World Fact Book 2004 (est.). Retrieved on December 3, 2004 from internet Web site http://www.cia.gov/cia/publications/factbook/Statoids Brazil, http://www.statoids.com/ubr.html

Brazil is a highly decentralized federation with 27 states (including the Federal District) and 5,559 municipalities (Afonso and de Mello, 2000). Brazil has had a long history of federalism and is considered one of the most decentralized countries in the developing world (Rodden, 2003). Brazil is a presidential democracy with a bicameral legislature: the lower chamber of Congress (Chamber of Deputies) consists of 513 members and the Senate consists of three senators from each state. While the overrepresentation of small states in the upper legislative chamber is a central feature of most federal democracies, this asymmetry is especially severe in Brazil and applies to both chambers (Stephan, 1999; Samuels and Snyder, 2001). In comparative perspective, party discipline is extremely weak in Brazil, and the legislature is extremely responsive to strong regional groups, especially the governors (Rodden, 2003). As discussed in greater detail below, weak party discipline and responsiveness to regional as opposed to national interests is a major contributing factor to the lack of fiscal discipline among the States of Brazil.

General Overview

In Brazil, SNGs account for approximately 60 percent of total government spending. In 2002, the total fiscal burden accounted for 35.5 percent of GDP, of which 68.8 percent was collected by the Federal Government, 26.6 percent by state governments and 4.7 percent by municipal governments. Available revenue—own tax revenue plus revenue transferred through the sharing system—was distributed as 60.5 percent, 24.7 percent and 14.8 percent of total fiscal burden, respectively. Taking into account specific grants, municipalities were assigned around 19 percent of total tax revenue (including social contributions), while almost 54 percent was left to the Federal Government. Municipal revenues account for approximately 17 percent of total revenues, but only 5.5 percent excluding revenue-sharing transfers from the Federal and state governments.

The tax system is currently affected by distortions in the state VAT, the ICMS, which is administered and collected differently in each one of the 27 Brazilian States (Guardia and Sonder, 2004). Federal Government transfers vary considerably from one state to another, ranging from 10 percent to about 80 percent of their funding. The North and Northeast are large net receivers of resources, while the Southeast is the main provider of revenues to the poorer regions (Guardia and Sonder, 2004). Municipalities are extremely transfer dependent with over 75 percent of municipal expenditures funded by transfers from Federal and state governments.

Brazil has undertaken three rounds of subnational debt rescheduling in the last two decades. Subnational net debt is approximately 14 percent of GDP. According to Rodden (2003), Brazil was forced to deal with one of the most serious and persistent debt problems in the world.

The 1988 Constitution is considered a benchmark in Brazilian Federalism, in which greater autonomy was granted to states and municipalities in tax, debt, and expenditure management and control (Afonso and de Mello, 2000). In addition, the enactment of the Fiscal Responsibility Act of 2000 is considered a major step towards imposing a hard budget constraint on the States of Brazil. Yet, the Constitution and the basic structure of intergovernmental relations undermine the essential mechanisms to impose fiscal discipline.

Expenditure Assignments

Expenditure responsibilities are enumerated in the 1988 Constitution. Federal exclusive areas of responsibilities found in the Constitution include national defense, common currency, interstate commerce, and national highways. These assignments are generally consistent with the normative principles for expenditure assignment to the Central government. Municipalities have become important elements of federalism in Brazil, primarily due to their active role in service delivery granted in the 1988 Constitution, specifically intracity public transportation, preschool and elementary education, preventive health care, land use, and historical and cultural preservation.

The Constitution does not itemize exclusive responsibilities for the states. The "joint" responsibilities to the Federal and state government include some very important spending areas, such as health, education, environmental protection, agriculture, housing, welfare, and police. According to the Constitution, the Federal Government sets the standards and state governments deliver the services. Lastly, the Constitution grants states "all powers not otherwise prohibited in the Constitution."

Although the Constitution grants a high degree of fiscal and budgetary autonomy to the states, it does a poor job of defining exclusive assignments. Instead, it lists a variety of shared responsibilities for Federal and state governments. In practice all three levels act in an uncoordinated fashion leading to confusion and disorder in service delivery (Rodden, 2003). However, the 1988 Constitution has seriously restricted states' ability to control personnel costs by prohibiting states for dismissing redundant civil servants or reduce salaries in nominal terms.. Given the importance of these costs in state budgets, it is very difficult for the states to make adjustments when fiscal conditions require spending cuts. The Fiscal Responsibility Law of 2000, as discussed in greater detail below, includes a number of provisions to limit payrolls as a share of total expenditure.

Revenue Assignments

The Constitution grants taxation authority to the three levels of government. Some taxes are exclusive to one level; others are collected at the Federal level and shared with states and municipalities, and others are collected by states and shared with their municipalities. The rates and rules of various taxes are determined federally, including some state and local levied taxes. The Federal Government assumes exclusive taxing power on personal income (IRPF), corporate income (IRPJ), payroll, wealth, foreign trade, banking, finance and insurance, rural properties, hydroelectricity, and mineral products (Rodden 2003). The Federal Government also administers a type of VAT tax, the IPI (*Imposto Sobre Produtos Industrializados*), which along with revenues from income taxes and rural properties must all be shared with state and local governments.

States play an important role in raising revenue. They are responsible for levying the largest revenue producing tax in the country, the VAT or ICMS, which accounts for 23 percent of total tax burden. The states are also assigned the power to tax motor vehicles, estate and gift taxes, and personal and corporate income tax using supplementary rates up to 5 percent. Lastly, municipalities were benefited with the changes in 1988 through assignments of wider tax bases and increases in revenue-sharing transfers. They levy taxes on services (ISS—*Imposto Sobre Servicos*), urban properties, retail sales of fuels, property transfers, and special assessments (Rodden, 2003).

To this day, Brazilian States along with Canadian provinces are the only known subnational units that administer their own value-added tax (Rodden, 2003b). Generally, this type of tax is assigned to the central government or used in unitary countries. Although Brazilian States obtain most of their own-source revenues from this tax (nearly 85 percent), it has resulted in a series of complex technical and administrative problems concerning the application of different VATs in different states, in addition to a federal VAT (IPI). In addition, the bases for the federal IPI, the states' ICMS, and the local governments' ISS overlap, leading to confusion and inefficiency.

IPI and ICMS are partial taxes, the former on manufactured goods only and the latter on all merchandises but not on services in general. They are highly selective, thus applying different rates to different goods.[1] In the case of the ICMS, the rate for any particular good varies among states, but interstate transactions are subject to two different rates (according to the region) set by the Federal Senate (Varsano, 1999).[2] In addition, individual states are capable of granting exemptions and other preferential treatments to favored sectors, as long as they have been unanimously approved by a committee of the Secretaries of Finance of the States (CONFAZ). In practice, logrolling among committee members occurs thus complicating the administration and increasing the burden of interstate commerce (Rodden, 2003b).

[1] There may be approximately 40 different rates (Guardia and Sonder, 2004).

[2] The applicable rate depends on the origin and destination of the trade flow. Transactions originating in the South and Southeast Regions (richer), except for Espíritu Santo, are taxed at 7%; all others at 12%. In addition, interstate trade with fuel and electric energy are zero-rated; and exports from anywhere in the Manaus Free Trade Zone and, under certain conditions, to Western Amazon are also zero-rated. See Varsano, 1999.

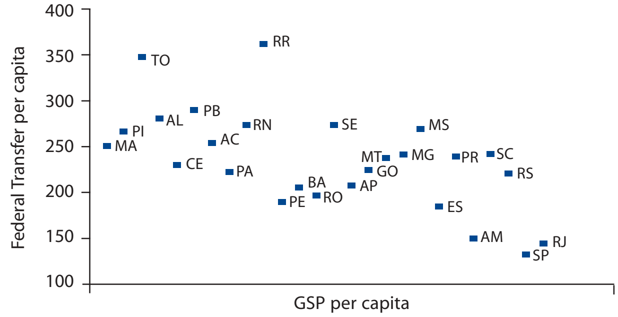
The major difficulty with the ICMS is the treatment of interstate transactions. According to Guardia and Sonder (2004) the two main issues concerning VAT taxes in interstate trade are as follows: where the tax is collected (at the state of origin or destination), and who gets the revenue (to the state of origin or destination). In Brazil, the ICMS is origin-based, which privileges net exporters in interstate trade, in this case the more developed states of the South. Although the system is strictly origin-based, in practice, the tax is shared among states, as both the origin and destination states collect the respective tax. The portion of tax revenue allotted to each state depends on the difference between the rates applied to internal and interstate transactions. For example, in an interstate transaction from the North to the South, the state of origin collects 12 percent. The state of destination absorbs the credit of the tax paid and collects the tax from the final consumer at the local rate of 17 percent (in this scenario) when the product is sold. According to Guardia and Sonder (2004), this is considered a transfer mechanism via the tax system.

States also compete vigorously, sometimes illegally, to attract industries by offering lower tax rates and exemptions for producers. This difference in rates advantages poorer states and creates incentives for "fiscal wars." Fiscal wars reduce the tax base, burden interstate commerce, complicate tax administration, and worsen interstate income disparities (Rodden, 2003). To the extent that the ICMS is an origin based tax, it allows states to export their tax burdens on to others. In particular the producer states in the South are able to export their tax burdens to the consumer states in the North and centre. Generally speaking, the ICMS is a poorly conceived and inefficient tax.

Intergovernmental Fiscal Transfer System

Although the overall vertical fiscal imbalance in Brazil seems to be low compared to other countries, the figures vary greatly from state to state. In large and wealthy states of the Southeast, the ICMS tax revenue is the principal source of state revenue, and it gives these States an independent fiscal base. In smaller and poorer states in the North and centre, however, the ICMS is not nearly enough to grant them fiscal independence. Thus, poorer states rely heavily on intergovernmental transfers. In the 1990s, for example, Sâo Paulo depended on federal transfers for only 7 percent of its revenue, while for Acre the transfer dependency rate was 75 percent. Municipalities depend on transfers for nearly 75 percent of their expenditures (Rodden, 2003). Revenue is transferred to states and municipalities by constitutionally-mandated revenue sharing arrangements and by nonconstitutional specific purpose transfers, for which there are five types of transfers as described in Guardia and Sonder (2004). The Constitution stipulates that states and municipalities spend at least 25 percent of all tax revenues on education.

Figure 2A.1 Federal Transfers to States in Brazil, 2003



Source: IBGE.

The first three types have no horizontal redistributive effects.[3] The first two revenue transfers represent the centrally collected taxes that the Federal Government gives back to the states as *devolution*, or for taxes that could have been collected as *compensation*. In these transfers, states are mainly compensated for the exemption of VAT from exports (states receive 75 percent and municipalities 25 percent). The third type is an intrastate redistribution of resources with criteria different than revenue collection capacity, thus horizontally neutral. Part of this transfer is the Education Fund (FUNDEF), which is ICMS revenue sent to the Federal Government and transferred to municipalities to invest in basic education and teachers training.

The fourth type of transfer is aimed at reducing regional differences in income disparities. These are legally mandated and represent a very large allocation of resources. These include the State and Municipal Participation Funds (FPE and FPM), which are funded 21.5 percent and 22.5 percent respectively, from the centrally collected income taxes (IRPF and IRPJ) and the VAT (IPI). The coefficients of horizontal distribution, however, are the result of political bargaining and do not show a clear relation with either relative tax capacities and tax efforts or expenditure needs of the individual states and municipalities, see Figure 2A.1 (Ter-Minassian and Craig, 1997). The last type of transfer is a federal grant to states and municipalities for specific purposes. These voluntary transfers are not regulated by law and have generally been negotiated between governments. Thus, they are often provided to the most politically powerful and the wealthiest states.

Subnational Borrowing

As a result of the crises of the 1990s, Brazil has taken important steps to prevent excessive subnational deficits and mismanagement of debt. The Fiscal Responsibility Law and the Penal Law for Fiscal Crimes of 2000 is the main step towards fiscal adjustment and hard budget constraints. This law sets limits on current spending, ceilings on borrowing, multiyear budget targets, and limits on loan guarantees (Haggard and Webb, 2004). The limits on public debt as a percentage of current receipts are 3.5 for the Federal Government, two times for states, and 1.2 times for municipalities. If the ceilings are exceeded, measures must be taken within 12 months.

The law also specifies a golden rule in which credit operations cannot exceed capital expenses. In addition, the law grants the President the responsibility to set debt limits to all levels of government, with the penalty of being prohibited from any internal and external operation in case of violation of the law. The law seeks to address the severe election-year expenditure spikes. Personnel expenditures may not be increased less than 180 days before the end of the executive's tenure in office. Furthermore, personnel expenditures cannot exceed 60 percent of total state expenditure. In order to undertake any financial obligation during an election year, the executive must prove that sufficient cash resources are available to repay in the same year, and credit operations based on anticipated revenues are prohibited during election years.

The Penal Law for Fiscal Crimes of 2000 attempts to improve the transparency of the central bank's operations prohibiting them from exchanging

[3] Horizontal redistribution refers to the purpose of equalizing revenues of richer and poorer states.

Box 2A.1: Brazilian Fiscal Responsibility Law (2000) Provisions

The Fiscal Responsibility Law (FRL) of May 2000 passed in Brazil is considered the most comprehensive and effective stabilization program implemented to date. This Law is a mixture of policies aimed at reducing public sector deficits, debts, and to discourage subnational borrowing. Article 35 of this Law prohibits the central government from bailing out any member of the federation.

The key provisions of the legislation are:

- ***Limits on current spending****:* outlays on payroll (including social security benefits, pensions, and payments to subcontractors) cannot exceed 50 percent of net revenues for the Federal Government (60 percent for subnational governments). Subceilings also apply to personnel outlays in the executive, legislature, and the judiciary;
- ***Ceilings on borrowing:*** provided in the legislation; actual ratios set by the Senate in a separate legislation. Authorization from Senate is required for borrowing, subject to technical approval from the Central Bank. Borrowing is prohibited in all subnational jurisdictions (including the Federal District) in a 180-day-period before the end of the incumbent's office;
- ***Multiyear Budgets***: required by law including three-year targets for revenue, expenditures, and indebtedness. The law does not set the limits but governs monitoring, and sanctions on noncompliant jurisdictions (i.e. ban on discretionary transfers and federal guarantees) and the incumbent (i.e. fines, loss of office, ban on reelection, etc.). Civil society is required to take part in the budget process at all levels of government; and
- ***Other:*** ceilings for borrowing related to capital expenditures follow the ***"golden rule."*** Other ceilings are based on debt service, and outstanding debt stock with respect to revenues.

Enforcement mechanism do not only include fiscal sanctions, fines and impeachment, but also nullifications of contracts or administrative decisions and prison terms ranging from three months to four years. Although it is still too early to measure the results of implementing the FRL, the clear legal sanctions are expected induce more compliance and introduce greater responsibility.

Sources: Rezende and Afonso (2002), and Gomez (2004).

debt securities of the states for federal public debt securities (Rodden, 2003). The law includes prison sentences for illegal efforts to issue public bonds. From year 2000 to 2002, 18 states improved their primary surplus, 8 states turned from deficit to surplus, and only 3 states reported primary deficits in 2002 (Guardia and Sonder, 2004).

Conclusion

There is no doubt that the 1988 Constitution has strengthened the Brazilian Federation. Although the Constitution provides more autonomy to subnational levels of government, other political, economic, and judicial forces restrict this autonomy. In addition, the Constitution lacks exclusive assignments to state level governments, as well as precise responsibilities on concurrent assignments to each level of government, which are crucial to efficiency in service delivery and accountability. The fact that concurrent responsibilities for education, health, and social protection are granted to both the Federal and state governments, gives voters little information about who is accountable for the performance of these services.

Proposed solutions to the problems associated with the ICMS have been under discussion since 1995, when the President proposed to Congress an amendment to the Constitution (PEC 175/95). Among these proposals include the simplification of the ICMS tax through centralization of tax collection and a reduction in number, complete abolishment of a subnational VAT, and improvements to the current VAT system. Discussions about tax reforms are still in progress in Brazil.

The main elements for Brazil's fiscal adjustments have been the refinancing of SNGs' debt by the Federal Government, imposition of a credible program of fiscal adjustment, and the legal prohibition of future bailouts with the establishment of the Fiscal Responsibility Law (FRL). However, senators are managing the enforcement aspect of the FRL. As previously noted, the senators are generally loyal to the region that they represent and party discipline is weak. Therefore, it is almost impossible to use the Senate as an effective enforcer of the law when it directly involves coalitions of politicians that are accountable to state interest groups (Rodden, 2003b). Nevertheless, the Federal Government's ability to commit to a no bailout policy is crucial in the success of the new institutions.

Overall, the Brazilian Constitution does not provide the information or the incentives to hold states accountable for their fiscal activities; the Senate does not have the right incentives to enforce the fiscal laws; and all levels of government are guided by the wrong political incentives. Although it is still too early to judge the performance of the new fiscal laws, the greatest challenge will be for voters to have the power to punish fiscally irresponsible representatives, who are believed to be the ones most likely to impose the hard budget constraints. Traditionally, however, voters have rewarded politicians who are able to attract national spending to their region, and the politicians have been successful in putting the onus on the central government to assume state debts.

Annexure 3:

Fiscal Federalism in Canada

Table 3A.1 Canada's Descriptive Statistics

	2004
Total Pop. (in mill.)	32.51
Pop. Density per km^2	3 3
Number of Intermediate-level Government Units	13
Number of local-level Government Units (approx.)	5,600
Coefficient of Variation of Pop. Distribution (in %)	198.91
GDP (USD in Billion)	959
GDP per Capita (PPP in USD)	29,800
GDP Real Growth Rate (in %)	1.70

Sources: CIA, World Fact Book 2004 (est.). Retrieved on December 3, 2004 from Internet Web site http://www.cia.gov/cia/publications/factbook/Statistics Canada available at http://canstat.net

The Federation of Canada is composed of 10 provinces and three territories (created and structured by federal legislation), in addition to nearly 5,600 municipalities.[4] Canada is not only considered one of the most decentralized countries in the world, but it is also considered a country where SNGs are most effectively subject to hard budget constraints (Rafuse et al, 2003). In the discussion below, we highlight those features of Canada's federal system that contribute to fiscal discipline among SNGs.

