Chapter 7

State Finances: Assessment of Revenue and Expenditure and Structural Reforms

7.1 This chapter has two parts. In the first part we have explained the methodology adopted to assess and project the revenues and expenditure of the states during our award period. In the second part we have examined those aspects which critically impact state finances and require the urgent attention of states. We have also made certain recommendations pertaining to reforms in this regard.

A. Assessment of Revenue and Expenditure:

7.2 In the previous chapter we have analyzed the state of Union Finances and made projections for the Union Government. For a proper assessment of the required proportion of devolution from central taxes and the quantum of grants-in-aid from the Centre to the states, it is essential to assess the finances of the states and make projections thereon.

7.3 The finances of the states have experienced deterioration during the latter half of the previous decade as well as the initial years of this decade, subsequent to which the states undertook far-reaching fiscal reforms that have resulted in considerable improvement. In our assessment we have taken these fiscal reforms into consideration.

Basic Approach

7.4 Assessing the finances of states is a challenging task because of the diverse nature of their economies as well as their expenditure needs. Keeping in mind this diversity, we have followed a normative approach to ensure that given their respective levels of fiscal capacity, expectations of efficiency are similar across states. This would require some improvements during the award period, especially for those states that are lagging behind.

7.5 The most important variable to be projected is the Gross State Domestic Product (GSDP) of states, which forms the base for various other items like tax revenues. For the purpose of GSDP projections, we have examined the projections assumed for the Eleventh Five-Year Plan. These projections are relevant for only two years of our award period and precede the recent economic slowdown. We have, therefore, modulated the Planning Commission estimates to factor in the impact of this slowdown and the subsequent gradual recovery to arrive at the yearly estimates of GSDP for states during the award period.

7.6 We had requested the states to provide us their projections of receipts and expenditure. We find that the states have projected Own Tax Revenues (OTR) of 7.5 per cent of GSDP in the year 2014-15 as compared to 7.9 per cent in 2007-08. Similarly, they have projected Non-plan Revenue Expenditure (NPRE) at 12.8 per cent of GSDP in the year 2014-15 as compared to 12.3 per cent in 2007-08. A consolidated picture is presented in Table 7.1 and state-wise details are given in Annex 7.1.

Table 7.1: Past Performance and Projections of the States' Receipts and Expenditure

(*per cent of GSDP*)

	2001-02	2007-08	2014-15
OTR	6.6	7.9	7.5
NTR	1.7	2.0	1.0
NPRE	14.4	12.3	12.8

7.7 In our assessment the projections given by states do not adequately reflect the past trend or the current economic outlook. We have, therefore, decided to make our own detailed assessment of the revenue and expenditure of each state. In doing so, we have taken into consideration not only the past trend, but also recent decisions relating to the recommendations of the Sixth Central Pay Commission (CPC), which have had a significant impact with regard to the states' finances. We have adopted a normative approach for receipts and expenditure while assessing the revenue and expenditure of the states.

7.8 The basic approach followed is to assess the base year (2009-10) estimates, based on the past performance and the budget estimates of the states. On the basis of the base year estimates and the norms adopted, we have projected each item for the award period. This approach is similar to the approach followed by previous Commissions. In this part we detail our methodology and the underlying assumptions of our approach.

Gross State Domestic Product

7.9 Gross State Domestic Product has been used as a proxy for fiscal capacity in projection of Own Tax Revenues of the states. It has also been used as the base to determine the fiscal reform path for states.

7.10 There are some differences in the methodologies for computing GSDP across states. Following the practice of past Commissions, we requested the Central Statistical Organization (CSO) for comparable figures of GSDP. They have given their estimates, which we have adopted. As is well known, GSDP is estimated at factor cost.

7.11 Comparable estimates are available for the 1999-2000 series, from 1999-2000 to 2006-07. This data has been used to obtain GSDP estimates for 2007-08, 2008-09 and 2009-10. The estimation has been carried out sectorally for each state, aggregated and then adjusted for consistency with the Gross Domestic Product (GDP) growth rates. Subsequently, a target rate of incremental growth has been fixed for each state depending on the projected growth rate for the Eleventh Five-Year Plan, to be achieved by the terminal year. The growth rates have been fixed in each of the years of the award period so as to reach the targeted growth rate in the terminal year in such a way that the all-state GSDP is consistent with the GDP projected for the award period.

