

*The state budgets for 2012-13 reflected a fiscal stance generally consistent with the roadmap laid down by the Thirteenth Finance Commission. Although all states, barring one, have revised their FRBM Acts, most of them do not include provisions for additional disclosures that enable transparent assessment of their finances. In the context of the renewed efforts to return to the fiscal consolidation path in the post-crisis period, there is a need to analyse the process of fiscal consolidation that involves, inter alia, efforts by the states to raise their revenues by tapping the available resources. On the expenditure front, states need to ensure improvement in the quality of expenditure, as it has a significant impact on the productivity and quality of life. The relationship between states' efforts to raise the quality of human capital through their social sector expenditure and the outcome in terms of the Human Development Index (HDI), therefore, needs to be closely studied. The financial losses of the state power distribution companies (discoms) and contingent claims arising out of this continue to be a drag on the finances of states. The recently-announced scheme for financial restructuring of state discoms is a positive step towards addressing the financial problems of state discoms provided it succeeds in its aim of nursing them back to health. To address the problem of supply constraints fueling food inflation, state governments need to improve the efficiency of the supply chain by encouraging greater public-private participation. There is also a need to improve the management of the surplus cash balances of the states.*

## 1. Introduction

2.1 With the states having embarked on the second phase of rule-based fiscal consolidation from 2011-12 in accordance with their FRBM Acts, the emphasis has to shift towards addressing key challenges to fiscal sustainability by drawing lessons from the past and developing new perspectives. While further improvement in terms of tax efforts through increasing efficiency and other initiatives is of utmost importance, the states need to focus and reorient their expenditure policies to achieve an improvement in the quality of expenditure while also aiming at fiscal sustainability in the medium term. This is imperative from the perspective of improvement in the quality of life as well as improvement of human capital. The improvement in the human development index (HDI) has implications for tapping the potential of 'demographic dividend', which would necessitate higher social sector expenditure as well as effective delivery of public goods. States also need to continue with their efforts to enhance fiscal

transparency so as to enable effective monitoring of the quality, durability and effectiveness of the fiscal correction process. From the perspective of fiscal stability, the implications of the recently-announced financial restructuring plan (FRP), which is expected to bring about a turnaround in the financial health of state power distribution companies (discoms), on state finances demand a careful analysis. This chapter raises key questions about the fiscal challenges faced by the states and attempts to provide an assessment on each of them.

## 2. Fiscal Transparency at the State Government level

***Why is fiscal transparency important for the states? What has been the progress in this regard at the state level?***

2.2 Fiscal transparency is at the core of overall fiscal stability, as it enables an accurate assessment of fiscal position, solvency parameters and fiscal sustainability. It can provide signals of

impending fiscal weaknesses that may help initiate timely corrective measures. The importance of fiscal transparency has been recognised, both internationally as well as domestically, as is evident from the number of committees<sup>1</sup> that have been constituted to look into this area. Although fiscal transparency at sub-national tiers of the government is desirable, given the difficulties in enforceability, the committees favoured identification of minimum standards in specific areas for fiscal transparency at the state level. These include compilation and dissemination of information relating to major fiscal indicators, outstanding liabilities, contingent liabilities (dissemination and risk assessment), major tax expenditures and quasi-fiscal activities. In addition, disclosures in respect of components of liabilities, consolidated sinking fund, risk-weighted guarantees, guarantee redemption fund, assets, claims/ commitments on revenue demands raised but not realised and liabilities relating to major works and contracts including committed liabilities therein have been considered desirable to move towards greater fiscal transparency. Under the Fiscal Responsibility and Budget Management (FRBM) Acts, states are required to bring out statements relating to the macroeconomic framework, medium-term fiscal policy and fiscal policy strategy. The Thirteenth Finance Commission (FC-XIII) further recommended the disclosure of information relating to assistance provided to all categories of urban local bodies.

2.3 The implementation status of the various recommendations in the area of fiscal transparency reveals that most of the states are now publishing data on major fiscal indicators (26 states) and many of them report outstanding liabilities (19 states) and guarantees (20 states). Subsequent

to the enactment of the FRBM Acts, all states are pursuing the targets for eventually achieving revenue balance and a fiscal deficit-GSDP ratio of 3 per cent. Further, they have started indicating targets for guarantees and outstanding liabilities. However, the majority of states do not report data on liabilities and guarantees in the prescribed formats. Only a few states provide information on assets (3 states), claims and commitments (11 states) and liabilities in respect of major works and contracts including some committed liabilities therein (7 states). Some states still do not publish 'Budget at a Glance'. Most states are yet to comply with the requirements of a sensitivity analysis for fiscal forecasts, and related quantification of fiscal risks. Information on extra-budgetary activities, quasi-fiscal activities and composition of debt and financial assets are only partially reflected. State budgets do not provide information on the financial position of local bodies (except for compensation and assignment to local bodies) and do not publish reports on their long-term public finances. State governments are yet to establish a formal institutional mechanism to assess fiscal and macroeconomic forecasts.