General Overview

In Canada, SNG spending represents nearly 60 percent of total public spending. The Federal Government accounts for the remaining 40 percent of total public spending. Both federal and provincial levels have broad tax bases. Provinces' exclusive taxes amount to nearly 53 percent of total spending, while it accounts for 56 percent after taking into account intergovernmental transfers. Provinces can set their tax rates and tax bases, thus they raise most of their revenues from own sources. In practice both federal and provincial levels depend mostly on personal, corporate and consumption taxes.

Depending on the province, intergovernmental transfers from the Federal Government can range between 10-12 percent to nearly 40 percent of their revenues. However, the overall share of provincial revenues from federal transfers has declined over the last four decades from 17 percent in 1980 to nearly seven percent in 1999 (Broadway and Watts, 2000). Finally, provinces mostly have "self-imposed" balanced budget rules which have resulted in nearly seven consecutive years of surpluses not only at the subnational level but also at the federal level. Only since the mid 1990s have the provincial governments begun to design and implement fiscal retrenchment programs, which will be discussed in more detail later.

[4] Information obtained from Canada Census Statistics 2001, retrieved on December 21, 2004 from internet Web site http://www12.statcan.ca/english/census01/products/standard/popdwell/Table-CD-PS2.cfm.

Expenditure Assignments

The Canadian Constitution enumerates the powers of the Federal and provincial governments. Territories enjoy the same power as provinces while under the Federal Government's jurisdiction. Municipalities are under provincial jurisdiction and their powers are listed in provincial legislation. Responsibilities exclusive to the Federal Government include money and banking, international trade, airlines, railways, foreign affairs, defense, and unemployment insurance, while education, health, social welfare, police, natural resources, and highways are exclusive to the provinces (Shah, 1995). There are four concurrent powers to the federal and provincial governments in the following areas: exporting nonrenewable natural resources, forestry resources and electrical energy, old age pensions and benefits, agriculture, and immigration (Broadway and Watts, 2000). Local governments are more directly involved in service delivery providing roads, sidewalks, street lights and bridges, regulation of urban transit, water and sewage, waste disposal, urban planning and regulation of land use (OECD, 1997).

Revenue Assignments

The Constitution Act of 1982 extended taxing powers to the provinces which currently enjoy overlapping taxing responsibilities with the Federal Government in all areas except customs, unemployment insurance premiums, and contributions to the Canada Pension Plan (Shah, 1995). This system has led to a harmonized administration of taxes between the federal and provincial levels. Under federal-provincial tax collection agreements, the Federal Government currently collects corporate income taxes for seven provinces and personal income taxes for nine provinces (Rafuse et al, 2003). Provinces have autonomy over setting their tax rates and bases, but most provincial income taxes are collected by the Federal Government with the condition that the provincial base be the same as the federal base. Municipalities, in contrast, are limited to taxation of real property, and all forms of revenue must have provincial/territorial authorizations. Municipalities derive additional revenues from licenses, permits, rents, and fines, and more than 50 percent of their revenues are in the form of grant transfers (OECD, 1997b).

Canada's Subnational VAT System

Canada represents an interesting case of a sales tax system. There is a federal VAT, the Goods and Services Tax (GST) throughout the country; and a provincial VAT in most parts of Canada, the Provincial Sales Tax (PST). Canada offers a variety of interesting situations: separate federal and provincial VATs administered provincially, joint federal and provincial VATs administered federally, and separate federal VAT and provincial Retail Sales Tax administered separately. The GST at the present time is not harmonized with the provincial retail sales taxes except in the province of Quebec (Bird, 1999).

In pursuit of developing a more uniform national sales tax system, the Canadian Federal Government and three small eastern provinces (Newfoundland, Nova Scotia and New Brunswick) introduced a so-called Harmonized Sales Tax (HST) in 1997. The HST system consists in replacing the previous federal and provincial sales tax systems with one harmonized VAT and one sales tax base; a combined federal-provincial rate of 15 percent in the three participating provinces; and federal administration of both federal and provincial sales taxes. The new combined rate consists of the seven percent GST and a provincial rate of eight percent (applicable to a base excluding the GST). HST revenues are then shared on the basis of province-specific consumption patterns, in accordance with allocation formulae developed jointly by the Federal Government and the provinces. Interprovincial trade is handled as under the Quebec Sales Tax (QST), discussed below (Bird, 1999). While this arrangement serves the Federal Government's objective of simplifying tax rate variation to save on administration and compliance costs, it hinders the tax autonomy of participating provinces.

The Quebec Sales Tax and GST, as they now exist, constitute an operational "dual VAT" system with none of the problems usually associated with such systems. The QST arrangement thus seems closer to a solution: there is a single administration; there is basic conformity on all important aspects of the dual VATs that might affect compliance costs; and there is complete autonomy in rate setting—and, to a limited extent, even in granting exemptions to final consumers, if desired (Bird and Gendron, 1998). Taxes on interprovincial sales from one business to another are basically handled by a deferred-payment destination-based system. Exports from Québec, whether to another province or another country, are zero-rated. Imports into the province from other provinces, or from abroad, are taxable, but the tax is assessed on interprovincial imports only when there is a sale by a registered trader to an unregistered trader or consumer in the province. Although special regimes apply to automobiles and a few other cases, in general, no attempt is made to collect tax on interprovincial purchases made directly by final consumers (Bird, 1999). Thus, the only functioning destination-based subnational VAT now in existence, to the best of our knowledge, is that in the province of Québec.

Intergovernmental Fiscal Transfer System

As previously noted, the share of provincial revenues from transfers has declined in the past four decades. Currently, provinces raise most of their funds from own-source revenue, and overall federal transfers account for only 13 percent of provinces' total revenues. However, the figures vary greatly from 10-12 percent in the higher-income provinces to nearly 40 percent in the lower-income provinces. Fiscal responsibility in Canada has become more decentralized than in other established federations where subnational governments rely more heavily on federal transfers. This can be attributed to the fact that provinces have access to all main broad-based taxes, and they are able to set their own rates. In Canada the primary goal of intergovernmental fiscal transfers is to maintain minimum national standards in provincial-local public services, thus, compensating for vertical and horizontal imbalances between provinces.

This has led to developing two types of transfers between the federal and provincial governments. The fist type is known as conditional transfers because they require certain conditions of spending. Any province can be eligible to receive them, allowing the Federal Government to influence the provinces through these transfers, which are outside its constitutional jurisdiction. The second type, unconditional block transfers, are made to low-income provinces. Their purpose is to provide a minimum national standard of public services. The major two are the Canada Health and Social Transfer (CHST) and Equalisation Transfer. The CHST is provided to fund health, post-secondary education, and social services according to provincial priorities. Equalisation transfers are under constitutional provision, and they are aimed at reducing the horizontal imbalances among provinces; thus, only the less wealthy provinces are eligible to receive them based on their tax capacities.

In Canada, there are wide disparities across provinces in revenue-raising capacity; Alberta, British Columbia, and Saskatchewan raise nearly eight percent more revenue per capita than the national average. Over the last four decades, Alberta, Manitoba, Quebec, and Saskatchewan have tended to spend above the national average on a per capita basis. However, even after tax capacities are equalized, the high-income provinces remain above the national average (Broadway and Watts, 2000). In principle, these systematic differences could arise from differences in need, cost, and preferences across provinces; which seems to be the case in Canada.[5] While the equalisation program focuses on horizontal imbalances, the CHST is the primary means for closing the vertical fiscal gap.

The current system of equalisation in Canada, however, has some issues that may have to be addressed in the future. The major issues are that equalization is based on tax capacity and not on need. In addition, the equalisation formula is based on the province's tax base relative to the national average, which provides an incentive to provinces to design policies that affect the tax base to attract more equalisation transfers. Lastly, there is ongoing debate on the future of the CHST. Provinces fund the bulk of services from their revenues, and particularly face rising health care costs. Yet, this is the area where the most stringent CHST standards apply and the only one with a financial penalty mechanism applicable to the use of provincial user fees, and with threat of withholding CHST for noncompliance.

Subnational Borrowing

In Canada, market discipline controls subnational indebtedness, and private rating companies evaluate public sector creditworthiness in a competitive environment. There are no federal controls on provinces' borrowing. A review of the trends in provincial government indebtedness in recent years suggests that, even in a well-developed and relatively transparent financial market as in Canada, market discipline on SNG borrowing has not been fully effective. Despite a clear deterioration in ratings, and related sizable increase in risk premiums on provincial bonds, particularly in the case of the more indebted provinces, provincial debt has increased steadily over the last several years. In 1994, it reached about 23 percent of GDP (Ter-Minassian and Craig, 1997). In order to cope with the rising debt of the 1990s, since 1993, several provinces have enacted some form of nonlegislated "budget rule." Most provinces required annual "balanced-budgets," except for New Brunswick and Saskatchewan, which require balanced budgets over four-year periods, and Yukon where deficits are permitted as long as net debt does not increase. In Qubec and Ontario, deficits can be offset with previous surpluses, and together with Nova Scotia, deficits may be permitted as long as they are offset in the next fiscal year. In addition, several provinces have established stabilization funds with the purpose of stabilizing fiscal position and improving long term fiscal planning. In terms of penalties, four jurisdictions have reductions in salaries in a year of a deficit, for not achieving their targets (Kennedy and Robbins, 2003).

Municipalities, unlike provinces, face very hard budget constraints. In practice, provinces regulate municipalities' revenues and expenditures, transfers, and borrowing. While rules differ from

[5] The Australian equalization program, unlike the Canadian, focuses on equalizing for differences in need and cost.

[6] Alberta and Ontario simplified the regulatory process and enhanced access to the capital markets (Bird and Tassonyi, 2000).

province to province, in general, provinces set strict limits and controls on municipalities over the type of debt, the time period of borrowing, and the use of the funds. In all provinces, municipalities are required to have balanced operating budgets. Short-term borrowing can only be used to finance work-in-progress or to meet short-term obligations before collection of local revenues. Long term borrowing by municipalities is more closely regulated and in some provinces, special agencies borrow on behalf of municipalities. While some provinces have begun to recognize the need for greater flexibility in municipal borrowing, others such as Qubec and British Columbia still borrow on behalf of the municipality and require voter or provincial approval, respectively. Not surprisingly, only a fraction of local capital expenditure has ever been financed by borrowing (Bird and Tassonyi, 2000).[6]

At the federal level in Canada, the Federal Spending Control Act of 1992 introduced spending limits until 1996 under the provision that overspending can be permitted in one year if offset in the following two years. As a result, spending levels were below the limits except for 1991-1992. Thus, overall the Act did not prove to be necessary to control spending and was not extended beyond 1996. More relevant are the nonlegislated policies that the government introduced. One was to set two-year rolling deficit targets, and a second was to set a debt repayment plan through a contingency reserve in its budget planning. The latter is reserved each year in case of adversity and it is applied to debt reduction if not needed. As a result, federal debt decreased from 67.5 percent of GDP in 1995-96 to 46.5 percent in 2001-02 (Kennedy and Robbins, 2003).

Canada offers a clear example of the strength of market and political budget constraints in the face of soft constraints at the provincial level, as measured by the vertical fiscal gap among provinces, as well as very hard budget constraints at the local level. Although a few small municipalities have faced severe fiscal difficulties, overall, the system seems to have been effective at avoiding very serious fiscal problems.

Conclusion

Canada is an interesting example of a highly decentralized federation that has been very effective at maintaining fiscal health through hard budget constraints, which in this case do not depend on hierarchical rules and regulation (at least at the provincial level), but instead to efficiently operating capital markets. The Canadian system provides for no constitutional restrains on provinces' tax rates, bases, or collection systems as well as no requirement to harmonize with each other or with the Federal Government (Bird and Tassonyi, 2000). Canada has thus 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. All provinces receive large unconditional transfers from the Federal Government, which in some provinces are greater than their own revenues. Provinces have no central review or control over borrowing, and it has been exceptionally successful in reducing public debt. The existence of very tight provincial control over local government means that, at the end of the day, provinces guarantee that municipal obligations will indeed be met. In addition, the Federal Government's commitment to budget balance or better has delivered seven consecutive years of fiscal surpluses that have reduced net debt by almost 30 percent of GDP while still affording sizeable tax reduction. The key challenge for the Canadian system is that capital markets continue working efficiently, and that there is no implicit federal guarantee of provincial debt.

Annexure 4:

Fiscal Federalism in Germany

Table 4A.1: Germany's Descriptive Statistics

	2004
Total Pop. (in mill.)	82.424609
Pop. Density per km^2	230.9
Number of Intermediate-level Government Units	16
Number of Local-level Government Units (approx.)	15,359
Coefficient of Variation of Pop. Distribution (in %)	93.86
GDP (USD in billion)	2,271
GDP per capita (PPP in USD)	27,600
GDP Real Growth Rate (in %)	-0.10

Sources: CIA, World Fact Book 2004 (est.). Retrieved on December 3, 2004 from Internet Web site http://www.cia.gov/cia/publications/factbook/; and Federal Statistical Office of Germany available at http://www.destatis.de/themen/e/thm_bevoelk.htm

At the present time, there are 16 German States (Länder). Three of the states—Bremen, Hamburg, and Bremen—are in fact large cities and are called city-states (Stadtstaaten).

General overview

In the German system, the Federal Government accounts for approximately 36.6 percent of total expenditures, while the states account for the remainder or 63.4 percent. The bulk of the revenues in the German system come from joint taxes, approximately 71 percent of the total, which are administered by the states, but the rates and bases are controlled by the Federal Government. Exclusively federal taxes account for 17 percent of all revenues in Germany. The most significant among them are excise taxes—mineral oils tax, tobacco taxes, and alcohol taxes. Exclusive state taxes account for five percent of all revenues in Germany. The most significant among these are the motor vehicle tax and the property net worth tax. Finally, exclusive local government taxes account for seven percent of all revenues. Joint or shared taxes account for the bulk of revenues in Germany or 71 percent of the total.

Depending on the state, federal transfers account for zero to five percent of total revenue and, in the case of the former East German States, as high as 25 percent. Despite the preponderance of tax revenues in the total, the states have only very limited revenue autonomy. Finally, the average deficit from 1975 to 1995 is over 10 percent of revenue and substantially higher among the eastern States. According to Rodden (2003), the problems of perverse incentives, persistent deficits, and dangerous debt burdens are now serious in the eastern states as well as Bremen and Saarland. In addition to describing the intergovernmental fiscal system of Germany, a major focus is the institutional features that give rise to the lack of fiscal discipline among SNGs in Germany. The point being that lack of fiscal discipline among SNGs plagues developed economies as well as developing and transitional economies, if the intergovernmental fiscal system is poorly conceived.

Expenditure Assignments

The German Constitution defines the responsibilities of the different levels of government. The communes are responsible for local utilities and services such as water supply, sewage and waste disposal, the construction and maintenance of local roads, and the provision of supplementary welfare benefits. The communes are heavily reliant on grant financing from the states and the vast majority of expenditure is mandatory. In addition, the states must approve all borrowing by the communes. The states are responsible for cultural affairs, in particular for schools and education, the administration of justice, police, universities, and health services. In addition, the Federal Government and the states cooperate on the planning and financing of concurrent tasks such as regional economic policy, coastline preservation and agricultural policy, and publicly funded research.

Table 4A.2: Distribution of Joint Taxes in Germany

Type of Tax	Federal	State	Local
Value-added Tax[a,b]	56	44	0
Income Tax[b]	42.5	42.5	15
Local Business Capital Tax[b]	4.6	16.1	79.3
Taxes on Earnings[b]	50	50	0
Interest Income Deduction[b]	44	44	12
Corporate Income Tax[b]	50	50	0

Notes:
[a] The proceeds of VAT are constitutionally mandated to be shared between the federal- and state-levels of government, but the respective shares are determined by federal legislation. The ratio is reviewed every two years, and adjusted if necessary in light of changing financial needs: this is an important element of flexibility in fiscal arrangements.
[b] Mandated by Article 106(3) of the Constitution.
Source: Trounin et al (2001).

Revenue Assignments

The states receive taxes collected within their geographic boundaries from the motor vehicle tax, inheritance tax, and betting and lottery tax, as well as some other taxes of minor importance. However, the rates of these taxes are set by the Federal Government. These unshared state taxes account for only 5.1 percent of total tax revenue; whereas, the states are responsible for approximately 63 percent of total expenditures. Clearly, there is a significant vertical fiscal imbalance (VFI). This VFI is addressed through joint taxes, which are federally mandated taxes. The revenue from these taxes is shared among the three tiers of government. The distribution of the shared taxes by type of tax is summarized in Table 4A.2. The joint taxes make up about three-quarters of total revenue.

While the states receive a considerable share of their revenue from taxes, as a practical matter, they have very limited ability to adjust the rates or the bases of these taxes. The benefit of this arrangement is that it constraints tax competition among the states to attract business. The limitation of this arrangement is that states do not have authentic revenue autonomy which is essential if governments are to internalize the cost of providing local services at the *margin*. In the German intergovernmental fiscal system, the states administer both the unshared and the shared state taxes. In other words, the states have very limited tax policy autonomy; however, they have significant autonomy in tax administration.