Base Year

7.12 The comparable GSDP estimates are available till 2006-07. Our first task is to project GSDP for the base year. In order to estimate the GSDP for each state for the base year and the intervening period, the GSDP figures for the primary, secondary and tertiary sectors were projected separately for each state, and then aggregated to obtain the state GSDP. As the first step, the Trend Growth Rate (TGR) for the all-state GSDP at factor cost as well as for GDP at factor cost has been calculated separately for each sector and the ratio of TGRs of the all-state GSDP and GDP has been arrived at for each of the three sectors. This ratio has been applied to the sectoral GDP growth rate for 2007-08 to obtain the all-state GSDP growth rate for each sector, for 2007-08. This, in turn, has been applied to the all-state GSDP for 2006-07 to obtain the all-state GSDP for each sector, for 2007-08.

7.13 As the next step, the annual average growth rate for each state for each sector has been calculated for the period 2001-07. These growth rates have been proportionately adjusted with a common factor across all states in such a way that the individual state GSDP estimates for each sector for 2007-08 add up to the sectoral all-state GSDP estimated, as explained in the previous para. The sectoral GSDP figures for each state have been added to arrive at the aggregate GSDP for 2007-08. This process has been repeated for the 2008-09 and 2009-10 figures.

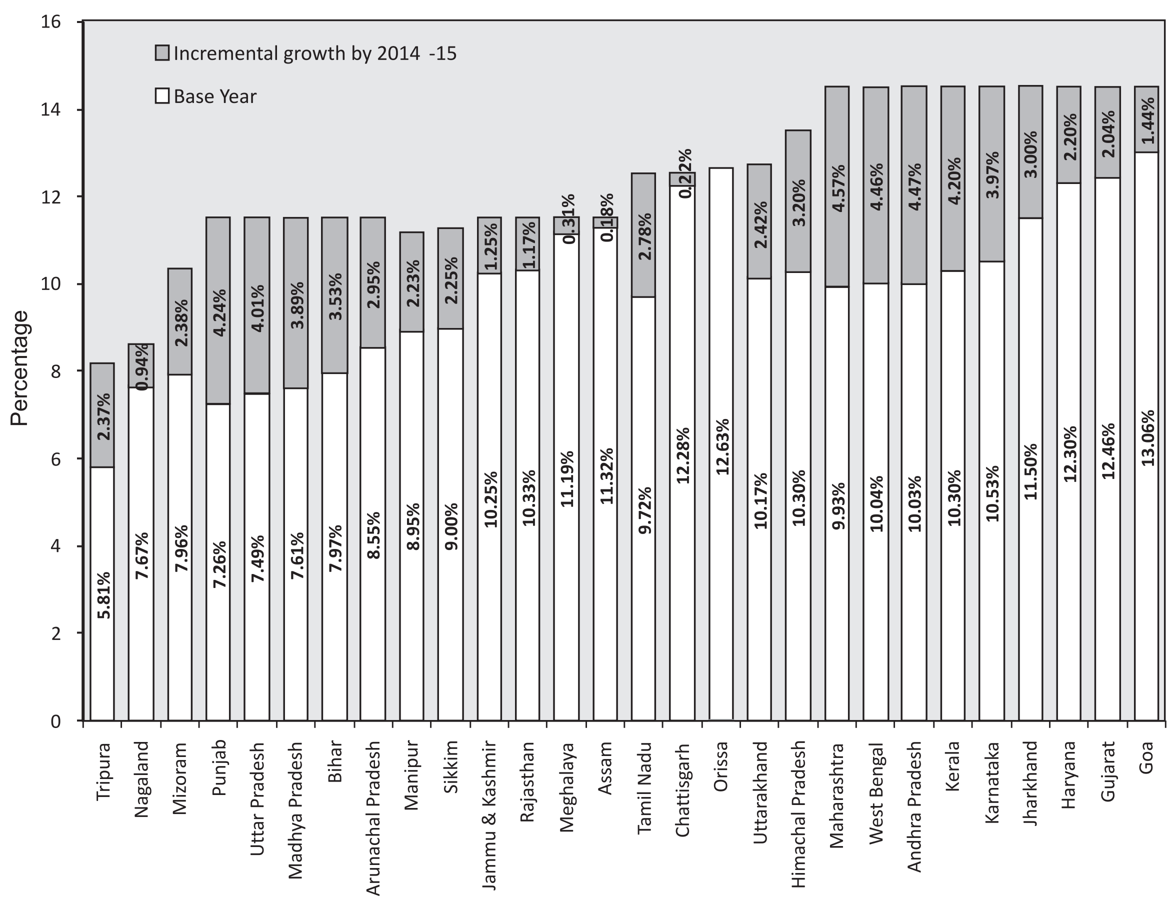
7.14 It has been observed that the ratio of the aggregate GSDP and GDP at market prices has been stable at 0.8 across the entire series (the ratio has a coefficient of variation of 1 per cent). To ensure consistency between the growth rates for GSDP and GDP, the aggregate GSDP figures for 2007-08, 2008-09 and 2009-10, calculated as explained in the previous para, have been further adjusted with a constant factor across all states in such a way that the ratio between the all-state aggregate GSDP and the GDP at market prices equals the average of the ratios of aggregate GSDP of all the states and the GDP at market prices. This gives us the estimates of GSDP at market prices for 2007-08, 2008-09 and 2009-10 as well as the corresponding growth rates.