2.4 Despite the above lacunae, fiscal transparency at the state government level has increased, particularly after the enactments of FRBM Acts. There is, of course, scope for further improvement in terms of uniform accounting practices and data consistency across the budget documents. All the states should publish documents such as 'key to budget documents', 'Budget at a Glance' and quarterly/half-yearly reviews of their fiscal position, and also disclose information on GSDP, financing of gross fiscal deficit (GFD) and public capital outlays. States

<sup>1</sup> Advisory Group on Fiscal Transparency (2001); Core Group on Voluntary Disclosure Norms for State Governments (2000); Working Group of State Finance Secretaries and members from the Ministry of Finance and Planning Commission, Government of India (GOI); Working Group on Information on State Government Guaranteed Advances and Bonds (2003); Group for formulating a Model Fiscal Responsibility Bill for State Governments (2003); Working Group on Compilation of State Government Liabilities (2005); Advisory Panel on Transparency Standards (2009).

should also publish the economic and functional classification of expenditure, based on the budgetary data. Apart from publishing the data on outstanding liabilities in the prescribed format, they should also disseminate information relating to interest rates and maturity profile in respect of various components of outstanding liabilities. To comply with the IMF code on fiscal transparency, states need to initiate sensitivity analysis, ensure public availability of the mid-year report and improve reporting on contingent liabilities, major tax expenditures and quasi-fiscal activities. The progressive adoption of best practices will enable the attainment of the goals of fiscal transparency and signal any impending danger to the fiscal position of the states.

### 3. Tax Efforts by the States

#### ***How have the states fared in terms of raising revenues through their own efforts to aid the process of fiscal consolidation at the state level?***

2.5 The issue of tax collection and tax effort is crucial in the literature on fiscal federalism in India where taxable capacity varies across states. It fits well within the larger body of literature on fiscal transfers from the centre to the states to address the problem of horizontal and vertical imbalances<sup>2</sup>, as it seeks to clarify whether larger amounts of central transfers to a state leads to substitution effects, where the state in question reduces its own tax effort because of these transfers.

2.6 Studies have shown that there has been a marginal increase in tax collections by the states

after the implementation of the FRBM Acts, but they do not explain how this corresponds to some measurement of what should have been possible to collect, *i.e.*, measurement of tax effort. In order to examine whether fiscal consolidation at the state level was contributed by the efforts of the states in resource mobilisation, an empirical exercise has been undertaken, which shows that the states have not made serious efforts towards increasing their tax revenues in the fiscal consolidation phase. A preliminary analysis of the own tax revenue (OTR)-GSDP ratio of the non-special category states reveals that the average OTR-GSDP ratio during the fiscal consolidation phase (2004-2008) at 6.9 per cent was marginally higher than the 6.7 per cent in the pre-consolidation phase (2000-2004). Grouping these states into three categories, *viz.*, (i) those with OTR-GSDP ratio above average (above the mean), (ii) those with OTR-GSDP ratio lying between the mean and one standard deviation below the mean and (iii) those with OTR-GSDP ratio more than one standard deviation below the mean, shows that during the pre-consolidation period, eight states were in the first group, six in the second group and three in the last group<sup>3</sup>. In the fiscal consolidation phase, while two states (Chhattisgarh and Madhya Pradesh) moved up from the second group to the first group, the others maintained their positions. In recent years (2010-2013), the average OTR-GSDP ratio has increased to 7.2 per cent, with one state (Jharkhand) moving from the third group to the second group and the rest retaining their positions of the fiscal consolidation phase.

2.7 The overall picture as given in the above paragraph is in terms of what the states have

<sup>2</sup> Horizontal imbalances result from financial differences between states and vertical imbalances result from the centre's entitlement to collect a larger share of taxes in relation to their share of total expenses as compared to the states.

<sup>3</sup> First period (2000-2004).

Group 1: Andhra Pradesh, Goa, Gujarat, Haryana, Karnataka, Kerala, Maharashtra and Tamil Nadu.

Group 2: Chhattisgarh, Madhya Pradesh, Odisha, Punjab, Rajasthan and Uttar Pradesh.