Intergovernmental Fiscal Transfer System

The vertical fiscal equalisation system describes only the distribution of tax revenues between the different tiers of government; it does not regulate the distribution of revenues among the individual states. This is achieved through a horizontal fiscal equalisation system. Horizontal apportionment of income tax revenues between the states proceeds according to the residence principle (i.e., income tax accrues to the taxpayer's State of residence). Corporate tax revenues are divided among states by a formula which is based on plant location, taking into consideration that companies may have branches in different states. This gets around the so-called headquarters problem with assigning corporate income tax revenues on an origin basis. Another difficult horizontal assignment concerns VAT revenue. Neither the source nor the principal residence can be applied in a meaningful way. As a pragmatic solution, VAT revenue is simply distributed to States on a per capita basis.

This primary system of tax revenue allocation is transformed by a second system which redistributes revenues between the territories based on the constitutional objective to create broadly equal living conditions across regions. States which are financially weaker in terms of their primary tax receipts receive both horizontal transfers from financially stronger states, and vertical transfers from the Federal Government to enable them to finance their fiscal tasks.

Fiscal equalisation of tax receipts among the states proceeds in three stages. At the first stage up to 25 percent of the value-added tax receipts of the states is redistributed to in favor of the states which are endowed with relatively low-tax revenues on a per capita basis after the primary tax allocation. Equalisation at the second stage is conditional on the states' revenue allocation after stage one, including half of its local government revenues. For each state, the resulting revenues per capital are compared to average revenues per capita. Revenues are redistributed from states whose revenues per capita or 'financial endowment' exceed average per capita revenue or "financial need" to the states with revenue per capita below the average.[7] For contributing states, the surplus of financial endowment over financial needs is transferred to the receiving states at a progressive rate which increases up to 80 percent. At this stage the financially weaker states reach 95 percent of their "financial needs."

At the third stage of the horizontal equalisation system, the fiscal endowment of the financially weaker states is lifted up to at least 99.5 percent of their 'financial needs' by supplementary grants of the Federal Government. In addition, there are supplementary grants to compensate states for special burdens: new states due to unification, small states to compensate for higher administrative costs per capita, and western states to compensate for the fiscal burden of unification. Finally, two states receive special supplementary transfers as federal aid for their debt servicing obligations, which is discussed in greater detail below.

The financial equalization system in Germany produces rather strange incentives. First, states that run a sound fiscal policy leading to an increase in the tax base (tax rates are fixed by the Federal Government) lose a considerable share of any additional tax revenue due to the transfers from states with excess fiscal capacity to states with weak fiscal capacity, as discussed above. In fact, the highest marginal rate is 80 percent. For individual states, an additional DM one million in income tax receipts—either personal or corporate—generates only between DM 80,000

[7] The effective population is regarded as 35 percent higher than actual population for the three city-states: Bremen, Hamburg, and Berlin.

and DM 290,000 in extra tax revenue, depending on the state. The remainder is allocated to the centre due to revenue sharing and the other states due to horizontal fiscal equalisation transfers.

Second, the fiscal equalisation system yields a substantial redistribution of income in favor of the financially weaker states. In 1996, which is the most current data available as of this writing, the per capita tax revenues of the poorest states, including local governments, amounted to 80.1 percent of the average prior to redistribution. After redistribution and supplementary transfers, it exceeded the average by 8.7 percent. By design the horizontal fiscal equalisation system should leave the ranking of the states by per capita revenues unchanged. After taking into account special transfers, however, the transfer system changes the ranking of states in terms of per capita revenues. For example, in 1996, the State of North Rhine-Westphalia had the highest revenue per capita prior to redistribution (DM 5,132), excluding the City-State of Hamburg, but fell to eighth place after redistribution (DM 4,753).

According to Wurzel (1999), the high marginal rate on additional revenue in financially strong states and substantial redistribution through fiscal equalisation kills any incentive for a state to run a growth oriented economic policy. Low rates of tax auditing by the states, which administer the joint taxes, may also be attributable to the fact that although they bear the cost of administration, only a small fraction of additional tax revenues accrues to them, so that it hardly pays for the individual states to strengthen audits. Indeed, tax competition, driven by the political incentive to seek to increase employment, could take the form of differential enforcement of the tax code by individual states.

Perhaps then, it comes as no surprise that taking a long term perspective the fiscal equalisation system appears to have had little success in achieving convergence of economic performance among the states (Wurzel, 1999). Between 1970 and the beginning of transitory equalisation arrangements for the former East German States in 1990 only one state ceased to be a recipient. More importantly, among the old states, the dispersion of GDP per capita has declined little. Similarly, over the same time span, the dispersion of unemployment rates remained roughly constant. While this development also reflects the lack of regional differentiation in collective bargaining outcomes, it also indicates that there is little or no convergence in the state's employment capacity.

Restrictions on Borrowing

According to Article 115, (see Seitz, 2000), of the German Constitution, federal borrowing is restricted by the golden rule: that is, government borrowing cannot exceed the amount spent on investment. Similar rules hold for the states and local bodies. Borrowing by local bodies is also restricted by state governments, which monitor the ability of the local bodies to meet projected debt service commitments. In 1969 a federal law was passed to make it possible to exceed constitutional limits on borrowing in case of "disturbances of general equilibrium." The Federal and State Constitutions were adjusted in 1969 to take this exceptional case into account.

In any event, all levels of government find innovative ways around debt restrictions. According to Seitz (2000), these practices include reclassifying current expenditures as capital expenditures; setting up entities whose operations are kept off-budget; and using innovative debt instruments such as private-public partnerships in running and financing infrastructure projects. Thus, for example, the massive transfers that were necessary to pay for East Germany's integration into the Federal Republic were financed almost completely through off-budget funds, especially the German Unity Fund, which made it possible to avoid constitutional borrowing restrictions.

The Court Mandated Federal Bailout of Bremen and Saarland

According to Seitz (2000), in 1988 the States of Bremen and Saarland turned to the Federal Constitutional Court to force the Federal Government to support both states in coping with their high public debts. Both states claimed that their high debts were caused by negative economic developments not under the control of the state governments—the crisis in shipbuilding in Bremen and the crisis in the iron, steel, and coal industry in Saarland—and that the high fiscal burden associated with high public debt made it impossible for the states to fulfill their constitutional duties. In addition, both states argued that they were forced to violate the requirements of Article 115 of the Constitution, which limits the annual budget deficits to the volume of investment spending. Both states also claimed that if they had to cope with the fiscal burden by themselves, they would have to introduce such severe expenditure cuts that they would run counter to another requirement of the German Constitution, namely the equalisation of living conditions throughout Germany. Furthermore, both states put forward that the majority of state expenditures, such as welfare payments, are fixed by federal law. Significant spending cuts would thus counter federal legislation.

In 1992, the Federal Constitutional Court supported the claims of the states. The Court reasoned that the German Constitution, especially the principles of fiscal federalism system set out in Articles 104-107 of the Constitution aims at establishing fiscal homogeneity and equalisation of living standards throughout Germany. These objectives can only be achieved by mutual support from the states to the Federal Government, and from the Federal Government to the states and among the states. Thus, the Court stressed the solidarity principle of the German federal system and concluded that if states experience "extreme budgetary hardship"—as was claimed by Saarland and Bremen—they were entitled to financial support from all other members of the federation.

In 1993, the Federal Government made a contract with Bremen and Saarland which promised both annual payments until 1998 to reduce the financial burden of the high debt. One of the main objectives of the bailout transfers was the reduction of the debt in both states to about DM 11.5 billion at the end of 1998 (Seitz, 2000). This target was missed considerably: at the end of 1998 the per capita debt of Bremen as about DM 16,600 (virtually identical to the 1992 figure) and about DM 16,650 in Saarland (virtually identical to its 1991 figure).

According to Seitz (2000), virtually all states and the Federal Ministry of Finance did not consider federal support to be a success. However, they supported its extension in Spring 1999. Insiders and political observers note that this consent was due to the fact that Saarland is governed by a SPD-majority government, whereas Bremen there is a grand coalition of SPD and CDU. Thus the two major parties in Germany were involved in governing one if not both of the states enjoying bailouts.

Conclusion

Though the large share of expenditures assigned to the states suggests a highly decentralized system, the German intergovernmental system is highly centralized in many respects but administratively decentralized. This feature of the German system has led some to characterize it as administrative federalism. The German system provides for significant expenditure autonomy, however, this autonomy is constrained by a large numbers of concurrent assignments which blur transparency and accountability and unfunded federal mandates which further restrict the flexibility of state governments to adjust expenditure programs to local conditions. In order to curtail tax competition among states, tax rates and bases are established by the Federal Government in most cases. Consequently, the states have very little real revenue raising autonomy. The vertical fiscal imbalance is addressed through tax sharing of the major taxes (income and consumption) among the three tiers of government. The intergovernmental fiscal transfer system results in considerable uniformity of revenues per capita among the states, however, several features of this system create perverse incentives with respect to economic growth and the conduct of tax administration by the states.

Although the borrowing autonomy of the states would seem to be controlled by a modified golden rule set forth in the German Constitution as modified in 1969, all levels of government have been complicit in circumventing these rules. As a practical matter, then, it seems fair to say that the states have significant borrowing autonomy. As discussed below, the lack of revenue autonomy combined with considerable expenditure and borrowing autonomy led to excessive borrowing in several states.

The end result of this ruling is that the Federal Government cannot credibly commit to a no-bailout policy, and the States of Germany clearly face soft budget constraints. The accompanying deleterious effects on fiscal discipline are obvious in the large deficits as a share of revenue and the dangerous debt burdens among some states, described above. Rodden (2003) concludes that Germany's complex, interdependent, collaborative style of federalism tends to dilute fiscal accountability and soften budget constraints. As a result, he writes, voters cannot identify which level of government taxes or spends for which goods and services, and they have neither the ability nor the incentive to monitor or discipline the fiscal decisions of states or local governments.

Annexure 5:

Fiscal Federalism in India

Table 5A.1: India

	2004
Total Pop. (in mill.)	1065.07
Pop. Density per km^2	323.7
Number of Intermediate-level Government Units	35
Number of Local-level Government Units (approx.)	649,812
Coefficient of Variation of Pop. Distribution (in %)	127.46
GDP (USD in Billion in PPP)	3,033
GDP per Capita (PPP in USD)	2,900
GDP Real Growth Rate (in %)	8.30

Sources: CIA, World Fact Book 2004 (est.). Retrieved on December 3, 2004 from internet Web site http://www.cia.gov/cia/publications/factbook/; and India Bureau of Census, available at http://www.censusindia.net

India is a Union of States comprised of 28 states and seven union territories. India's Constitution is federal in character. The federation however did not come about as a result of any treaty amongst States. States are creation of the Constitution and the Parliament has powers to create new states, merge states and alter their boundaries. India did not confer any constitutional status to third tier of governance i.e., local bodies, till the 1992 Constitutional amendments which gave recognition to local governments, specifically panchayats and municipalities. The 73rd and 74th Constitution amendments create a framework for vesting functions and taxing powers to the third levels of government. However, powers, functions and revenues resources are all to be decided by the states by passing appropriate legislation in their legislatures within the framework established by the national constitution.

Over the years, the States of India have sought to finance their increasing needs for expenditures through different forms of transfers from the Union Government and loans, rather than by raising additional tax revenues and/or charging for services delivered. This has resulted in the states running large revenue and fiscal deficits and accumulating potentially unsustainable debt burdens. In this process, most states have compromised budgetary discipline, resorted to off-budget forms of borrowings, and accumulated large contingent liabilities, with the attendant risks of default.

General Overview

During the ten-year period beginning in the mid-1980s, there was a slow but steady deterioration in the revenue deficits of the states. Starting in 1997-98, however, this steady decline turned into a sharp deterioration. More specifically, state revenue deficits averaged 0.8 percent of gross domestic product (GDP) between 1987-88 and 1996-97, and 2.8 percent of GDP from 1997-98 to 2000-01. Then, in both 2001-02 and 2002-03, the states made some progress in reducing their revenue deficits. However, the revised estimates for 2003-04 show another sharp deterioration in state fiscal balances. The states are financing these deficits through borrowings. Consequently, the total debt of the states has increased from the already high level of 20.7 percent of GDP in 1987-88 to 35 percent of GDP in 2004-05 (Budget Estimates).

The growth in state revenue deficits is attributable to the failure of revenue receipts to keep pace with the growth in revenue expenditures. From 1998-99 to 2002-03, revenue expenditures as a share of GDP grew by 13 percent. Meanwhile, the total revenue receipts of the states as a share of GDP increased by only eight percent. Absent a matching increase in revenue receipts, the fiscal shock represented by the large wage and pension increases by the states in 1997-98 has led the way to large and persistent revenue deficits and growing state debt burdens as a share of GDP.

The states of India account for approximately 49.2 percent of total revenue expenditure and 51 percent of capital expenditure, or approximately 49.5 percent of total expenditure. In this respect, India is highly decentralized. But in 2003-04 (Revised Estimates), state expenditures on wages, pensions, and interest on debt were approximately 76 percent of the total revenue receipts of the states. Since these are largely committed or nondiscretionary expenditures, many states are severely constrained in their ability to compress revenue expenditures as a means of balancing their revenue accounts.

Expenditure Assignments

The Seventh Schedule (Article 246) delineates 'the subject matter of laws made by the Parliament and by the Legislatures of the states' and indicates the Union List (List I), states List (List II) and the Concurrent List (List III). List I invests the union with all functions of national importance such as defence, external affairs, communications, constitution, organization of the Supreme Court and the high courts, elections etc., List II invests the states with a number of important functions touching on the life and welfare of the people such as public order, police, local government, public health, agriculture, land etc. List III is a concurrent List, which includes administration of justice, economic and social planning, trade and commerce, etc.

However, the role of the states is unclear in regard to concurrent responsibilities with the Union, and local governments lack any exclusive responsibilities. A large fraction of state budgets goes to cover committed or nondiscretionary expenditures on wages, pensions, and interest. Subsidies are large and poorly targeted. Due to the need to compress expenditures, state policies are depriving public infrastructure and important social services of funds. As a result, the quality of state services is suffering.

States are borrowing to cover persistent revenue deficits and, as a result, are accumulating large and unsustainable levels of debt. Absent an increase in revenues, the states find themselves in a virtual debt trap: borrowing just to cover recurrent expenditures with very limited flexibility to compress expenditure. Therefore, any adjustment in total expenditure must focus on squeezing supplies (i.e., vaccines, medical equipment, chalk, etc.), deferring maintenance, and reducing investment on public infrastructure (i.e., schools, hospitals, roads, and bridges). Failing to invest adequately in public infrastructure jeopardizes the ability to sustain economic growth, and the inability of states to provide skilled personnel like doctors and teachers with vital supplies and equipment compromises the quality of essential social services (i.e., health and education).

Revenue Assignments

In India, tax assignments among the tiers of government are based on the constitutional principle of separation of bases. The union List includes among others, taxes on income other than agricultural income, excise duties, customs and corporation tax. Residuary powers to tax items not specified in the any 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 local area for consumption or sale; sale of goods except newspapers but including works contracts and goods sold through hire purchase; transport of goods or passengers by road or inland waterways, and road or inland waterway tolls; professions; luxuries, entertainment, and gambling; and finally, stamp duties and registration fees on documents and court fees collected through judicial stamp duties.

The inability of the states to tax nonagricultural income and services has hindered their ability to access broad-based and more buoyant taxes. The state sales tax regime is highly distortionary; other taxes remain unexploited (e.g., the property tax, professions tax, and the like); and there is very low cost recovery rates from economic services provided by the states (e.g., irrigation, power, and transportation).

The system of sales tax prevailing in India is a form of restricted cascading type origin tax. This system hinders the smooth flow of interstate trade and the growth of a common market. The central sales tax (CST) treatment of state exports enables them to extend their sales tax jurisdiction beyond their territories and thereby raise revenues from citizens of other states. Taxing at the first point of sale narrows the sales tax base. States, in addition, are conferred with the authority to levy tax only on select services like entertainment, electricity, and transportation. As a result, sales tax rates have to be higher on taxable commodities in order to raise a given level of revenue thus making the sales tax more distortionary and inefficient.

Driven by pressures to raise more and more revenue from a relatively narrow and inelastic sales tax base, many states levy turnover taxes on all transactions (nine states), surcharges on the basic sales tax liability and additional sales tax (14 states), and entry taxes (six states). The states decided to adopt uniform floor rates in 1999 and 21 of 28 states have implemented a destination based VAT starting April 1, 2005. The Union Government has made a commitment to the states to compensate for the loss of their revenues to the extent of 100 percent of the loss in the first year, 75 percent of the loss in the second year, and 50 percent of the loss in the third year.

Local governments are dependent upon the state governments to give them taxation powers, as local bodies have no direct constitutional authority for taxing any tax base. The states are in charge of passing laws to delegate taxation powers to the local governments. However, local governments have not been empowered with clearly defined own source revenues.

Intergovernmental Transfers

The system of intergovernmental transfers was introduced by the Constitution of India to mitigate the mismatch between the functions and sources of revenue assigned to the states. The Constitution provides for both sharing with the states of central tax revenue and giving grants-in-aid to the states in need of assistance. Both the channels of transfers are guided by the recommendations of Finance Commissions that operate under Article 280 of the Constitution. In addition to these two channels, with central planning gaining emphasis, the allocations by the Planning Commission have also become a major form of transfers from the centre to the states. In addition to these two agencies, various central ministries make transfers for specific purposes, frequently referred to as centrally sponsored schemes, such as poverty alleviation, family planning, and education; and deficit financing mostly provided with an implicit central guarantee (McCarte, 2001).

As described above, India has a very elaborate and complex system of resource transfers from the Centre to the states. The multiplicity of agencies making transfers often work at cross-purposes and this makes achievement of objectives difficult. The tax transfer is not sufficiently equalizing, as a result some states get too much revenue relative to their tax capacity, and the low-income states get too little. As all the tax sources of the Centre are now shared, the states share in the buoyancy, or lack of it, of the central taxes. While the states stand to gain when the central taxes are buoyant, the reverse happened in the first few years of the EFC period, when central taxes did not grow as expected.

The Planning Commission's Gadgil formula [i.e., 70:30 (10:90) loan-grant mix] is outdated and creates incentives for the states to make irresponsible and unsustainable borrowing decisions, especially because the grant cannot be taken without the loan transfer. Furthermore, the states are using plan borrowings to finance their revenue deficits. Plan borrowings are meant to finance economic development. This is extremely short-sighted and, if allowed to continue, will jeopardize the ability of India's economy to sustain robust economic growth.

The GoI does not transfer funds directly to local bodies, except for implementation of some specific programs of rural development, health, and education. In many of these cases, funds are transferred to specially created institutions and district level societies. These societies are not politically responsible to local government institutions. Transfers from states to urban and rural local bodies are recommended by the State Finance Commissions every five years. However, the experience has been that the volume of transfers has been inadequate mainly because the states themselves have been facing financial crisis. These transfers have been lump sum and ad hoc with no criteria on local bodies' capacity or need. There are few states, however, where local bodies play a more active role.

Subnational Borrowing

The Constitution under article 293(3) puts limits on the borrowing powers of the states, any borrowing requires prior approval from the Centre if they have any outstanding debt to the Centre. Since all states have such liabilities, unrestricted power to borrow is blocked. Until recently, borrowing was mainly financed by banks under regulations that specified the portion of assets that had to be invested in state securities approved by the central government. Additionally, states cannot borrow from above except for loans from multilateral investment banks intermediated by the central government.

However, the Centre is not fully exercising *ex ante* control over state borrowing, although a move in this direction has been made in the last two years. The Centre is not exercising *ex post* control over states that divert plan borrowing to finance revenue deficits. In fact, state plan borrowings are routinely diverted to finance persistent state revenue account deficits.

In the past, the Centre has rescheduled state debt and granted waivers of interest and principle, usually on the basis of recommendations of the Finance Commissions. The Twelfth Finance Commission has again recommended major debt-rescheduling with a lower rate of interest and a debt-waiver scheme. However, this has been linked to states adopting fiscal responsibility legislation and also to eliminating revenue deficits over a five year period. Nevertheless, such waivers may create expectations that the Centre will bailout the states in the event of a future fiscal crisis. In which case, the states of India lack incentives to behave in a fiscally prudent manner.

Conclusion

The challenges facing India's decentralized system of finance run wide and deep. Many of the key problems with the current system have their roots in the design of the constitution and legal system. Due to the deteriorating fiscal situation of the states, the Government of India has taken several initiatives, including the creation of a Fiscal Reform Facility, which sought to provide financial-grant incentives to the states, in order to encourage a movement toward budget balance over the five year period coinciding with the implementation period of the Eleventh Finance Commission (2000-2005). The largely unsuccessful experience with the implementation of the Facility has made it necessary to explore other policy alternatives in managing subnational fiscal crises and improving fiscal management of subnational governments.

The major weakness identified in the current system is a lack of coordination between the allocations determined by the Finance Commission and the Planning Commission (Kurian and Dasgupta, 2003). Thus, the plan generates liabilities for debt service, maintenance of assets, and payroll which have to be covered by Finance Commission transfers. Thus, each Commission addresses only a portion of the problem without looking at it in totality. Another common critique concerns mixing grants and loans by the Planning Commission. There are arguments that allocation of loans should be guided by feasibility of the projects while grants should address geographical spillovers and national priorities.

In addition, decentralization has not gone far beyond the states, contributing to low levels of efficiency and accountability, poor monitoring, and low quality of local public services. Although the States of Karnataka and Kerala have moved ahead on decentralizations, there still remains a lot to do to enable them to function as self-governments. Only until urban and rural communities are empowered will they take the initiative and develop the capacity to deliver results, and the communities to hold them accountable for performance.

Although the Twelfth Finance Commission has addressed some of the weaknesses in India's system such as doing away with the grant-loan link, encouraging greater decentralization, encouraging fiscal responsibility laws, etc., there is still a long way to achieve a successful intergovernmental system. A successful reform will have to be a joint effort of the states and the Centre. Designing such a reform will be a great challenge.

Annexure 6:

Fiscal Federalism in the Russian Federation

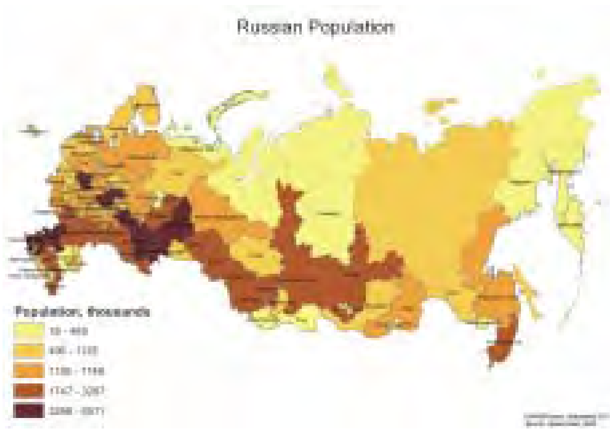


Table 6A.1: Russia's Descriptive Statistics

	2004
Total Pop. (in mill.)	143.78
Pop. Density per km^2	8.4
Number of Intermediate-level Government Units	89
Number of Local-level Government Units (approx.)	29,633
Coefficient of Variation of Pop. Distribution (in %)	97.02
GDP (USD in Billion)	1,282
GDP per Capita (PPP in USD)	8,900
GDP Real Growth Rate (in %)	7.30

Sources: CIA, World Fact Book 2004 (est.). Retrieved on December 3, 2004 from internet Web site http://www.cia.gov/cia/publications/factbook/; and Russia Census 2002, http://www.gks.ru/scripts/free/1c.exe?XXXX25F.1.3.1.1/000070R.

The Russian system of government is currently divided in two subnational tiers of government: 89 regions (49 oblasts, 21 republics, 6 krays, 10 autonomous okrugs, the federal cities of Moscow and St. Petersburg and one autonomous oblast) and more than 12,000 local governments.

Subnational authorities of modern Russia were created out of the local branches of the Soviet state hierarchy. Under the Soviet Union, the government structure of Russia had four tiers: (i) the Russian Soviet Federative Socialist Republic (RSFSR); (ii) the regional tier (ethnic republics, *krais*, *okrugs*, *oblasts*, and autonomous areas);[8] (iii) a first local tier (subregion cities and *rayons*);[9] and (iv) a second local tier (subcity districts and subrayon towns, townships, and rural districts).

Before the Perestroika era, each administrative unit was nominally governed by the local Soviet (council). However, elections to these Soviets were not competitive and a single candidate for each seat was effectively nominated by the Communist Party. Thus, all decision-making was made within the Party apparatus and local Soviets were only rubberstamping these decisions and implementing them through the local executive branch. In particular this hierarchy determined a deconcentrated manner of governance where each level relied for implementation of its policies on the level below and most field agencies were directly reporting only to the bottom level of government. This hierarchy was upset with the free subnational elections of March 1990 allowing competition among several candidates for each seat in all subnational Soviets. Political autonomy of local councils effectively introduced dual subordination of local executives both to the

[8] Oblast is a name for the subnational entity in a number of Slavic languages. The word krai (which also means border or end) is used for regions located along the economic and geographic periphery. Okrug is a Slavic loan translation of German Kreis, a term to denote administrative subdivision.

[9] A rayon is the Russian equivalent of a local government district, such as a U.S. county.

local constituency and to the higher-level executive bodies.

As a result, implementation of many central government policies continued to rely on now independent subnational authorities, a situation which would continue until a state apparatus being developed in parallel to local agencies. However, the reliance on subnational implementation units made the center vulnerable to the actions of subnational authorities. In stark contrast to the central control during the Soviet era, during the early transition local authorities were able to take advantage of the fact that they had *de facto* control over key elements of government administration, including tax administration and internal security.

General Overview

Subnational governments are responsible for about 55 percent of total expenditures in the Russian Federation mostly in the areas of education, health, social protection, transportation and public utilities. Own-source revenue is approximately 45 percent of the consolidated budget in all regions, which creates a dependency on revenue-sharing and other federal transfers to fund expenditure responsibilities (Martinez-Vasquez et. al 2004).

While the overall level of subnational borrowing remains low at about three percent of GDP as of 2002, there is an increasing trend towards greater subnational deficits, accumulation of debt, and loan guarantees, which resulted in the insolvency of a large number of regions in the aftermath of the August 1998 crises. Commercial bank debt has become the primary source of deficit finance, particularly since promissory notes (veksels) were disallowed since 1997 (Dabla-Norris et al, 2000).

Expenditure Assignments

The division of expenditure responsibilities in Russia suffers ambiguity, especially between regional and local governments. Nevertheless, the ambiguity is not due to lack of legislation; instead, it is due to poor definitions used in the legislation. Legislation is not clear in the assignment of concurrent responsibilities and it fails to differentiate assignments based on regulation, financing and the actual provision of public services.

Article 71 of the new Constitution of 1993 establishes exclusive authority of the federal government in defense, common market, railway, and telecommunications. Moreover, it shares responsibility with regional governments for law enforcement, social policy, the media, education, healthcare, and social protection. As to the local level, the first law on *Local Self-Government* (1991) did not enumerate the specific functions. The Constitution establishes local government's autonomy in local affair's but fails to assign any direct responsibilities with the exception of the protection of public order (Arts. 130-133).

The *Budget Code* (art. 84-87) provides somewhat more specific assignments regarding financial responsibility but not regulation and delivery, establishing exclusive responsibility to the federal government of national defense, space exploration, federal courts, financial support to regional governments and official statistics. For the regional level, the *Budget Code* states exclusive responsibility for supporting mass media established by regional governments and for providing financial aid to local governments. Lastly, for the local level the *Budget Code* enumerates municipal housing and utilities, construction and maintenance of local roads, waste utilization, transit, and earmarked subsidies to population. Local government service

Table 6A.2: Expenditure Responsibilities of Regional and Local Government According to the Kozak Laws

Expenditure functions	Settlements	Urban districts	Municipal districts	Regions
General Public Services				
Archives	Formation of the Settlement Archive	Formation and Depository of the Municipal Archive	Formation of the District Archive, Depository for District and Settlement Archives	Formation and Depository of the Regional Archive
Public Order and Safety				
Street Patrolling	None	By local police	By Local Police	None
Education				
Preschool	None	Maintenance of Buildings, Financing of Utilities, and Organization of the Rest with Regional Financing	Maintenance of Buildings, Financing of Utilities, and Organization of the Rest with Regional Financing	Financing of Wages, Textbooks, Equipment and Supplies
Primary	None			
Secondary	None			
Tertiary	None			
Vocational/Technical	None	None	None	Provision
Health				
Ambulance	None	Organization of Ambulance Service, Primary Healthcare, and Obstetrical Service	Organization of Ambulance Service, Primary Healthcare, and Obstetrical Service	Airlift
Outpatient Clinics and Hospitals	None			Provision of Special Treatment (Dermatology, TSD, Tuberculosis, Narcology, Oncology, and so on)
Public Health	None	None	None	
Insurance for the Unemployed	None	None	None	Financing
Social Security and Welfare				
Social Protection	None	None	None	Child Benefits, Support to Labor Veterans, Orphans, Homeless/Destitute Children, Single Mothers, and Mothers with many Children
Guardianship	Facilitation	Provision	Provision	None
Labor Market Policy	None	None	None	Retraining, Public Works
Housing and Community Amenities				
Social Housing	Provision	None	None	Financing of Subsidies to Households
Garbage/Waste	Collection	Collection and Utilization	Utilization	None
Water	Organization	Organization	None	None
Sewerage	Organization	Organization	None	None
Planting of Greenery, Forest Protection	Provision	Provision	None	None
Street Sweeping, Lighting, and Signs	Provision	Provision	None	None
Funeral Services and Maintenance of Cemeteries	Organization	Organization	Organization	None
Firefighting/Fire Protection	Basic Fire Protection	Basic Fire Protection	None	Organization of Firefighting

Table 6A.2: Expenditure Responsibilities of Regional and Local Government According to the Kozak Laws (contd.)

Expenditure Functions	Settlements	Urban Districts	Municipal Districts	Regions
Recreational and Cultural Affairs				
Physical Culture Development	Facilitation	Facilitation	None	Organization of Regional Programs
Libraries	Municipal Libraries	Municipal Libraries	Library Collectors	Regional Libraries
Museums Arts	None None	None None	None None	Organization and Support of Regional Museums, Folk Crafts, Other Cultural Activities
Entertainment	Facilitation of Service Provision	Facilitation of Service Provision	None	None
Places of Recreation	Arrangement	Arrangement	None	None
Protection of Historical Sites	Within the Settlement	Within the Settlement	None	Sites of Regional Importance
Fuel and Energy				
Central Heating	Organization	Organization	None	None
Heating Fuel (Natural Gas, Firewood, Coal)	Organization	Organization	Organization (Natural Gas)	None
Electric Power Supply and Lighting	Organization	Organization	Organization	None
Agriculture, Forestry, Fishing, and Hunting	None	None	None	Support to Agricultural Producers
Transportation and communication				
Telecommunications	Facilitation of Service Provision	Facilitation of Service Provision	Facilitation of Service Provision	None
Road Network	Organization within the Settlement	Organization within the Settlement	Organization between Settlements	Organization between Districts
Public Transport	Organization within the Settlement	Organization within the Settlement	Organization between Settlements	Organization between Districts and Suburban
Railroads	None	None	None	
Airlines	None	None	None	
Other Economic Affairs and Services				
Urban Planning and Land Management	Development of Plans and Zoning of Settlement Land	Development Plans and Zoning, Maintenance of Land Records	Maintenance of Land Records, Zoning of Intersettlement Lands	Planning the use of Agricultural Land
Other Expenditures				
Environmental Protection	Organization within the Settlement	Organization within the Settlement	Organization between Settlements	Organization between Districts
Prevention and Handling of Emergency Situations	Participation in Responding to Local Incidents	Participation on Local Incidents	Participation on District Incidents	Regional and Intersettlement Incidents
Ecological Control	None	Provision	Provision	None
Equalization of Constituent Jurisdictions	None	None	Equalization of Settlements with District Funds According to Regional Methodology	Equalisation of Districts and Settlements According to Federal Guidelines

Source: Martinez-Vazquez, Timofeev, Boex (forthcoming).

responsibility is not clear in federal legislation and in practice they vary from region to region. Very often, local government service responsibility is a product of informal historical developments.

Compared to the present *de jure* and *de facto* division of responsibilities among levels of government in the Russian Federation, the Kozak laws introduce a number of drastic and mostly positive changes. Importantly, the adopted legislation enumerates exclusive responsibilities of each tear and type of subnational governments (see Table 6A.1). A number of responsibilities not suitable for local governments were elevated to the regional level (health insurance for the unemployed, support to some disadvantaged categories of population, most outlays on general education). At the same time, street patrolling was separated from federal detective and police services and assigned exclusively to the local level. Remarkably, the regional level was stripped of any law-enforcement powers except in fire protection.

The Kozak laws also make clear the principle that for "delegated" responsibilities the upper-level government delegating those responsibilities has the power to regulate but also the obligation to ensure there is sufficient funding. For all other local responsibilities (own or nonmandated), the upper level governments cannot introduce expenditure norms. Finally, the new laws give regional (municipal) governments the discretion to independently determine the terms of remuneration for state (municipal) servants as well as the number of employees of state (municipal) institutions.

Revenue Assignments

Revenue assignments have become increasingly centralized since the mid 1990s. The current federal legislation does not allow any level of government to introduce taxes beyond those enumerated in the *Law on the Basic Principles of Taxation*. Permitted taxes are categorizes as "federal", "regional", and "local" revenue sources. As of January 2004, "federal" taxes include VAT, excises, custom duties, the corporate income tax (CIT), taxes and royalties on natural resources extraction, the personal income tax (PIT), the social tax (on payroll), and other minor federal revenue sources. However, in the Russian Federation, the tax category does not always imply the level that received the proceeds from the tax. For example, succession and gift taxes are classified as federal, the revenue has been allocated to the subnational levels.

In a similar manner, the land tax which is classified as a local tax is shared among all three levels of government. Parts of the PIT collection and excises on goods are shared by the federal level with regional governments based on point of collection for these taxes. Regional level can reallocate a portion of these to their local governments. In addition, royalties on natural-resource extraction is partly assigned to regional governments at the point of collection. After eliminating sales taxes in January 2004, the "regional" taxes include the enterprise assets tax, the forestry tax, the transport tax (on engine power), and the gambling tax. All of the previously mentioned, except the forestry tax, can serve as "regulated" sources of revenue for local governments, so that regional governments can share those revenues with their localities on a derivation or pint-of-collection basis.

The list of "local" taxes as of January 2004 include: the individual property tax; land tax; the individual entrepreneur's patent; and the advertisement tax. Furthermore, the currently federal legislation strictly assigns tax instruments to each level and does not allow regional governments to devolve part of their taxing powers to localities (Martinez-Vasquez et al 2004).

Despite all the progress to date, the Russian Federation still lacks explicit and stable revenue assignments at the local level. Formally, local governments do have their "own" revenue sources and they can set rates for some local taxes; however, these sources of revenue are (for now, at least) quite limited. In reality, revenue sharing on a derivation basis is the most important source of revenues at the local level after intergovernmental grants. In addition, during almost the entirety of the transition period, revenue assignments for local governments have been ever-changing.

Intergovernmental Transfers

The fiscal transfer system has gone through substantial reform from the transition, but mostly from 1994 when rates for federal-regional revenue tax sharing were standardized across regions and annually set in the federal budget law (has been nearly unchanged).