Group 3: Bihar, Jharkhand and West Bengal.

achieved and not their actual taxable capacity to tap into the available resources. Tax efforts of states can be indirectly captured through their own tax buoyancies. The results of the empirical exercise undertaken in this regard are presented in Box II.1. A state-wise analysis of the buoyancies of the states was carried out to see the tax efforts by individual states. The fact that the OTR buoyancy was lower for 13 out of 17 states in the fiscal consolidation period than for the period before fiscal consolidation suggests that for most of the states, tax efforts during the phase of consolidation were lower than in the pre-

consolidation phase. This was further borne out by the tax-wise buoyancies for major state taxes. As the fiscal consolidation period witnessed steady increase in the ratio of current transfers from the centre to GSDP, there could have been some substitution effects at play. OTR buoyancies for the recent period, *i.e.*, 2010-11 to 2012-13(BE), show an improvement over the fiscal consolidation phase in 14 out of 17 states. The proposed shift to the goods and services tax (GST) regime would reduce the states' flexibility in determining the rates for taxes that will get subsumed in the GST. Raising tax revenues then would depend more on

### Box II.1 Tax Efforts of the States

The states witnessed significant fiscal consolidation during the period 2004-08. The assumption that fiscal consolidation at the state level would have, *inter alia*, included the contribution of states' own tax efforts is along expected lines. Thus, the relationship between states' revenue generation and their capacity to raise revenue reflecting the states' tax efforts necessitates empirical investigation.

State-wise OTR buoyancies were calculated as a ratio of annual growth in own tax revenues with the nominal GSDP growth rate of the states for the period before fiscal consolidation (2000-04) as well as for the period of fiscal consolidation (2004-08). Based on the calculated buoyancies of the two periods, it is observed that the average buoyancy for the fiscal consolidation period was lower than in the pre-fiscal consolidation period in 13 out of 17 states. However, buoyancy in an individual year, *i.e.*, 2005-06, was higher than unity in 11 states. Notably, that was the year in which most states made the transition from sales tax to value added tax (VAT). It may be mentioned that Gujarat is the only state witnessing a gradual increase in its tax buoyancy in the second period.

To ascertain the efforts of the states in the case of major state-level taxes, the buoyancies of motor vehicle tax (MVT), state sales tax (SST) and stamp and registration fees (SRF) with respect to their respective tax bases were also worked out. While the number of motor vehicles registered in the

states was taken as the tax base for the MVT, the state's GSDP was taken as the tax base for SST and SRF. The buoyancy of MVT was found to be lower in the period of fiscal consolidation (2004-08) than in the period before fiscal consolidation (2000-2004) in 7 out of 17 states. Similarly, the buoyancies of SST and SRF were lower in 8 states and 7 states, respectively, during the fiscal consolidation period than in the pre-consolidation period, implying that the tax efforts in sub-categories of OTR, though appearing to be better than overall OTR, still indicate the lack of sufficient tax efforts on the part of the states.

A comparison of the own tax buoyancies for the recent period, *i.e.*, 2010-11 to 2012-13(BE), shows that the overall buoyancy for the OTR for this period was higher than in the 2004-08 period in 14 out of 17 states<sup>4</sup>. A more nuanced analysis of some of the components of OTR<sup>5</sup>, such as SST and SRF, shows that while the buoyancy of the SST was lower in the 2004-08 period in 12 out of 17 states, in the case of the SRF the buoyancies were lower in all the states other than Jharkhand. The above analysis about recent trends in tax collections by states does not inspire confidence in the tax-raising efforts of the states, although the data for the past three years do have a positive element. Although the improvement in the recent period is encouraging, the impact of the impending GST regime on states' efforts to raise OTR has to be factored in when conducting future studies.

<sup>4</sup> It was lower for Chhattisgarh, Jharkhand and Madhya Pradesh.

<sup>5</sup> Since the number of registered motor vehicles for all three time points, *viz.*, 2010-11, 2011-12, 2012-13, were not available, buoyancies for the states in MVT could not be worked out.



improving efficiency and compliance by tightening vigilance and increasing the use of information technology for tax collections.

#### 4. Quality of State Government Expenditure

***Why do states need to focus on the quality of expenditure? What is the institutional framework available to states?***

2.8 The quality of expenditure has always been an important issue in state finances. At present, revenue expenditure accounts for around 80 per cent of states' aggregate expenditure. The expenditure pattern of the state governments suffers from inherent structural rigidities from components such as subsidies, salaries and wages, pensions and interest payments. As the states play an important role in the development of social and economic infrastructure, expenditure compressions should focus on non-essential components of aggregate expenditure. Getting the right size and the right composition of government expenditure to maximise growth rates while also providing adequately for the government's obligations, such as provision of health and education, are integral to re-sizing the public expenditure of the states. Nevertheless, states need to identify unwarranted items of revenue expenditure that have low growth and welfare implications. The states have done well during 2010-11 to 2012-13 (BE) in comparison with their earlier performance during 2000-01 to 2009-10 in terms of increasing development expenditure and social sector expenditure as a ratio to aggregate expenditure. The capital outlay has increased while the non-development revenue expenditure has come down in recent years, resulting in a lower committed expenditure-revenue receipts ratio. All these developments point to the fact that the quality of expenditure is on the path of improvement, but the scope for downsizing non-essential expenditure and the quality of delivery still remain.