Federal transfers to Russia's regions are distributed under four major categories: i) equalisation grants;
ii) subventions; iii) subsidies; and iv) mutual settlements. The equalisation grant is the most

Box 6A.1: 1994 Equalization Scheme in the Russian Federation

The Fund for Financial Support of the Regions (FFSR) had two equalization windows in its formula. The first formula window, called "Regions in Need of Financial Assistance," attempted to equalize the availability of revenues across regions. The second window, called "Regions in Need of Additional Financial Assistance," was designed to provide additional funding to regions with unmet expenditure needs. The overall level of available money for the FFSR was determined every year in the federal budget. The funding rule for the FFSR has been subject to change virtually on an annual basis since the fund's introduction in 1994. Until 1994, the funding for the FFSR was set at 22 percent of the federal share of VAT collections, while funding was increased to 27 percent of federal VAT collections in 1995. For 1996 and 1997, the funding rule was changed to 15 percent of all federal tax collections, excluding import duties and the 10 percent federal share of the PIT. The 1998 budget lowered FFSR funding to 14 percent of federal collections with the same exclusions. Although the basic calculations for the first-window formula of the FFSR remained unchanged during the transition years, some of the coefficients were altered. Revenue data from an earlier year were used to reduce disincentives to revenue mobilization. To determine FFSR transfers, Russian Federation was divided into three groups (two groups of regions in the northern territories and one for the rest of the Federation) mainly to capture differences in the cost of living. Within each of these three groups, regions for which adjusted per capita revenue collections were below 92 percent of the group average were entitled to capacity-equalizing transfers. Steps two and three of the first-window calculations determined the size of the transfer by figuring the available funds to those regions with a positive claim as determined in the first step. The formula for the second window of the FFSR, in its 1997 version, was based on expenditure data for the base year of 1991. Until 1996, the base year for measuring expenditure needs was 1993; in 1997, the previous year was considered more representative of actual expenditure needs. To approximate the 1997 expenditure-levels needs for all regions, base year expenditure data were adjusted for changes in legislation for the years in between. Revenue capacity for the second window was determined the same way as for the first window. Each transfer claim was computed in the second window formula as the difference between the sum of adjusted revenues, and the transfer from the first window, if any, and the estimated expenditure needs. The remaining window steps calculated the funding amounts for those regions with positive expenditure gaps.

Source: Martinez-Vazquez and Boex (2001).

dominant of the four and its size is set prior to the beginning of the fiscal year in the annual federal budget law. In general, the legislated amounts based on the need/capacity formula are considerably different as a result of political bargaining in Parliament. The share of equalisation grants in total federal transfers increase from 50 percent in 1995 to 70 percent in 2000. The remaining share is mostly for "mutual settlements" which are ex post budgeted for emergency situations and political lobbying.

Since 2001, equalization grants, which are unconditional, have been complemented with transfers for subnational government reimbursement for the two major federal mandates: payment of monthly child benefits (reported as "subventions") and subsidies for payment on various goods and services by persons with disabilities (reported as "subsidies"). Currently, regional-local government transfers are through the assignment of discretionary intergovernmental transfers (as "regulated" revenue sharing or subvention) or through long-term entitlements of local governments to a fixed portion of the yield from "regional" taxes to equalize disparities across their local governments (Martinez-Vasquez et. Al, 2004).

A great source of ambiguity in the Kozak laws is the lack of specific requirements for the methodology of distributing equalisation grants to localities.[10] This constitutes a regression from the 1997 Law, which required regions to use a stable formula and provided a (in some ways too specific) list of parameters to be used. We must note that these requirements were rarely met in practice. It would seem more appropriate to find a finer balance between the flexibility of regional governments and some minimum standards of sound fiscal practice. Although certain parameters of the equalisation scheme can be determined annually, the general framework for grant allocation should be a long-term decision. For example, the base level for expenditure standards can be set each year on the basis of macroeconomic conditions; however, the basic structure of the formula and the methodology for assessing the cross-jurisdictional costs differentials should be fixed on a long-term basis.

Figure 6A.1 shows how the composition of federal transfers to the regions evolved in 1995-2003. The figure shows the distribution of the total amount of federal transfers by four major categories: equalisation grants, subventions, subsidies, and mutual settlements. [11] As can be seen from Figure 6A.1, the share of mutual settlements, which are not budgeted *ex ante* and result from emergency situations and political lobbying, has fallen from 40 percent in 1995 to less than five percent in 2003. At the same time the share of equalisation grants in total federal transfers increased from fifty percent in 1995 to 60 percent in 2000. The remaining share is mostly accounted for by earmarked subsidies and subventions. This shows that recently the Federal Government has been able to keep regional governments to the budgeted amounts of federal aid, an increasing proportion of which has being earmarked.

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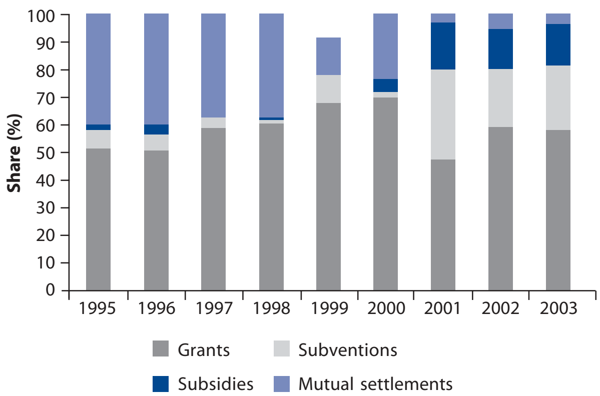
[10] The Kozak laws refer to the Budget Code, which currently requires only the fulfillment of the "social standards," which have never been developed by the federal government.

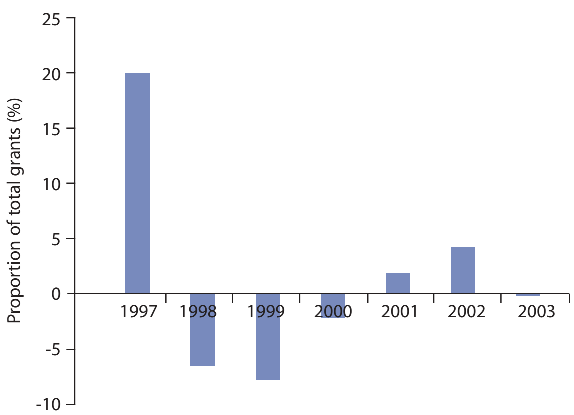
[11] Until 1998, the budget item on "subventions" reported compensation to the City of Moscow for the costs related to its status of the nation's capital. In 1999, the "subventions" item accounted for the Federal Governments' aid to regions in stocking up "supplies of necessities" in localities of the Far North. Being a relic of the Soviet planners' decision on location, the northern settlements still have to be subsidized on humanitarian grounds before an eventual relocation is carried out.

Figure 6A.1: Composition of Federal Transfers to Regional Governments



Source: Updated from Martinez et al forthcoming (2004).

Figure 6A.2: The Flow of Federal Loans (as % of Federal Grants)



Source: Updated from Martinez et. al forthcoming (2004).

At the same time, the centralization of VAT collections resulted in a significant increase in regional governments' dependence on federal transfers. The average transfer-dependence of SNG measured as a share of subnational expenditures financed with federal transfers has been increasing since 1999 and reached 35 percent in 2002. However, at the same time the extent of variation has been narrowing. Thus, the outcome of the recentralization appears to be a more uniform share of subnational expenditure burdens being eased with federal transfers.

Besides reducing the extent of mutual settlements, the Federal Government has also been able to resist regions' requests for intergovernmental loans. Figure 6A.2 shows the flow of federal loans as a proportion of federal grants in 1997-2003. The 1997 bailout to clear wage arrears was partially repaid in the years immediately following. However, in 2001 a new upward trend started to be sharply discontinued in 2003.

Subnational Borrowing

The legal framework for subnational borrowing in Russia has gone through numerous laws and significant changes since the federation. The entire body of budget legislation to federal and subnational governments was replaced by the 1998 *Budget Code*, effective January 1, 2000. In contrast with earlier legislation, the *Budget code* prescribes that subnational budget deficits may only be financed with domestic borrowing. It further limits the deficit of local budgets to 10 percent of pretransfer revenues and the deficit of regional governments to 15 percent (Martinez-Vasquez and others 2004). Overseas borrowing may become possible—using resources as collateral—but such borrowing would require approval from the central government.

Conclusion

The Kozak blueprints for reform have generally moved the reform agenda in the right direction. However, it appears unbalanced as being too rigid on some accounts and too vague on others. It would seem more appropriate to find a finer balance between the flexibility of regional governments and some minimum standards of sound fiscal practice. Under the current plan subnational governments will continue to be deprived of an adequate level of revenue autonomy, which will hurt accountability and the overall efficiency of the government sector. Thus, clearly the job is not finished and more work will be needed in the near future. But, of course, this should be expected as intergovernmental fiscal relations is a life continuing changing process, which will continue to demand study and reform for years to come.

In summary, Russia's record during the transition years in introducing budget discipline and fiscal responsibility among SNGs is a long and torturous one, but it has been ultimately successful. A major lesson is that fostering fiscal responsibility at the subnational level requires first mending the institutions of fiscal federalism to create appropriate incentives and behavioral responses from SNGs, and second commitment and political will from the federal authorities to impose a rule based intergovernmental system that limits bargaining and discretionary actions between the centre and SNGs.

Annexure 7:

Fiscal Federalism in the United States

Table 7A.1: United States' Descriptive Statistics

	2004
Total Pop. (in mill.)	293.03
Pop. Density per km^2	30.4
Number of Intermediate-level Government Units	50
Number of Local-level Government Units (approx.)	87,525
Coefficient of Variation of Pop. Distribution (in %)	110.84
GDP (USD in Billion)	10,990
GDP per Capita (PPP in USD)	37,800
GDP Real Growth Rate (in %)	3.10

Sources: CIA, World Fact Book 2004 (est.). Retrieved on December 3, 2004 from internet website http://www.cia.gov/cia/; and the U.S. Census Bureau available at http://www.census.gov

Currently, the United States is composed of 50 states, one federal district (Washington D.C.), and 87,525 local governments among general purpose local governments (counties, municipalities and townships), special purpose local governments, school district governments, and special district governments. In addition, the U.S. also claims administrative relations with: two federacies (Puerto Rico and Northern Marianas); three associated states (Republic of Palau, Federated States of Micronesia, and Republic of the Marshall Islands); three local home-rule territories; three unincorporated territories; and 130 Native American domestic dependent nations (Griffiths and Nerenberg, 2002). The United States federal system is highly decentralized, generally regarded as an example of a well-managed federal fiscal system.

General Overview

Over time, the US has experienced a change in the mix of spending and revenues at each level of government towards greater decentralization. Federal Government expenditures in 2002 were 50 percent of total expenditures, while the remaining half of total expenditures is in the hands of state and local governments. Education accounts for about 18 percent of direct expenditures at the state level and about 38 percent of local spending. In 2002, states derived nearly 66 percent of total revenues from own-source revenue, while local governments raised 55 percent of local total revenues from own-sources. Although the U.S. is characterized by very low fiscal imbalances, transfers from the Federal Government accounted for 30 percent of states total revenues. Similarly, local governments depend on intergovernmental transfers for nearly 37 percent of their total revenues (33 percent from state and four percent from federal levels). In 2002, state and local debt outstanding was 16 percent of GDP, a modest increase from 14 percent of GDP in 1970 (OECD, 1997c).

Expenditure Responsibilities

The powers and roles of the Federal and state governments are enumerated in the Federal Constitution of 1789. However, the Constitution is somewhat vague regarding the assignment of specific functions to each level of government. As a result, over the years, the role of each level of government has evolved in response to changing conditions. The Federal Government has traditionally been responsible for providing national defense and public welfare, while states and local governments have been typically responsible for providing basic public goods and services, primarily education, police and fire services, transportation, public works, public welfare, and higher education at the state level. The Federal Government has overtime expanded its role in many areas of public activity, especially public welfare and public works. Similarly, states have expanded their role in funding public education, while the provision of these services still remains largely at the local level.

States enjoy general competencies in all functions which are not constitutionally a responsibility of the Federal Government and which do not interfere with federal law.

Expenditure functions of local government are stated in the State Constitutions and State Laws. Local governments, instead, are creations of state governments that issue a charter outlining its responsibilities. Cities/municipalities have general competency in delivering services which are not a formal assignment of the Federal or state government and which are not in conflict with state or federal law. States provide some funding for these services either through own tax

Table 7A.2: State Sales Tax Rates and Combined Average City and County Tax Rates

States	State	Local	States	State	Local	States	State	Local
Alabama	4%	7.95%	Kentucky	6%	6%	North Dakota	5%	5.50%
Alaska	–	1.05%	Louisiana	4%	8.55%	Ohio	6%	7.15%
Arizona	5.60%	7.65%	Maine	5%	5%	Oklahoma	4.50%	8.10%
Arkansas	6%	7.95%	Maryland	5%	5%	Oregon	–	–
California	6%	7.95%	Massachusetts	5%	5%	Pennsylvania	6%	6.25%
Colorado	2.90%	6.15%	Mariana Islands	–	–	Rhode Island	7%	7%
Connecticut	6%	6%	Michigan	6%	6%	South Carolina	5%	5.55%
Delaware	–	–	Minnesota	6.50%	6.70%	South Dakota	4%	5.25%
Dist. of Col.	5.75%	5.75%	Mississippi	7%	7%	Tennessee	7%	9.40%
Florida	6%	6.70%	Missouri	4.23%	6.80%	Texas	6.25%	7.90%
Georgia	4%	6.80%	Montana	–	–	Utah	4.75%	6.45%
Guam	4%	4%	Nebraska	5.50%	6.30%	Vermont	6%	6%
Hawaii	4%	4%	Nevada	6.50%	7.35%	Virginia	4%	5%
Idaho	6%	6.10%	New Hampshire	–	–	Virgin Islands	4%	4%
Illinois	6.25%	7.50%	New Jersey	6%	5.95%	Washington	6.50%	8.35%
Indiana	6%	6%	New Mexico	5%	6.50%	West Virginia	6%	6%
Iowa	5%	6.60%	New York	4.25%	8.40%	Wisconsin	5%	5.40%
Kansas	5.30%	6.75%	North Carolina	4.50%	7.05%	Wyoming	4%	5.15%

Source: US Sales Tax Clearinghouse, 2004.

revenues or through federal transfers. Hence, the design and provision of local services is highly regulated by state and federal requirements.

Revenue Assignments

The US has a decentralized tax administration providing each level of government (federal, state and local) maximum fiscal independence and control over tax base and rates. Federal and state governments can each levy any tax not prohibited by the Constitution or in the case of states by any federal law, except for import and export duties. Both the federal and state tiers of government levy a tax on personal income, although the federal income tax leaves only limited room for the states. Each level is largely responsible for collecting its own taxes, but the states can minimize administrative efforts to an extent by "piggybacking" on the federal income tax structure and returns. There is no broad-based national sales tax, thus states levy their own expenditure taxes. Most states rely on the use of personal income and general sales taxes, which produce more than two-thirds of all state tax revenue. General sales tax rates vary from state to state, ranging from zero to seven percent (See table 7A.2). Additional state revenue comes from a variety of fees and other charges. Since states choose from a variety of tax bases and rates, the US enjoys a low degree of vertical fiscal imbalance.

Local governments derive their power to tax from state governments. Property taxes are the mainstay of local governments and provide the major source of funding for schools. Each state's property tax system is different, with variations in the types of property taxable, and the ways taxes are levied. During the past decade, however, the relationship between property taxes and state and local government services has changed significantly. It has been argued that years of surplus revenue, coupled with voter dislike of the property tax, have resulted in major property tax cuts that have led states to shoulder a growing share of education costs. In addition, a number of states rely heavily on businesses and personal property to provide a large portion of property tax revenue. Under current law, state and local income and property taxes are deductible from the federal individual income tax.

Income tax administration is coordinated between the Federal Government and each of the 50 states including the District of Columbia through agreements to exchange information, thus reducing administrative costs and the opportunity for tax evasion. Individuals and businesses file both federal and state income tax returns and at times there can be considerable horizontal tax overlapping for individuals living and working in different jurisdictions, and businesses that operate in more than one state. In these cases, one jurisdiction would allow a credit for taxes paid to another, but in the case of businesses, funds are allocated according to apportionment formulas which vary from state to state. The Federal Government has proposed a uniform formula for apportioning business income, but it has no power to enforce it (Stotsky and Sunley, 1997).

Intergovernmental Fiscal Transfers

State governments in the US enjoy very large fiscal autonomy and they enjoy access to broad tax bases. Incomes taxes are applied at both levels of government, while sales taxes are at the state level only. Although the US is characterized by very low fiscal imbalance, state and local governments are heavily dependent on transfers from the Federal Government to meet their financial needs. A large portion of Federal grants are transferred to local governments through the states, in addition to state's own grants to local governments. While there is no system in place to equalize fiscal capacity across states, horizontal fiscal equalisation occurs only indirectly (and partially) via grant-in-aid programs (CoA, 2001). Grants can be either conditional or unconditional. Conditional grants can be block grants for health, social services, and other areas, while categorical grants require states to apply them to particular areas of expenditure. These categorical grants act as federal mandates on the states receiving the federal assistance. The Federal Government uses these specific purpose grants, although containing equalisation factors in their formulas, to ensure minimum standards. The criteria of distribution include measures of need of the community, capacity of providing services, cost of providing services, and tax effort. The formulas can be very simple or very complicated but they are generally related to population and per capita income. Formula grants include matching and nonmatching grants. Medicaid is the largest matching program and its distribution varies across states ranging from 50 to 80 percent of state per capita income. Although the Federal Government has made efforts to decrease the number of grant programs, there are still over 500 matching grants. Most of these grants are for education, social services, health, transportation, pollution, and regional development (Stotsky and Sunley, 1997).