2.9 Expenditure reforms were an important driver of the FC-XIII's approach to the fiscal roadmap for the future. The major thrust of expenditure reforms was to improve the supply of public goods through a reduction in the existing untargeted and regressive subsidies. The Commission underlined the need to improve transparency and accountability by putting in place stricter audit procedures, in general, and operational audit, in particular, for proper assessment of the 'efficiency and effectiveness' of various items of expenditure. It also suggested that 'institutional deepening' through the creation of local body ombudspersons, fiscal councils and independent evaluation organisations would help in better expenditure management. The efficient allocation of public expenditure is crucial not only for setting the pace of fiscal consolidation at the state level but also for raising their economic potential over the medium term.

2.10 In this context, international experiences indicate the use of a wide variety of measures, including placing of limits on certain expenditures, prioritisation of expenditures, greater decentralisation of executive functions, improved cash management and greater accountability in the delivery of services against specified targets. Many countries have embarked on a massive effort at 'government re-engineering' to better target dwindling budgetary resources towards high priority uses. This relates to both the size and sectoral allocations aimed at removing inefficiencies arising from misallocation, design and implementation of schemes and delivery of services. This process seeks to deepen reforms and strengthen capacity for an effective and efficient delivery of basic public services. The amendment of the FRBM Act, 2003 by the centre and the introduction of a Medium-term Expenditure Framework Statement in the Act, which, *inter alia*, includes three-year rolling targets in respect of expenditure indicators, is expected to

bring about fiscal discipline and create the fiscal space essential for the government to pursue its objective of faster, sustainable and more inclusive growth during the Twelfth Plan. The adoption of some of these principles by the states could facilitate the management of expenditure guided by considerations of economy, efficiency and effectiveness.

## 5. Social Sector Expenditure and Human Development

### *Has the social sector expenditure of the states helped human development? What are the lessons for policy makers?*

2.11 The concept of human development signifies improvement in the quality of life of the people in terms of various health and educational indicators. Through betterment of health, education and skills, human development creates human capabilities that can lead to productivity enhancement and acceleration in economic growth. In a broader sense, human development also implies improvements in terms of human rights, participation and freedom of choice. The Human Development Index (HDI) is a composite index measuring the basic dimensions of human development, viz., long and healthy life, education and a decent standard of living as measured by per capita consumption expenditure. Given that social services are primarily state government responsibilities, with more than 80 per cent of combined government expenditure in these areas being incurred by the states, the necessary public interventions would largely have to be at the state level. While it is natural to expect that better

financial health should allow a state to spend more on human development, the relationship between a state government's social sector expenditure<sup>6</sup> and HDI warrants closer examination.

2.12 Under the premise that the onus of human development rests squarely on the state governments, an empirical exercise was undertaken for the period 1993-94 to 2006-07, covering 15 states<sup>7</sup> in 2000-01 and 18 states in 2007-08, including the three newly-formed states of Chhattisgarh, Uttarakhand and Jharkhand (Box II.2). Since the level of PCI (which impacts the quality of life in general through an improvement in economic conditions and enables people to spend more on their health, education and nutrition) is already captured in the HDI, the empirical exercise is limited to measuring the impact of per capita social sector expenditure on HDI. The exercise shows that the lagging states have not attempted to catch up with the better-performing states by allocating a larger share of their aggregate expenditure for human development, as their per capita social sector expenditure has remained significantly lower than that of the leading states, resulting in the persistence of disparities in HDI across states. To reap the benefits of demographic dividend, the country's human resources need to be strengthened and this calls for higher per capita social sector expenditure by the states. It is important for populous states of India to make a considerable improvement not only in terms of the amount of social sector expenditure but also in terms of the mechanism of delivery of social services.

<sup>6</sup> Social sector expenditure consists of social services, along with the warehousing & food storage and rural development heads under economic services.

<sup>7</sup> Andhra Pradesh, Assam, Bihar, Gujarat, Haryana, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Odisha, Punjab, Rajasthan, Tamil Nadu, Uttar Pradesh, West Bengal.

## Box II.2

## Social Sector Expenditure and Human Development - An Empirical Exercise

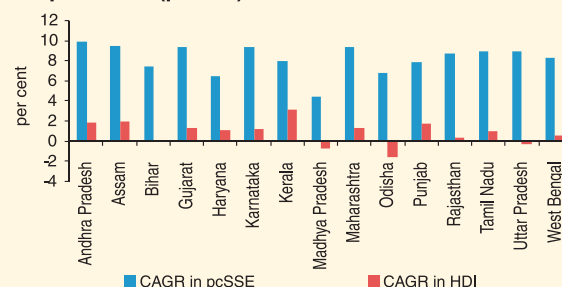
Social services are primarily the responsibility of state governments. Since the level of the Human Development Index (HDI) can be expected to be related to the state governments' social sector expenditure, it is helpful to examine the relationship between a state government's social sector expenditure and HDI. An empirical exercise was, therefore, undertaken to study the relationship between the social sector expenditure of the major states in India and their respective HDI. Since HDI brought out by the Planning Commission is available with a gap of 7 years, the exercise attempts to relate the HDI performance with the social sector expenditure undertaken in the preceding 7 years. The exercise covers 15 states in 2000-01 and 18 states in 2007-08, including the three newly-formed states bifurcated from existing states, viz., Chhattisgarh, Uttarakhand and Jharkhand. A look at the average ratios of social sector expenditure to aggregate expenditure for both time points reveals that during the first period the ratio of social sector expenditure to total expenditure in 11 states was higher than the average for 15 states; of these, three were among the top five states and four among the bottom five states. The scenario in the second period shows that only in seven states (of the earlier 11 states) was the ratio of social sector expenditure to total expenditure higher than the average for 15 states<sup>8</sup>, with three each from the top five and the bottom five states. These results suggest that lagging states have not made any discernible attempts at closing the gap with the leading states in terms of higher outlay on social sector expenditure.

Since the above exercise does not factor in an important characteristic of the Indian economy *i.e.*, the population size of these states, an exercise based on per capita social sector expenditure was conducted. The analysis involves examining the relationship between average per capita SSE (pcSSE) in the preceding seven years and HDI. The relationship turns out to be positive, implying that higher pcSSE leads to better outcome in terms of HDI. The co-efficient of correlation is found to be highly significant with 'r' value more than 0.75 for both the periods. It is important to note that the HDIs for the three bifurcated states, viz., Bihar, Madhya Pradesh and Uttar Pradesh, are not strictly comparable, since the newly-created states performed better than the parent states in 2007-08, except in the case of Chhattisgarh, which lagged behind Madhya Pradesh. The positive impact of pcSSE on HDI is also borne out by regression analysis<sup>9</sup>. The disparities in pcSSE, in terms of co-efficient of variation, are higher

in the second period of analysis than in the first period, increasing from 20.0 in 2000-01 to 23.5 in 2007-08. The co-efficient of variation in HDI also increased from 16.3 to 23.0 during this period.

A comparison of state-wise growth in average per capita social sector expenditure and HDI in 2007-08 over 2000-01<sup>10</sup> shows that, by and large, states that increased their per capita social sector expenditure have also seen an improvement in their HDI. The exceptions are Odisha, Madhya Pradesh and Uttar Pradesh which, despite an increase in per capita social sector expenditure, have witnessed a decline in HDI. Although Bihar increased its per capita social sector expenditure, its HDI has remained unchanged between 2000-01 and 2007-08. Kerala registered the maximum increase in HDI, although the growth in its per capita social sector expenditure was not the highest, benefitting from early start in expanding social sector expenditure (Chart 1).

Chart II.1: Growth in per Capita Social sector Expenditure (pcSSE) and HDI : 2007-08 over 2000-01



The rank correlation between HDI in 2000-01 and 2007-08 is extremely high (0.93,  $t=12.2$ ), which suggests that almost the same states have performed well in both time periods and likewise for the worst-performing States. The gap between the top five states and bottom five states in terms of the pcSSE of 2000-01 has worsened in comparison with the national average, as the divergence in terms of per capita SSE for the same states has increased from 40.2 per cent to 49.6 per cent.<sup>11</sup> In recent times (2007-08 to 2012-13) the gap in terms of per capita SSE has come down from 49.6 per cent to 42.8 per cent, which may contribute somewhat to reducing the disparity among states in terms of expected HDI.

<sup>8</sup> The expenditures of the bifurcated states were added to their parent states for the purpose of comparison.

<sup>9</sup>  $\lg\_HDI = -4.23 + 0.51 \lg\_pcSSE$   
(5.47)\*\*\* (4.46)\*\*\* [1<sup>st</sup> period]

$\lg\_HDI = -4.20 + 0.47 \lg\_pcSSE$   
(4.24)\*\*\* (3.50)\*\*\* [2<sup>nd</sup> period]

\*\*\*Figures in parentheses are t values, which are significant at one per cent level.

<sup>10</sup> During the second period, per capita social sector expenditure of the bifurcated states has been combined with that of their parent states and the HDIs of the bifurcated states have been merged with their parent states weighted by their respective population.