In the US, however, intrastate fiscal capacity disparities are larger than interstate disparities (Stotsky and Sunley, 1997). States utilize the same type of grants as the Federal Government to transfer funds to localities. However, the number of grants and their functions are more limited. Over half of state-to-local government transfers are for public elementary and secondary education. The equalisation formula is generally based on tax effort and expenditure needs across districts.

In the US, grants influence the level and composition of spending by the recipient governments, and they are the main mechanism by which Federal and State governments influence actions of lower level governments. In addition, empirical research has found that in the US matching grants stimulate more spending than nonmatching grants, suggesting that intergovernmental transfers are important at determining the level and the mix of public provision of goods and services in the United States.[12]

Subnational Borrowing

Subnational governments in the United States are, in principle, free to borrow without federal involvement. In reality, the Federal Government subsidizes subnational borrowing by exempting the interest on state and local bonds from federal income taxation (Stotsky and Sunley, 1997). Over time, the U.S. has had four significant periods of defaults by state and local governments. Of these, there have been only two direct bailouts of a State or local government by a responsible higher government.[13] Central government and US States have followed a no-bailout policy, with only one exception in Camden, New Jersey. A primary lesson from the US fiscal history is that the central government can resist the political and economic need for local government bailouts if the appropriate market and fiscal institutions are in

[12] See Craig and Inman (1982, 1986) and Stotsky (1991).
[13] Federal Government bailout of Washington D.C. in 1997; and New Jersey bailout of the city of Camden.

place (Inman, 2003). By 1970, all States had adopted Balanced-Budget rules (BBR), except for Vermont which does not have a BBR. The stringency of the balanced-budget requirement varies from state to state. There are four restrictions that generally apply depending on the stage in the budget process at which balance is required: the governor must submit a balanced current budget, the legislature must enact a balanced-budget, the governor must sign a balanced budget, and the state cannot carry-forward a deficit into the next business cycle. Although states are typically required to satisfy all four restrictions, they apply a combination of the four, including some states which are allowed to realize an operating deficit that would carry over into the next fiscal year (Inman, 2003). The risk arises when states do not address their deficits immediately and deficits are pushed to the future. According to Stotsky and Sunley (1997), regardless of the constitutional rule, the municipal bond market ultimately imposes discipline on the state budgets. While some states may issue short-term debt (ten states have no restrictions on debt issuance), they create a problem when issuing large volumes of short-term debt carried over subsequent years to hide deficits. This was the case that took place in New York City which was on the brink of default in 1975 (Stotsky and Sunley, 1997). The largest share of state and local government borrowing has typically financed highways, education facilities, water and sewage facilities, and other utilities.

In addition, states may face statutory and constitutional limitations on their taxing and spending powers. These laws typically limit the growth of expenditures or revenues to the growth rate of personal income. Thus, it is expected that states with tax limits would face higher borrowing costs, while those with expenditure limits might face lower borrowing costs. Overall, 25 states have passed some form of limitation (Poterba and Rueben, 1999). Similarly, states impose limitations to local governments, typically by placing limits on property tax rates. However, these limitations have not proven to be very effective in constraining state governments, even though they have been more effective at constraining local governments (Stotsky and Sunley, 1997).[14]

Unlike the Federal Government, states are not able to issue long-term debt. Issues of general obligation debt require at least the approval of the legislature and in many states, voter approval. The issue of revenue bonds requires legislation to create an agency to issue bonds and the creation of a revenue stream to repay the debt. These practices mean that the issuance of debt is fully in the public view. It is extremely rare for a state government to borrow long-term funds to cover operating expenses, although Louisiana did in 1988 and Connecticut in 1991. There do not appear to be any other examples of this practice in recent years.

Conclusion

Although the U.S. is considered to be highly decentralized compared to other federations, their subnational governments still rely highly on intergovernmental transfers, which exert a large influence on the composition of subnational spending. Moreover, state governments have relied increasingly on income and payroll taxes making their tax revenues vulnerable to

[14] See Kenyon and Benker (1984) and Preston and Ichniowski (1991).

economic fluctuations. Despite this vulnerability, the personal income tax remains the most promising for state taxing power expansion. Although states have the chance to piggyback on federal tax collection, no state has elected to do so because of the high degree of conformity required under the federal tax law, vulnerability of state revenues to change anytime the federal tax base changed, and also the loss of state jobs (Stotsky and Sunley, 1997).

In recent decades, state governments have been pressured by local governments to assume funding responsibilities for certain programs and to increase intergovernmental aid, most of these arising from inter-jurisdictional disparities. Particularly, public education has pressured for increased funding responsibilities at the state level due to spending inequalities across communities. Although states have made efforts to reduce inequalities through increased aid, the U.S. relies heavily on tax competition across districts for equalisation of local public services.

Although subnational borrowing has been rising in recent decades, the promising reliance on fiscal institutions, a federal no-bailout policy, and a very well-developed financial market will continue to contribute to SNGs fiscal health.

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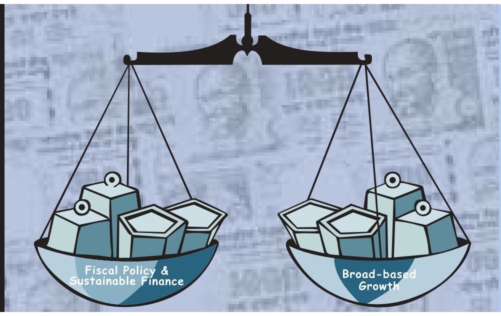

Subnational Fiscal Reforms in India — Achievements and Apprehensions

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Editors Note:

The following paper by Mr. Arunabha Maitra takes us beyond the immediate REFORM Project (which focuses on the need for capacity-building given the emerging fiscal challenges faced by Indian states). The paper provides a historical perspective on the evolution of the emerging fiscal challenges and the rationale for state fiscal practitioners' capacity enhancement.

Prelude

Sub-national fiscal reforms in India emanated from the same sense of urgency of systemic crisis as was witnessed during the balance of payment crisis faced at the Centre during early nineties. The factors contributing to the near-collapse situation were partly cumulative in nature, embedded in the debt financing process of State plans and largely by way of abrupt financial shock due to the implementation of the Fifth Pay Commission recommendations. However, for a better understanding of the incubation of the crisis, the state finances during the decade of nineties need to be examined carefully.

Unlike the Centre, the aggregate revenue deficit of the States was less than one percent of GDP upto the year 1995-96. The fiscal deficit, however, was in close proximity to 3 percent of GDP during this period. The situation can be visible from the Table 1.

The deterioration in the fiscal situation of the States in the nineties, especially in the latter half, has, in fact been more acute than what would appear from the aggregate deficit figures from the above. The frequency distribution of the States according to their respective deficits in terms of percentage of GSDP over the selected years during the decade depicts a deteriorating situation across the States in the Table 2.

The above table clearly indicates the deteriorating fiscal balance acoss the States with the progress of the decade of nineties-especially during the latter half. While only one State had revenue deficit of 3 percent or above as percentage of GSDP in 1990-91, the number of States in this category increased to 14 in 1998-99 in which at least 2 States registered revenue deficit of 7 percent or more. Likewise, the States also showed deteriorating fiscal deficits during this time span. The situation was alarming in the context of rising share of revenue deficit in fiscal deficit indicating more and more borrowed money is spent to meet current revenue expenditure leading to unsustainable debt burden resulting in higher debt servicing and creating further pressure on revenue expenditure.

Table 1: Aggregate Budgetary Balance of the States (as Percent of GDP)

Year	Revenue Deficit	Fiscal Deficit	Primary Deficit
1990-91	0.84	3.28	1.69
1991-92	0.81	2.93	1.19
1992-93	0.72	2.92	1.06
1993-94	0.47	2.49	0.56
1994-95	0.73	2.86	0.84
1995-96	0.77	2.75	0.86
1996-97	1.43	2.97	0.97
1997-98	1.29	3.10	1.00
1998-99	2.72	4.47	2.34

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Table 2: Frequency Distribution of States According to the Size of Revenue Surplus/ Deficit and Fiscal Deficit as Percentage of GSDP (No. of States)

Surplus /Deficit as % of GSDP	Revenue Deficit			Fiscal Deficit		
	1990-91	1995-96	1998-99	1990-91	1995-96	1998-99
Surplus States	8	9	6	2	0	0
Deficit States						
0 to 1	7	5	1	0	0	0
1 to 2	4	7	2	0	3	1
2 to 3	5	2	2	6	5	0
3 to 5	1	1	9	5	10	5
5 to 7	0	1	3	6	3	11
Over 7	0	0	2	6	4	8
Total States	**25**	**25**	**25**	**25**	**25**	**25**

Debt Financing of State Plans

There were several factors, which contributed to the fiscal crisis at the sub-national level that were embedded in the federal fiscal structure itself.

Given the unique distinction between plan and non-plan concept in India and the systemic structure and accepted rituals of arriving at the size of annual plan of the States, it was almost inevitable that sooner or later the revenue deficits of the State Governments would go out of control. In absence of adequate efforts in enhancing States own revenue receipts and establishing a linkage with the size of plan, the funding of annual plan, besides the central assistance, was by and large dependent on debt financing without giving serious thought on its cumulative impact on the financial health of the States. The gap between plan size and State's own resources that has been filled in the form of 70 percent loan and 30 percent grant, were largely deployed in social sector from which there were no financial returns to the State Governments. Even in the infrastructure sector such as power, irrigation and water supply, user charges were so much subsidized that such projects could cover only a fraction of its operating and maintenance costs, leave alone the return on investment. As per the convention, the revenue components of the plan liabilities are expected to be transferred to the non-plan account of the State budget at the end of each plan period. This would enable the Finance Commissions to assess the non-plan revenue deficit of the States for gap filling purpose. In reality, majority of States have not transferred the liabilities to the non-plan account from the 7th Plan period. This compressed the current revenue balance in order to preserve the plan expenditure, which increased incrementally each year. All these resulted in the gradual indebtedness of the States resulting in more pressure on the State finances.

It is also interesting to observe that much this was happening when the Eleventh Finance Commission was in office and was not informed of the already looming danger. At a much later stage, the Twelfth Finance Commission observed "At present, the normal central assistance and the additional central assistance are given to the general category states by the centre in the form of 70 per cent loan and 30 per cent grant (10 per cent loan and 90 per cent grant in the case of special category states). This means that if a general category state wants a grant of INR 30 from the centre, it must necessarily borrow INR 70 from the same, and that, too, at a rate of interest which is often higher than the open market rate. It is also well known that the existing plan process inherently encourages larger plan size. All these result in states getting deeper into debt on account of structurally mandated borrowings." With the deteriorating State finances in the later half of nineties, possibly due to absence of defined monitoring system at the Centre, the Government of India did not seriously think to impose the provisions of the Article 293(3) of the Constitution to curb the debt build-up of the States again perhaps from the consideration of federal fiscal relationship

Pay Commission and Aftermath

At this juncture a very important event took place. The Fifth Pay Commission set up by the Government of India to recommend fresh wage indexation of its employees, submitted its report that was accepted by the Government. The worst case scenario followed when the State Governments, following the queue of the Centre, decided to implement the recommendations for their respective employees. Though the Centre had means to absorb the pressure of the new wage indexation, the States had to face the consequences with their depleted resources. The implementation of the recommendations by the State Governments was called 'the single largest adverse shock to India's strained public finances in the last decade' and the act of India's fiscal profligacy' (Godbole,1997; Acharya,2001). As a result, the wage bill of the employee went up and subsumed the greater part of its total revenue receipts, which eventually exceeded its own revenue receipts.

Rising Interest Burden

Another factor contributing to the deteriorating landscape had been the increasing interest rate at which the Sates were borrowing. Interest rates on loans from the Government of India to the States were raised towards the market rates (Govinda Rao, 2000) and the States became increasingly dependent on small savings loan, a relatively expensive but assured route of borrowing. Coupled with the rising debt build-up as well as increasing rates of interest, debt servicing headed towards an unsustainable level and thereby had a strong impact on revenue accounts.

Off-budget Borrowing

In the regime of deteriorating budgetary balances and increasing liabilities, a number of States took recourse to off-budget borrowings to meet the rising expenditure requirements through Special Purpose Vehicles (SPVs) with commitments to meet debt servicing obligations from the budget. The SPVs often had very little or no revenue base of their own and thus, what were created were not actually contingent liabilities, but off-budget liabilities of the State Governments. The off-budget borrowings became common phenomena in road constructions, rural water supplies, and power sector (the last, largely a loss-making proposition) and in some cases to meet the requirement of salaries. Between 1996 and 2000, the aggregate State level guarantees grew at a compound annual growth rate of 24.1 per cent as compared to that of 7 percent observed between 1992 to 1996 (Crisil, 2002). If these off-budget liabilities were added to the budgeted liabilities, the magnitude of the fiscal crisis in reality was far worse and needed immediate correction.

The deterioration of State finances reached an alarming stage and received much attention of the Centre when the States not only frequently resorted to overdraft from RBI but also had to be bailed out by the Centre to avert suspension of treasuries for a prolonged period.

Initial Interventions

From the existing federal fiscal relationship and historically dearth of experience of the States, the States could not be expected to make the first move towards necessary interventions as traditionally they were accustomed to being dependent on the leadership and initiatives of the Centre. However, later in the document we will see that a number of States started looking towards emerging fiscal solutions, realizing that no State could wait for the Centre to solve every problem.

Alarmed by the intensity of the problem, almost in the last year of the decade, the Centre came up with a proposal to convert the ways and means given to the States into a medium term, non-plan, soft loan to bail out the States. This was achieved through a Memorandum of Understanding (MoU) with the Centre committing to exploring possibilities to enhance its own revenue receipts and reduce unproductive expenditure towards a budgetary balance in the medium term. About 16 States signed the MoU with the Centre by 1999 accepting the proposal. However, the main lacuna of the initiative was that it was not well-structured nor did it have any defined system to monitor progress.

Eleventh Finance Commission

Simultaneously and consecutively two things happened .In the Presidential notification dated July 3,1998, in which several Terms of Reference(ToR) were given to the Eleventh Finance Commission (EFC), paragraph 4 mandated to the EFC that "…the Commission shall review the state of finances of the Union and the States and suggest ways and means by which the governments, collectively and severally, may bring about a restructuring of the public finances so as to restore budgetary balance and maintain macro-economic stability". Subsequently, the Presidential notification dated April 28, 2000 extended the above ToR and added the following: "In particular, the Commission shall draw a monitorable fiscal reforms program aimed at reduction of revenue deficit of the State and recommend the manner in which the grants to the States to cover the assessed deficit in their non-plan revenue account may be linked to progress in implementing the program."

The EFC in its main report addressed the former mandate and in its subsequent supplementary report dealt with the additional ToR.

The EFC report listed in general terms the following - necessary and attainable - fiscal adjustments required of both the Centre and the States by fiscal year 2004-05:

- A 2.63 per cent increase in the Tax : GSDP ratio with 1.48 percent coming from Central taxes, and the balance 1.15 per cent coming from the States;
- A 0.75 per cent increase in non-tax revenues with States accounting for 0.50 percent and the Center accounting for balance 0.25 per cent (The state level was higher since the beneficiaries of many public services could only be identified at the state level); and,
- A decrease in revenue expenditure by 2.3 percentage points of GDP, with the state revenue deficit being entirely eliminated and only a 1 per cent deficit remaining for the Center.

Thus, by 2004-05 EFC envisaged the following fiscal profile for both States and the Center:

- The growth rate of the economy would be restored to7.5 per cent per annum as achieved in the mid-nineties;
- Inflation rate would be kept at 5 per cent;
- The current account deficit would be kept below 1.5 per cent of GDP;
- Revenue account balance would be restored in case of the States;
- A revenue deficit of 1 per cent of GDP was left in the Central budget;
- The combined fiscal deficit was brought down to 6.5 per cent of GDP;
- Aggregate tax revenues of the Centre and the States measured 16.7 per cent of GDP;
- Non-tax revenues reach a level of 3.2 per cent of GDP; and,
- Capital expenditure of the Centre and the States taken together would rise to 6.6 per cent of GDP.

Incentivization of State Reforms

To attain the targets set for the budget variables in the restructuring program, the EFC recommended a reform plan over a wide area embracing the revenue sources, composition of expenditure, public enterprises and inter-governmental fiscal relations. However, the State level reforms initiatives as recommended by EFC culminated in its supplementary report on the additional ToR mandated in April, 2000 as mentioned above.

Admitting the constraints of prescribing a monitorable fiscal reform at the sub-national level in a country like India, the EFC in its supplementary report mentioned the following: "It is difficult to lay down State specific targets of fiscal reforms focusing on revenue growth and expenditure compression for each of the next five years and enforce these, as the performance in this regard is affected by factors beyond their control such as growth of output in the economy, rate of inflation and the budgetary position of the Centre. This is why the fiscal policy rules adopted in several countries in recent years allow a good deal of flexibility in operation and only lay down certain limits/norms in broad terms." The EFC in its main report recommended non-plan revenue deficit grants of INR 33,359.07 to 15 normatively assessed non-plan revenue deficit States during its award period. Before making any recommendation as per the additional term of reference to recommend the manner in which the grants to the States to cover the assessed deficit in their non-plan revenue account, may be linked to the progress in implementation of such a program, it must have been in upper most mind of the Commission whether the already recommended grants to cover States' deficit can be linked to any conditionality and exposing the entitlement to a possible uncertainty thereby breaching the consideration of equity. However, the EFC observed that in the past Finance Commissions' norms to restore budgetary balance were seldom realized or adhered to ; as a result the fiscal situation of the states deteriorated continuously and balance from current revenue plummeted to be covered ultimately by the borrowings. Thus, there is need for a monitorable fiscal reforms program for the States to restore revenue balance of the States.