<sup>11</sup> Top 5: Kerala, Maharashtra, Gujarat, Tamil Nadu and Haryana. Bottom 5: Bihar, Uttar Pradesh, West Bengal, Assam and Madhya Pradesh.

## 6. Financial Viability of State Power Distribution Companies: Impact on State Finances

***What are the implications of the deteriorating financial health of the state power distribution companies (discoms) on the finances of state governments? What are the recent policy measures taken to address the problem of mounting short-term liabilities of state discoms?***

2.13 While the revenue accounts of several state governments continue to record surpluses, despite recent moderation witnessed in some of them, this needs to be seen in the light of the mounting accumulated losses in state power distribution companies (discoms), estimated at ₹1.9 trillion as at end-March 2011. Non-revision of tariffs, subsidy arrears, the high cost of buying short-term power and high distribution losses are some key reasons for the financial ill-health of the discoms. As the discoms have largely availed of short-term borrowings from banks and financial institutions to cover cash losses, it has raised serious concern not only for the discoms but also for the banks/ financial institutions that have lent to them. State governments extend support to the discoms through various direct and indirect channels. Budgetary support by the state governments is in the nature of subsidies and grants *in lieu* of subsidised power provided to certain categories such as agricultural and domestic consumers, and equity/bond investments and direct loans to discoms. Off-budget support is in the form of state government guarantees for the loans obtained by discoms from banks/financial institutions. In addition to these regular channels of direct and indirect financial support, the state governments had issued power bonds effective 2001 under a one-time settlement scheme to clear the dues of state electricity boards (SEBs) to central power sector utilities. The debt servicing/repayment of these bonds had an impact on state finances.

2.14 Growing concerns over the financial health of discoms in recent years have led to several

committees being set up at various levels to examine the issues plaguing these utilities and to suggest appropriate remedies so as to address their commercial viability and prevent further deterioration in their finances. The Expert Group on 'Financial Health of State Distribution Utilities' was constituted by the Planning Commission to assess the cumulative losses of the distribution utilities in seven states and work out financial restructuring and turnaround plans for the power distribution companies in these states. Based on the recommendations of this Group and its own assessment, the centre has brought out a scheme for the financial restructuring of state discoms (Box II.3). The near-term impact of the scheme will be on the interest outgo and, thereby, the revenue expenditure of the states that opt for the financial restructuring scheme. The portion of operating losses and interest commitments of state discoms in Rajasthan, Tamil Nadu, Haryana and Uttar Pradesh (not covered by the banks/ financial institutions) would also have to borne by the state governments. Under the scheme, banks are expected to support the restructuring of debt by waiver of penal interest, moratorium on repayment of principal and restructuring of existing loans.

2.15 Of the seven states identified by the Expert Group, Madhya Pradesh government has opted not to avail of the scheme, as a major portion of the short-term liabilities of the state discoms are with the state government. The state government has restructured these loans so as to ease the financial pressure on the discoms. The other states are in the process of working out the modalities for the scheme with the various stake holders.

2.16 The restructuring of the short-term liabilities of state discoms to bring about a turnaround in their financial position can be successful only under the following conditions: (a) removal of systemic deficiencies of the state discoms; (b) elimination of the gap between average revenue realised and average cost of supply as early as



**Box II.3****Scheme for Financial Restructuring of State Power Distribution Companies (Discoms)**

In an attempt to enable the turnaround of state-owned power distribution companies (discoms) and ensure their long-term viability, the Ministry of Power announced a scheme, formulated and approved by the central government, for the financial restructuring of state discoms on October 5, 2012. The scheme has been prepared keeping in view the fragile health of the state discoms arising from serious systemic deficiencies in their working.

The scheme contains various measures required to be taken by state discoms and state governments to improve the operational performance of the discoms. The salient features of the scheme are set out below.

- 50 per cent of the outstanding short-term liabilities (STL)<sup>12</sup> as of March 31, 2012 to be taken over by state governments. This shall be first converted into bonds to be issued by discoms to participating lenders, duly backed by state government guarantee.
- Takeover of the liability by state governments from discoms in the next 2-5 years by way of issuance of special securities in favour of participating lenders in a phased manner, keeping in view the fiscal space available until the entire loan (50 per cent of STL) is taken over. The door-to-door maturity will not be more than 15 years, with a moratorium of 3-5 years on the principal repayment.
- The state government would provide full support to the discoms for payment of interest for this portion.
- The balance 50 per cent of the STL would be rescheduled by lenders and serviced by the discoms with a moratorium of 3 years on the principal. Repayment of the principal and interest would be fully secured by state government guarantee.
- The restructuring/rescheduling of the loan is to be accompanied by concrete and measurable action by the discoms/states to improve the operational performance of the distribution utilities.
- The central government will provide a transitional finance mechanism (TFM) in support of the restructuring effort, subject to the fulfillment of mandatory conditions. The TFM will have the following features:
  - Liquidity support for three years beginning 2012-13 in the form of grants equal to the value of the additional energy saved by way of accelerated AT&C loss reduction beyond the loss trajectory specified under the Restructured Accelerated Power Development and Reform Programme (RAPDRP); eligibility for

the grant from the centre would arise only if the gap between average revenue realisation (ARR) and average cost of supply (ACS) for the year has been reduced by at least 25 per cent during the year judged against the benchmark for the year 2010-11.

- Capital reimbursement support of 25 per cent of principal repayment by the state government on the liability taken over by the state government under the scheme; the amount is to be reimbursed only in case the state government takes over the entire 50 per cent of the short-term liabilities (corresponding to the accumulated losses) outstanding as at end-March 2012.
- A separate arrangement would be worked out, after due consultation with the Ministry of Power and the concerned states, to finance the operational losses and interest for the first three years on a diminishing scale; the remaining portion of operating losses will have to be financed by the respective state government.
- To monitor the progress of the turnaround plan, two committees at the state and central government levels are to be constituted.

The scheme has been made effective from the date of notification, *i.e.*, October 5, 2012, to remain open up to December 31, 2012, unless extended by the central government. The scheme would be applicable to all state-owned discoms that have accumulated losses and face difficulty in financing operational losses, subject to the fulfilment of certain mandatory conditions stipulated under the scheme. The central government's support to states under the scheme in the form of grants and capital reimbursement would be contingent upon the states meeting certain stringent mandatory conditions relating to tariff setting and revenue realisation, subsidy payment, time-bound plan for metering all categories of consumers and finalisation of audited accounts.

**Implications for the State Governments**

As per the announced scheme, 50 per cent of the outstanding short-term liabilities (STL) of the state discoms to lending institutions would be taken over by the state governments through issuance of special securities in favour of participating lenders in a phased manner, until the entire bonds corresponding to 50 per cent of short-term liability are taken over by the state government. The state government will provide full support to the discoms for payment of interest until the entire bonds are taken over by

(Contd....)

<sup>12</sup> Outstanding short-term loans and payables for power purchase of more than 60 days corresponding to the accumulated losses of the discoms as on March 31, 2012.

(...Concl.)

the state government. Repayment of the special securities will commence at the end of five years, with one-tenth of the principal being repaid to the lending institutions every year.

The conversion of the debt of discoms into state government bonds would have to take place within the FRBM space. State governments would ensure that issuance of special securities is within the targets prescribed in the FRBM Acts and, even if fiscal space including the debt-GSDP ratio under the FRBM targets is available, states would have to remain within their net borrowing ceilings (for each of the relevant fiscal) fixed annually as per the formula prescribed by the Thirteenth Finance Commission. Phasing of special securities for the seven states with debt-ridden discoms based on provisional figures for short-term liabilities is set out in Table 1. However, in case a state is able to find more fiscal space during any year, it would ensure that liabilities are taken over as soon as possible.

**Table 1: Phasing of Special Securities by the State Government to the Discoms**

(Amount in ₹ billion)

State	50 per cent of short-term liabilities (STL)	2012-13	2013-14	2014-15	2015-16	2016-17
Andhra Pradesh	31.51	22.11	9.40	-	-	-
Haryana	78.59	25.18	24.96	28.45	-	-
Madhya Pradesh	5.85	0.72	5.13	-	-	-
Punjab	58.23	8.81	10.04	11.45	13.05	14.88
Rajasthan	198.55	26.49	34.96	39.86	45.44	51.80
Tamil Nadu	95.73	8.84	25.26	28.80	32.83	-
Uttar Pradesh	129.67	19.19	22.45	25.59	29.18	33.26
<b>Total</b>	<b>598.13</b>	<b>111.34</b>	<b>132.20</b>	<b>134.15</b>	<b>120.50</b>	<b>99.94</b>

' - ' nil.

Source: Ministry of Power.

possible through periodic tariff revisions; and (c) rationalisation and better targeting of subsidies. While the proposed restructuring/rescheduling of loans is to be accompanied by concrete and measurable action by the discom/states to improve the operational performance of the discoms, past experience in the implementation of remedial measures suggested by the Ahluwalia Committee has not been encouraging. Hence, the strict enforceability of the conditions associated with the restructuring package has to be ensured so that the overall financial stability in the economy is not threatened by the restructured loans turning into non-performing assets.