To incentivize the States to undertake the monitorable fiscal reforms, the EFC recommended to set up an incentive fund. Half of the Fund amount would be created by withholding 15 per cent of the revenue deficit grants earlier recommended in its main report for 15 assessed non-plan revenue deficit States and the remaining half by the equal amount of contribution by the Centre. Thus, the total size of the fund would be INR 10607.72 crores for a period of 5 years. The release of the fund to the States would be made annually on the basis of improvement on revenue account. The stake of the assessed deficit States were more in the program since on making improvement annually they would not only recover their respective withhold amount of revenue deficit grant but also gain earmarked amount from the contribution of the Centre as well. For the assessed non-plan revenue surplus States, the incentive would flow from the contribution of the Centre on making improvement annually. Distributions of the contribution of the Centre among the States (earmarked entitlement) were made on the basis of 1971 population. At the end of the fourth year of the award if any State was unable to draw its share, the amount would be distributed among the performing States on pro rata basis in addition to their original entitlement and to be made available to them if they qualify This was for the first time in the history of the federal transfer the efficiency consideration received prominence over equity. The performance of the States would be monitored by an agency which, *inter alia*, would have representation of Planning Commission, Finance Ministry and the respective States.

Difference within EFC

The recommendations of the EFC were not unanimous. One of the members furnished a note of dissent on these recommendations on the following grounds:

- Withholding a part of revenue deficit grant was unjustified and contrary to the spirit of Article 275 of the Constitution which authorized the Finance Commission such grant in aid.
- Withholding any part of the statutory grant would itself serve to debilitate and destabilize the finances of the States that are in revenue deficit on non-plan account, and thereby upsetting the reform process instead of strengthening it.
- It would create a most unhealthy precedent to impose conditionalities on the release of any part of these grants.
- If the rule of fiscal prudence was to be imposed, it should apply to all states equally and should not discriminate against States who happen to be receiving revenue deficit grants of which 15 per cent had been withheld to form a part of incentive fund.
- Recommendation for reallocation of the withheld amount of revenue deficit grant of the non-performing assessed Deficit State after the 4th year of the award period to any performing assessed surplus State would contradict the recommendations of the main report of the Commission since accepted by ATR and also violate the Constitutional provision.

However, the EFC submitted its recommendations on the view of majority. Differences of opinion within EFC on the monitorable fiscal reform program and constitution of the incentive fund was not difficult to understand. For the last 50 years both vertical and horizontal resource sharing in a federal set-up in India was done within an umbrella of certain provisions by and large governed by the Constitution as well as some accepted norms greatly influenced by the equity considerations. Any deviation from this system was bound to create some resistance from the conservative fiscal federalism. However, the fiscal shock to the sub-national governments at the end of the decade of nineties was never experienced in the past and, thus, needed a bold as well as well structured correction program to restore fiscal balance in the medium term. From that angle, initiatives prescribed by the EFC was much warranted even at the cost of sacrificing some of the so far accepted practices.

States' Fiscal Reforms Facility (SFRF)

Government of India accepted the recommendations of the EFC and translated them in the form of a structured scheme titled the Stats' Fiscal Reforms Facility (2000-01 to 2004-05) incentivizing the States to undertake medium term fiscal reforms program. The first and foremost task of the scheme was to spell out a single monitorable indicator that would not only objectively capture the improvement on revenue account of the individual State but also will be the basis for the release of the incentive grants every year.

Improvements had to be monitored from the base tear adopted by EFC (i.e., 1999-2000). The guideline issued by the Ministry of Finance defined the single monitorable indicator as revenue deficit as percentage of revenue receipts. As per the revised budget estimates of the States only available at that time, the percentage of revenue deficit to revenue receipts was 27.40 for the State sector as a whole. Any target to restore revenue balance by the last year of EFC award period (i.e., 2004-05) asked for at least 5 percentage point annual improvement in the monitorable indicator for of each State. It was decided that above improvement would suffice the release of the corresponding annual earmarked amount of grants from the incentive fund for each State.

After considering the difficulties of special category States, the Ministry of Finance decided that annual improvement of 2 percentage points in monitorable indicators would be sufficient to get the release from the incentive fund prospectively from 2002-03. As recommended by the EFC, if a State failed to get its earmarked amount in any year, the amount would not be lapsed but would available to the State in subsequent years on attaining cumulative performance. The States were asked to draw a medium term fiscal reform program (MTFRP) following the required reduction in monitorable indicator and the contours of EFC prescribed restructuring and also to enter into a Memorandum of Understanding with the Ministry of Finance on the MTFRP.

The EFC recommended that the monitorable program should give equal weight to the rising of revenue and compression of expenditure. The specific components indicated by the EFC for monitoring were only suggestive; so were the weights. Ministry of Finance favored the idea to have a single monitorable indicator for the sake of convenience of monitoring. Revenue deficit as a percentage of revenue receipts give equal weight to revenue and expenditure. Moreover, revenue deficit was a component of fiscal deficit.

Therefore an annual reduction in the ratio by 5 percentage point automatically bring about a reduction in the fiscal deficit and more and more fiscal space for asset creation which was so essential at that time.. These apart, the indicator was simple and could be easily understood without any scope of ambiguity for interpretation.

The MTFRP might cover atleast 4 major elements of the State level reforms (i.e., fiscal reforms), power sector reforms, public sector restructuring, and budgetary reforms. The fiscal reforms would cover widening of tax bases and rationalization of tax rate, pricing services such as irrigation, water, bus fares, computing the subsidy elements and preparing a schedule to reduce the subsidy elements, indexation of prices/user charges to input costs, abolition of vacant posts in Governments except primary school is in the end of the teachers and health workers, work charged establishments to be redeployed to new capital works without engaging new work charge staff, tapering off subventions to Grant-in-Aid institutions etc. In most of the States power sector corporations were incurring huge deficit thereby causing substantial outflow from the budget. Without addressing the power sector reforms any reform initiative can't be meaningful. It was clarified that the power sector reform would aim at reducing the negative contribution of the SEBs to the State revenues. While the Ministry of Power was separately working out a set of monitorable reform milestones (which subsequently took shape as Accelerated Power Development & Reform Program) the basic ingredients of power sector reforms that would be included in MTFRP were achieving an average tariff equal to cost of power within 2 years, setting up State Electricity Regulatory Commissions(SERC) and implementing the awards of SERCs, unbundling of basic services or setting up separate profit centers, reducing T&D losses by 5% every year, metering up to 11KV sub-station level. Most of the State Owned Public Sector Units were running at a loss. Hence, the PSUs were required to be restructured. The SFRF required the States to identify the need of continuing certain services within the State domain regardless whether the PSUs were making loss or profit. The road map of the restructuring program would be evolving VRS package, time bound program for winding up the PSUs, for profit making PSUs the extent of dilution of government shareholding, phasing out infusion of government fund over 5 years unless the unit was socially desirable. The SFRF guidelines also indicated some essential budgetary reforms for transparency and better monitoring, such as, incorporating information on salaries and allowances as a separate schedule in the budget, schedule on pension and terminal benefit, scheme-wise and sector-wise schedule of subsidies (explicit) in the budget, schedule of guarantees outstanding etc. In fact, all these provisions in the MTFRP and MoU had far reaching consequences in adopting certain elements of integrated financial management system like treasury computerization by the larger States for better management of finances.

Another interesting initiative of SFRF was to include some off-budget elements of expenditure in the concept of conventional revenue deficit which were hitherto adversely affecting the State finances. Specifically, inclusion of contingent liabilities which would directly constitute budget liability and subsidies due to PSUs (particularly to State Electricity Boards), irrespective of the situation whether government would pay or not such a subsidy upfront, in the revenue deficit of the States was a bold and much needed step to capture the actual financial condition. However, excepting a few States like Karnataka and Andhra Pradesh, this initiative could not be successful due to non-availability of requisite data at the Finance Department of other States.

Implementation of SFRF

Most States made the effort to comply with the SFRF guidelines. Orissa and Karnataka were the first States to develop MTFRP and they signed MOU with the Government of India.

In the case of Orissa, state finances were very unhealthy and immediate corrective steps were required to arrest and reverse the negative trends, which did in fact occur as a result of the MOU. In addition, the EFC recommended revenue deficit grants to the State for first three years of the award period of which 15% was withheld and tied up with the incentive fund. Unless the State drew MTFRP and signed MoU, there was no chance of getting this grant so essential for the State. However, the State government made very sincere effort to follow the reform path and subsequently along with a structural adjustment loan from a multilateral was able to turn around the situation by the end of the award period of the EFC.

In contrast, Karnataka was much prepared to undertake reform initiatives when the SFRF was launched. The state had already constituted a Tax Reforms Committee followed by achieving essential trigger points to go for structural adjustment loan from the multilaterals. The state had created the data base for off budget SPV borrowings and was poised for power sector reforms. Since the state was assessed as revenue surplus by the EFC, the amount due to the state from the incentive fund was not sufficiently attractive. However, the state came up with the MTFRP and signed MoU with the Government of India without much delay. One reason which perhaps prompted the State Government towards this initiative was the decision of the Government of India to bring facilities from multilateral lending agencies in the ambit of SFRF. The Government of Karnataka as a mark of its commitment to fiscal reform passed Fiscal Responsibility and Budget Management Act (FRBMA) in 2002, well before the enactment by the Government of India in the Parliament.

Besides these two States, the Government Andhra Pradesh was also taking a number of reform initiatives. However, there was delay in signing the MoU with the Government of India due to prolonged negotiation on some elements of MTFRP of the State. Although all the 28 States had drawn up the MTFRP, 27 States signed MoU with the Government of India barring Goa.

By the end of the EFC award period only 14 out of 28 States had utilized their full entitlement. A table showing the States by their entitlement and actual receipts of incentive fund is given in Annex-I. This table shows that, at the end of the EFC award period, INR2296.87 crores remained undisbursed in the incentive fund. As per the recommendation of the EFC this amount would be distributed on a *pro rata* basis among the performing States. However, the Ministry of Finance did not act according to the recommendations. As a result, the EFC recommended that the next (i.e., Twelfth) Finance Commission should:

- Review the monitorable fiscal reforms program of each State and the release of the grants/ incentive to the States.
- Examine the whole matter and take a final view regarding the releases of withheld grants in aid and incentive amount to various States and make suitable recommendations.
- Take a final decision in respect to the release of withheld grants in aid along with other incentives.

At a later stage, the Twelfth Finance Commission as per the mandate, examined the SFRF and recommended the discontinuation of the Scheme which was accepted by the Government of India as per convention. Therefore, the residual balance of the incentive fund ceased to exist with effect from 1st April, 2005 – the beginning date of the award period of the Twelfth Finance Commission.

However, the performing States did not agree with the decision of the Ministry of Finance and persistently demanded the additional share. On the other hand , the non-performing deficit States raised the issue that in case the undisbursed withheld part of revenue deficit grant in the incentive fund was not disbursed as per with the recommendation of the EFC, these might be returned to the States to whom it was earmarked by the EFC originally.

EFC's projections vis a vis States' performance

Table 3 below shows the aggregate performance of the States as against the EFC's projections on major fiscal parameters (as percentage of GDP) in each year of the award period. For easy comparison ,the actual performance of the State sector has been given in the parenthesis.

Comparison between EFC prescription and actual performance of the States as per cent of GDP exact in each year may not be accurate as for its calculation, the EFC had adopted 1993-94 base year series of GDP. However, in order to be consistent throughout this paper, now available, data from the 1999-00 base year series is used. When the two data sets are used as either absolute increase/decrease at the end of the award period of EFC (i.e., 2004-05) the following picture emerges.

- The own tax efforts by the States did not materialize as per the expectation of EFC fully as it fell shot of the EFC prescribed target by 0.39 percentage points due to absence of

Table 3: Actual Performance of the States in Aggregate vis a vis Eleventh Finance Commission's Projection (as % of GDP)

Indicator	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	99-05 (% points)
Own Tax Revenue	5.29 (5.05)	5.52 (5.41)	5.75 (5.33)	5.98 (5.55)	6.21 (5.56)	6.44 (5.77)	1.15 (0.72)
Nontax Revenue	1.03 (1.48)	1.13 (1.49)	1.23 (1.38)	1.33 (1.45)	1.43 (1.36)	1.53 (1.47)	0.50 (-0.1)
Central Transfers	4.06 (3.76)	4.25 (4.20)	4.44 (4.12)	4.63 (4.04)	4.82 (4.19)	4.99 (4.24)	0.933 (0.48)
Total Revenue Receipt	10.38 (10.29)	10.90 (11.11)	11.42 (10.83)	11.94 (11.04)	12.46 (11.11)	12.96 (11.48)	2.58 (1.19)
Total Revenue Expenditure	13.33 (13.10)	13.25 (13.70)	13.17 (13.52)	13.09 (13.35)	13.01 (13.43)	12.96 (12.73)	(-)0.35 (-0.37)
Of which Interest Payment	(2.29)	(2.46)	(2.69)	(2.82)	(2.93)	(2.75)	0.46
Revenue Deficit	-2.96 (-2.80)	-2.37 (-2.59)	-1.78 (-2.69)	-1.19 (-2.31)	-0.06 (-2.32)	0 (-1.25)	(-)2.96 (-1.55)
Fiscal Deficit	-4.71 (-4.61)	-4.27 (-4.14)	-3.83 (-4.10)	-3.39 (-3.97)	-2.95 (-4.41)	-2.50 (-3.40)	(-)2.21 (-1.21)

Note: The numbers in parentheses are the actual state performance against each respective EFC prescription.

required rationalization of taxes by majority of States. However, keeping in view the sluggish growth of the economy during the initial years, the improvement of the State sector as a whole was moderately good during the period.

- There had been no improvement in the non tax revenues of the States during the 5 years period. However, to improve the collection of the non tax revenue a bold reform process was required to be initiated by the States byway of rationalization of user fees and other non tax recoveries which remained a distinct area of under achievement of the States during SFRF period.
- The problem was particularly on the revenue expenditure side. During the first four years of EFC period instead of a compression by 0.32 percentage points, the revenue expenditure went up by 0.42 percentage points. Even if the trend in "non-interest payment" revenue expenditure had not come down, it would be assumed the effect of pay revisions due to Fifth Pay Commission had leveled off. Therefore, the crux of the problem was rising interest payments, which the EFC failed to recognize in its restructuring model.
- However, while monitoring of SFRF the above fact was captured in the scanner and as a corrective step a parallel initiative of debt swap scheme was launched by the Government of India. The essence of the scheme was the prepayment of higher interest bearing central loans by a part of NSSF flow and additional market borrowings which was relatively less costly. Since the swapped amount was entirely central loans, no prepayment agreement or cost was necessary. Due to the swapping though there would not be any change in the stock of debt, the revenue expenditure would come down due to lesser interest payment. The scheme was launche2002-03 and had contributed significantly in bringing down revenue expenditure on interest payments in 2004-05.
- The aggregate revenue deficit of the States at the end of the award period of the EFC could not be eliminated as projected by EFC. The reduction of fiscal deficit to 2.5 percent level was still remained unachieved. These under achievements were not only contributed by the States fiscal effort less than that anticipated but also the central support less than that projected together with the economic slow down.

A Critique of SFRF

Numerically the State Fiscal Reform Facility required States to reduce their revenue deficit as percentage of revenue receipts by 5 percentage points in each year from the base year of the EFC (i.e., 1999-2000). The results of this effort can be found in Table 4.

The performance across the States has been given in Annex II. Out of 28 States, 50 percent of the States (14 States) could achieve the fiscal targets as envisaged in SFRF. The observations on the general performance of the scheme are as follows.

- The target of the scheme to achieve the compression in the monitorable indicator by 25 percentage points at the end of its terminal year was under achieved by 8.16 percentage points. Elimination of revenue deficit as prescribed by the EFC was, therefore, a far cry.
- Except the assessed deficit States, the incentive for reform was not enough to compel other states to embark on the recommended fiscal

Table 4: Aggregate Reduction of Revenue Deficit as Percentage of Revenue Receipts by the State Sector during the Five Years of EFC Award Period

	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	Target
Annual	27.23	23.32	24.81	20.88	20.89	10.89	5.00
Cumulative		3.91	2.42	6.35	6.34	16.34	25.00

reform measures.

- There was apparently a design failure of the scheme. In the base year, the States were in different magnitude of the monitorable fiscal indicator. A uniform reduction target of 5 percentage points was comparatively easier to achieve by the States which had higher revenue deficit as percentage of revenue receipts than the States having much lesser percentage. For example, it was relatively easier to compress the ratio from 85-90 percent to 60-65 percent within a span of 5 years than do the same order of compression from a level of say 7 percent.
- For Special Category States a separate target of monitorable indicator should have been prescribed. However, as a damage control, a target of reduction of the monitorable indicator was reset at 2 percentage points prospectively from 2002-03.
- It was too optimistic to capture the off budget elements in the concept of deficit so early in the reform period. In absence of inadequate data base , lack of information available at a centralized place and dearth of transparency, the concept could not be operationalized in most of the States ultimately, except in case of some advanced States. Therefore, there was alleged confusion and question of duality in monitoring the scheme and the release from the incentive fund. The idea was noble but premature without sufficient capacity building of the States at large.
- From the beginning, the capacity building of the States should have been addressed to create a knowledge base to carry forward a robust framework of MTFRP as a tool of reform process. Besides, except in few cases, the States did not have much expertise to proceed beyond a certain point. Some of the larger States understood the implication of capacity building and initiated the process within their limited capacity. Treasury computerization was one of the glaring examples. In recognition of the situation, under a bilateral agreement, a States Fiscal Reform Management (REFORM) project was introduced in three States by the USAID for capacity building.
- The SFRF had largely failed to address the problem of a steady convergence to a stable and sustainable debt path. It was also true that the prescription of general debt relief package of both Tenth and Eleventh Finance Commission was inadequate compared to the magnitude of the problem.
- The need of the States to meet the reform cost could not be addressed to in a structured manner from the very beginning. Subsequent approach to partially cover the need mainly by additional open market borrowing was not a satisfactory device.
- However, the unambiguous gain was that the States had been sensitized to adopt reform initiatives. It was not a denying fact that improvement in revenue deficit as a percentage

of revenue receipts by 16 percentage points during five years period was no mean achievement considering the fiscal situation of the States in 1999-00.

- The MTFRP framework had given the States and the Centre a more credible and robust framework to view the State finances and its projections, the need for corrective steps and measurable impact of such steps. It should also to borne in mind that before the SFRF, the Indian States were never exposed to such structured fiscal reforms program in the past. From that angle the efforts of the States were really commendable.
- The Eleventh Finance Commission recommended that the Twelfth Finance Commission would review the entire scheme and make recommendation regarding its continuance which was kept in the ToR. Accordingly TFC reviewed the SFRF and recommended its discontinuation basically on three grounds. Firstly, the size of the incentive was much small to provide adequate incentive for prudent fiscal behavior. Secondly, the withholding of a part of revenue deficit grants led to further widening of deficits only to be bridged by borrowings which had further financial implications. Thirdly, fixation of uniform target to all States was a harsh treatment to smaller deficit States and indirect reward to larger deficit states. Besides, TFC criticized the way the scheme was operated and concluded that a scheme which lend itself to such arbitrary flexibility was not desirable.

Debt Sustainability and SFRF

Since 2000, States' revenue receipts have only been able to meet a portion of their revenue expenditures. Thus, most States' borrowings were used to meet their current account expenditures and, as such, could not generate investment returns to help service pubic debt. In 1999-2000 the percentage of States' revenue deficit as a part of their fiscal deficit was nearly 61 per cent. Due to increasing borrowing there had continuous pressure on the debt build up of the States making the debt servicing more and more unsustainable. Therefore, the FRF had to address the problem of debt accumulation and its impact on revenue expenditures by developing a road map to bring State debt down to sustainable levels.

In addition, this debt burden was compounded as State Governments routinely extended guarantees to cover the rising deficits of the State public sector undertakings (PSUs) such as State Electricity Boards. It is estimated that such State guarantees represented 7 per cent of GDP (INR.1,66,116 crores) by 2002. More significantly, a large proportion of such guarantees were given against such projects where there was no immediate possibility of servicing the loans from the cash flows. Thus, liability of servicing the interest and principal repayment devolved largely on the States themselves. The percentage of consolidated debt (budgeted-debt plus off-budget guarantees) to the total revenue receipts by the end of 2001-02 exceeded the 300 per cent benchmark level for the following states: West Bengal, Uttar Pradesh Rajasthan, Punjab, Orissa, Maharashtra and Kerala. Another disturbing development was that States had started to routinely resort to guarantee-backed SPV borrowings in order to meet their own revenue needs. Therefore, the Ministry of Finance had to take urgent steps to address these problems and it did so as supplementary items to the SFRF.

Firstly, each State had an annual borrowing limit imposed on it through Article 293(3) of the

Constitution. This prevented them from borrowing above the prescribed limit. While financing the Annual Plan, the States were indiscriminately following the gap filling approach towards higher plan size through unshackled debt financing route. This had to be checked with the instrument of borrowing ceiling. However, the methodology of fixing borrowing ceiling was a matter of debate and always had scope for further refinement.

Secondly, all SPV borrowings were brought under the ambit of the article 293(3) of the Constitution.

Thirdly, the RBI issued advisory to all commercial lending institutions not to lend solely on the strength of State Government's guarantee and apply due diligence while advancing to State projects. In this vein, the credit rating of State projects was made compulsory before approaching the debt market. However, all these initiatives were essential but not sufficient to create immediate impact of debt servicing liability on revenue expenditure.

In order to improve the fiscal scenario, a debt swap scheme was launched by the Ministry of Finance to help the States to capitalize on the prevailing low interest regime. In this debt swap scheme, States were able to pre-pay expensive loans contracted from the Center through a combined low coupon bearing small savings along with additional open market borrowings. During the year 2002-03, 20 per cent of net small savings loans flown to the States from September to rest of the year together with new additional open market borrowings of INR 10,000 crores was made available for swapping of high cost central loans. Like wise, in 2003-04, 30 per cent of net small savings loans complemented by additional market borrowings were used for the swap. Finally, in the year 2004-05 40 per cent of NSSF and additional open market borrowings was utilized for the purpose.

During the three years period as against estimated high cost central loans of INR 1,14,317 crores, an amount of INR 1,02,034 crores was swapped under the scheme. It was estimated that savings of interest as well as deferred capital repayment would amount to INR 98,000 crores over a spread of years. The scheme also enabled the States to indirectly limit their debt accumulation by swapping new annual NSSF loans for an equal amount of loans. In summary, this debt - swap scheme was developed as a necessity and its impact would be experienced in the years to come.

Finally, and as expected, the issue of ensuring a convergence in the medium term to sustainable and stable debt was remained to be achieved during the first four years of the SFRF. The improvement emerged slowly from the terminal year of SFRF as shown in Table 5.

The Second Phase (2005-10)

The second phase of Indian State Fiscal reform has occurred during the period of the Twelfth Finance Commission (TFC). The TFC has emphasized institutionalization of the reforms process at sub-national level and recommended that each State should enact a Fiscal Responsibility and Budget Management Act with the following core and non-negotiable provisions:

- Eliminating revenue deficit by 2008-09;
- Reducing fiscal deficit to 3 per cent of GSDP or its equivalent defined as ratio of interest payment to revenue receipts by 2008-09;
- Bringing out annual reduction targets of revenue and fiscal deficits;

Table 5: Aggregate Outstanding Debt of the States Over the Years in Terms of Selected Ratios

	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06
Debt as% of GDP	24.7	27.0	29.2	31.2	32.3	32.0	31.4
Debt as% of Revenue Receipt	240.3	242.8	269.5	282.9	290.7	278.6	261.6

- Bringing out annual statement giving prospects for the state economy and related fiscal strategy;
- Bringing out special statements along with the budget giving in detail number of employees in government, public sector and aided institutions and related salaries.

Unlike EFC, the TFC also made a number of recommendations to encourage States to embark on the road of fiscal reform. As examples:

- For those states enacting FRBM legislation, consolidating central loans contracted up to the end of 2003-04 and outstanding as on 31st March, 2005 for a fresh term of 20 years and re-setting interest payments to 7.5 per cent per annum;
- A debt waiver each year of the TFC award period that would be linked to reduction in

Table 6: TFC Suggested Restructuring Path of the State Finances and Performance of the States up to 2008-09 (BE) as a Percent of GDP

1	2004-05 2	2005-06 3	2006-07 4	2007-08 5	2008-09 7	Impt. inputs 8
Own Tax Revenue	5.90 (5.77	6.07 (5.92)	6.24 (6.10)	6.41 (6.25)	6.58 (6.34)	0.68 (0.57)
Own Nontax Revenue	1.20 (1.47)	1.23 (1.33)	1.26 (1.61)	1.29 (1.33)	1.32 (1.26)	0.12 (-0.21)
Total Revenue Receipt	11.60 (11.48)	11.92 (12.01)	11.24 (12.87)	12.56 (13.40)	12.88 (13.55)	1.28 (2.07)
Total Revenue Expenditure	13.60 (12.73)	13.52 (12.20)	13.44 (12.16)	13.36 (12.92)	13.28 (12.99)	-0.32 (0.26)
Of which, Interest Payment	2.90 (2.75)	2.72 (2.36)	2.54 (2.28)	2.36 (2.19)	2.18 (2.04)	-0.72 (-0.71)
Capital Expenditure	2.60 (1.88)	2.70 (2.20)	2.80 (2.31)	2.90 (2.73)	3.00 (2.72)	0.40 (0.84)
Revenue Deficit	2.00 (1.25)	1.60 (0.19)	1.20 (-0.71)	0.80 (-0.48)	0.40 (-0.56)	-1.60 (-1.81)
Fiscal Deficit	4.50 (3.40)	4.20 (2.56)	3.90 (1.69)	3.60 (2.30)	3.30 (2.12)	-1.20 (-1.28)
Inst.pnt/Revenue Receipt	24.90 (23.98)	22.91 (19.66)	20.92 (17.73)	18.93 (16.36)	16.94 (15.08)	-7.96 (-8.90)

Note: (-) indicates surplus in column 2 to 7.

revenue deficits provided the absolute amount of the fiscal deficit did not exceed the level of 2004-05;

- Discontinuation of Central governments lending to the States in order to encourage States to be dependent on the debt market where preferred interest rates would be available;
- In view of the loss of Central loans, States would have to improve their credit ratings in order to raise capital at a preferred rate of interest; and,
- States were advised to establish a fund for future debt amortization using the debt swap scheme during the TFC award period as well as to form a guarantee redemption fund.

Finally, the TFC also suggested restructuring of Central and State finances during its award period. The restructuring path suggested by TFC vis a vis the mid term performance of the State sector as a whole until now is highlighted below. The performance of the States is given in parenthesis.

Debt Consolidation and Relief Facility

On accepting the recommendations of TFC, the Government of India established a Debt Consolidation and Relief Facility (DCRF) for the period 2005-06 to 2009-2010. At the same time, it advised the States to enact and adhere to the targets of the FRBMA if they were going to be able to enjoy central government support, loan consolidation and debt write-offs.

To date, 26 of India's 28 states have passed FRBM legislation and availed the DCRF facility. The only states that have done so yet are West Bengal and Sikkim.

With respect to the DCRF, the TFC made the following estimates on how States could benefit from debt restructuring during the award period:

- Due to consolidation of central loans, the States would experience an INR 11928.91 crores reduction in their loan principal;
- Due to lower interest rates on central loans, States would pay INR 21275.65 crores less interest;
- The total repayment due from the State sector on account of central loan after the consolidation and rescheduling would be INR 32198.69 crores from 2005-06 to 2009-2010;
- On enactment of FRBMAs, States would receive INR 33204.56 crores debt relief during the five years period of TFC and,
- If the States would reduce their revenue deficit to the corresponding amount, the DCRF package would be slightly more than INR 65000 crores, which is much larger than the earlier incentive fund.

Conclusion

Although it is still too early to discern any tangible results from the TFC-prescribed state fiscal reform initiatives, a close look at Table 6 indicates the following trends:

- A continuing shortfall in States' own tax revenue compared to the TFC projection - this is in spite of the growth of tax revenue due both the VAT and overall buoyancy of the economy - which indicates a need for greater rationalization of State taxes;
- States' non-tax revenue continued to trend poorly and this needs to be addressed

separately with a roadmap for non-tax revenue reform linked to specific fiscal milestones;

- Total revenue receipts are higher than the TFC projection due, perhaps, to higher central transfer to the States than estimated by the TFC;
- States have not been able to compress their revenue expenditures, which is largely due to increased expenditures in education and health as well as greater capital expenditure;
- Central interest payments as a percentage of GDP is one year ahead of the target year, which can be attributed to the debt swap scheme and resetting interest rates to a lower level for the consolidated central loans; and,
- State revenue deficits are nearly 1 percentage point less than the TFC target and this has been achieved a year earlier than planned due to an improvement in revenue receipts as a result of the buoyant economy.

Going forward, there is apprehension on the sustainability of state fiscal performance of recent years. As examples:

- In the event of down turn of the cycle (which is in any case inevitable as an economic phenomenon) how far the States would be able to sustain the improvement in deficits;
- States might not be able to maintain a tight revenue balance due to various reasons and this coupled with tight rule based control on fiscal deficit would adversely affect the process of asset creation, which was not desirable;
- A strong opinion that it was not fair to introduce a rule based fiscal regime with control over both revenue deficit and fiscal deficit. TFC could set target for fiscal deficit while leaving the revenue deficit to the prudence of the States; and,
- In which way the States should be equip themselves at this juncture to face all eventualities without depending much on the Centre's initiatives.

In addition, there has been some discussion as to how effective a rule-based finance commission can be. Especially when considering the negative and unavoidable effect an economic down turn will have on the ability of States to meet fiscal performance targets while maintaining development funding. Thus, the discussion is now considering a fiscal correction path that is more than just a series of fiscal metrics but, a fiscal framework that would be based on two key factors that would enable an objective ex post facto evaluation of fiscal performance while at the same time ensuring an accountable and credible fiscal policy. These two factors would be: (1) fiscal rules to ensure sustainability while allowing short-run flexibility; (2) a multiyear spending framework that sought to increase predictability and stability by allowing the automatic stabilizer to operate in response to cyclical variation. Together, these factors would provide States with the opportunity to control expenditure in a customized fashion while doing so in a Medium Term Expenditure Framework as an effective tool to control the expenditure linked to revenue expectations and exogenous shock.

Finally, the Thirteenth Finance has now assumed office and a new set of terms of reference have been mandated. The Commission had been, inter alia, given the mandate to review the state of Union and the States finances, keeping in view, the DCRF. The Commission will suggest measures for maintaining a stable and sustainable fiscal environment consistent with equitable growth and the DCRF. To conclude, there has been considerable progress in Indian state fiscal reform both in terms of effort and results. Many lessons have and are being generated. However, the overriding lesson, indeed clarion signal, has been the problem of hands-on fiscal management skill and capacity in state governments. Thus, the problem of fiscal management capacity building at the States level needs to be addressed to urgently to usher in the possible third phase of reforms. To this end, there is much expectation this will be a key recommendation of the Thirteenth Finance Commission.

Annexure I

Allocation and Release of Incentive Fund to States — (2000-05)

States	Total Amount Allocated for 2000-05	(INR in Crores) Total Amount Released so for 2000-05	Whether Able to Draw Full Allocation
Andhra Pradesh	424.87	221.61	
Arunachal Pradesh	188.76	113.01	
Assam	159.44	159.44	Yes
Bihar	411.41	411.41	Yes
Chhatisgarh	113.66	113.66	Yes
Goa	7.76	0.00	
Gujarat	260.73	55.40	
Haryana	98.02	55.17	
Himachal Pradesh	716.18	318.19	
Jammu & Kashmir	1726.77	1731.25	Yes
Jharkhand	138.94	105.47	
Karnataka	286.15	286.15	Yes
Kerala	208.48	69.05	
Madhya Pradesh	293.14	338.05	Yes
Maharashtra	492.33	55.55	
Manipur	272.23	293.05	Yes
Meghalaya	245.75	245.75	Yes
Mizoram	254.7	53.43	
Nagaland	535.48	422.97	
Orissa	315.35	315.35	Yes
Punjab	174.97	65.03	
Rajasthan	438.33	438.33	Yes
Sikkim	128.15	128.15	Yes
Tamil Nadu	402.36	402.36	Yes
Tripura	377.31	377.31	Yes
Uttar Pradesh	972	579.44	
Uttaranchal	44.77	36.59	
West Bengal	919.68	919.68	Yes
Total	**10607.72**	**8310.85**	
Amount remained unreleased		**2296.87**	

Annexure 2

Revenue Surplus/Deficit as % of Revenue Receipts

(INR crore)

Items/Years	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
0	7	8	9	10	11	12
Andhra Pradesh	-7.34	-18.46	-13.19	-13.28	-11.02	-8.90
Arunachal Pradesh	17.01	-1.90	5.14	6.94	11.70	-0.52
Assam	-20.75	-13.83	-14.78	-4.70	-8.82	-2.94
Bihar	-34.74	-20.84	-13.42	-11.73	-2.05	6.85
Chhatisgarh		14.52	-12.99	-2.08	-10.76	2.01
Goa	-17.01	-15.24	-12.20	-9.11	-8.65	-6.77
Gujarat	-25.38	-40.04	-42.11	-19.94	-20.31	-19.92
Haryana	-20.55	-9.24	-13.89	-7.91	-2.78	-2.31
Himachal Pradesh	-2.86	-42.13	-23.16	-40.52	-40.37	-25.00
Jammu & Kashmir	-9.82	-16.97	-5.15	4.88	5.57	6.34
Jharkand*			-6.79	-11.60	4.11	-4.74
Karnataka	-18.02	-12.56	-21.44	-16.36	-2.53	6.27
Kerala	-45.63	-36.05	-28.77	-38.76	-31.15	-27.18
Madhya Pradesh	-22.21	-16.71	-28.17	-8.73	-31.32	8.70
Maharashtra	-16.89	-26.50	-27.21	-30.13	-24.18	-24.46
Manipur	-26.00	-7.55	-13.70	-6.56	-3.08	5.25
Meghalaya	1.68	4.65	-2.99	6.55	6.09	-3.25
Mizoram	-3.61	-23.35	-30.01	-10.70	6.07	7.08
Nagaland	-0.82	-2.88	-7.71	-11.83	23.17	8.42
Orissa	-43.74	-27.99	-40.21	-18.67	-15.05	-4.41
Punjab	-36.52	-24.91	-42.35	-33.91	-29.35	-24.56
Rajasthan	-37.18	-21.24	-31.23	-30.07	-22.20	-12.06
Sikkim	0.12	11.51	7.91	9.51	11.95	8.93
Tamil Nadu	-26.95	-18.76	-14.55	-23.28	-6.60	-2.47
Tripura	-1.57	-5.86	2.92	-4.29	4.83	15.30
Uttar Pradesh	-33.74	-25.41	-24.20	-18.39	-58.74	-18.59
Uttaranchal		-1.05	-12.65	-14.25	-21.10	-23.26
West Bengal	-90.95	-52.20	-60.92	-59.45	-55.09	-41.31
All States-USD	**-27.23**	**-23.32**	**-24.81**	**-20.88**	**-20.89**	**-10.89**

Note: 1. Data of Jharkhand is not available for 2000-01

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