## 7. Supply Chain Management and Food inflation

***What is the importance of supply chain management in controlling food inflation? How can state governments help strengthen the supply chain?***

2.17 Asymmetries in price transmission across the supply chain for agricultural commodities are one of the important reasons for food inflation in India. While agricultural marketing is a state

subject, inflation management is viewed largely from the national perspective. As food price inflation mostly arises from supply-side shocks, efficient management of the supply chain can play a major role in controlling price increase by limiting the scope of leakages. An efficient supply chain mechanism ensures reasonable prices for producers as well as protects the interests of the final consumer by minimising intermediation costs/storage losses. It also reduces volatility in product availability and prices, thereby improving the overall efficiency of the system.

2.18 Supply chain can be strengthened by: (i) enhancing the capabilities of farmers, (ii) strengthening infrastructure and (iii) legislative interventions. By encouraging farmers to organise themselves into groups - growers' groups, co-operatives, self-help groups and producer companies - supply chains can be streamlined as well as made more egalitarian. Also, investments across the entire agri-value chain spectrum, such as the creation of cold chains and rural godowns, new agricultural marketing infrastructure, and modernisation of existing markets, could be

promoted by providing them with appropriate fiscal incentives. As suggested by the Inter-Ministerial Group on Inflation, perishables could be taken out of the ambit of the Agricultural Produce Market Committee (APMC) Act to encourage arbitrage activity by small traders and farmers by allowing them to freely trade perishables through buying where it is cheap and selling where it is expensive. Similarly, from the long-term perspective of inflation management, it is crucial to improve *mandi* governance by holding regular elections of agricultural produce market committees as well as to bring professionalism into the functioning of the existing regulated markets through public-private partnerships.

2.19 The Working Group of the Twelfth Five-Year Plan on “Agriculture Marketing Infrastructure, Secondary Agriculture and Policy Required for Internal and External Trade” has identified areas of agriculture marketing that should be emphasised during the Plan period. These include: a) greater responsibility to producer organisations; b) direct linkage with retailers/ processors/ exporters; c) price discovery through virtual market platforms; d) direct marketing; e) organised retailing and removing restrictions on FDI for greater competition; f) market access for small producers; g) reforms in the APMC Act; h) an integrated value chain system that covers areas such as partnership, information and communication technologies, leveraging networks, value chain financing, smallholder policy, and contracts; i) promotion of innovative marketing models for effective market participation and j) public-private partnerships (PPP) for efficiency and effectiveness. Measures in some of these areas have already been taken, such as amendments to the APMC Act by some state governments to provide for the introduction of private market, e-market, direct purchase market, farmer-consumer market, contract farming and an inter-market dispute settlement mechanism. Further

measures are required, particularly in providing a convergence platform at the national, state and district levels, where private players join hands with a large number of farmers through ongoing schemes and programmes of the central and state governments in a PPP mode.

## 8. Surplus Cash Balances of the States

***How do the surplus cash balances of the states affect their finances? Why do states accumulate these balances?***

2.25 State governments have been accumulating large surplus cash balances since 2004-05. These cash balances generally increase towards the final quarter of the year to provide for delays in the release of funds by the central government. Apart from the improved revenue account position of the states, the accumulation of large surplus cash balances indicates that some states tended to borrow more than their fiscal deficit.

2.26 Given that states have ample surplus cash balances and the GFD-GSDP ratio is envisaged to decline in the coming years, it is essential that states adopt a need-based approach to their market borrowings. Since states earn a lower rate of return on these investments, instead of over-borrowing, they may consider using their surplus cash balances to finance their GFD. The FC-XIII has suggested that there should be a directed effort by states with large balances towards utilising their existing cash balances before resorting to fresh borrowings. Alternatively, the cash surplus may be used to pre-pay old high-cost debt, as has been done by some states in the past. Further, states may make efforts towards capacity building for better cash management. Effective cash management is possible only if state governments develop the skills and capacity to record, monitor, and project short-term inflows and outflows. States should encourage co-ordination among state entities that collect revenue and expend funds.

**Conclusion**

2.27 The budgeted fiscal stance of the state governments during 2012-13 was generally in line with the revised road map of the FC-XIII. Measurement and reporting of implicit obligations of the states will reflect the true fiscal positions of the states. States need to exploit their revenue-raising potential, with special emphasis on improved efficiency and compliance through the use of information technology and vigilance in preparation for the transition to the GST regime. The quality of expenditure also needs to be improved by

cutting down on non-productive expenditure while increasing expenditure that would impart counter-cyclical growth impulses to the economy. Public expenditure on building human capital stock would be the major determinant of inclusive growth in the future and will be critical to reap the demographic dividend. The financial losses of state power discoms continue to act as a drag on the finances of the states. The financial restructuring scheme, if implemented in the right spirit, may get rid of one of the most daunting problems of state finances by turning state discoms into financially viable units.