Projections

7.15 The Plan document for the Eleventh Five Year Plan has projected real growth rates by state for the plan period. Based on these growth rates, the states have been divided into three categories, viz. states with projected real growth rate of less than 8 per cent, states with projected real growth rate between 8 and 9 per cent, and states with projected real growth rate of 9 per cent and above. As stated in Chapter 6, we have projected a nominal growth rate of 13.5 per cent for GDP for the terminal year. To ensure consistency with the GDP growth rate for the terminal year, the states in the first, second and third categories have been assigned terminal-year nominal GSDP growth rates of 11.5 per cent, 12.5 per cent and 14.5 per cent respectively. For special category states, the lesser of the category growth rate and TGR has been taken as GSDP growth rate for the terminal year. This may be seen from Figure 7.1.

7.16 For the period 2010-15, a growth path has been worked out such that the ratio of aggregate GSDP to GDP is held constant at the level used for estimation of the base year GSDP. The incremental growth has been distributed across states in such a way that the ratio of year-on-year improvement for each state to the total improvement to be achieved during the award period is same for all

Figure 7.1: GSDP Projections



the states. State-wise, year-wise projected GSDP growth rates are given in Annex 7.2.

Own Tax Revenue

7.17 Para 6(v) of our Terms of Reference (ToR) states that: In making its recommendations, the Commission shall have regard, among other considerations, to 'the taxation efforts of the Central Government and each State Government and the potential for additional resource mobilisation to improve the tax-Gross Domestic Product ratio in the case of the Union and tax-Gross State Domestic Product ratio in the case of the States.'

7.18 Own Tax Revenue (OTR) of the states mainly comprises Value Added Tax (VAT), state excise, stamp duty and registration fee, and motor vehicles and passenger tax. The share of OTR within the own revenue resources of the states has increased in recent years.

7.19 We have analyzed and projected Own Tax Revenue together, as was done by both FC-XII and FC-XI. However, deviating from the FC-XII methodology, which used the TGR, we have made use of buoyancies for projection of the base year and have assumed an improvement path for the tax-GSDP ratio for the projection period. The reason for this deviation is that a TGR-based approach would not have captured the assumed changes in GSDP. Our GSDP estimates for the base year are lower than the trend-based estimates due to the recent economic slowdown. In other words, buoyancies are more relevant than TGR for estimation of tax growth rate in the base year in terms of ensuring that the impact of the slowdown on GSDP is translated into an equivalent impact on OTR.

7.20 Since 2005-06, the states have replaced the sales tax regime with a VAT regime. The initial negative impact of VAT on the OTR of states has been compensated by the Centre. In order to ensure that the trend is properly captured, we have treated this compensation obtained by the states (otherwise classified as grant-in-aid to states) as OTR of states.

Base Year Estimates

7.21 The base year estimates for OTR have been arrived at on the basis of buoyancies observed in the states over the years 2001-08. The buoyancies have been used to obtain tax growth rates for 2008-09 and 2009-10 with the help of the GSDP growth rates estimated for these years. Further, the tax growth rates for 2008-09 have been applied to the actual figures for 2007-08 to arrive at the estimates for 2008-09, upon which the growth rate for 2009-10 has been similarly applied to calculate the projected OTR for 2009-10. This figure has been compared with the budget estimates for 2009-10 and the higher of the two has been taken as the base year estimate.

7.22 FC-XII had suggested a detailed fiscal reform path to enable each state to reach the targeted revenue balances by 2008-09. All states, barring West Bengal, Punjab and Kerala, successfully achieved this target by 2007-08 itself. In the case of these three states, however, the revenue balance is seen to fall far short of their revised estimates for 2008-09, resulting in continued revenue deficits in their budget estimates for 2009-10. Other than these three states that have either not adopted a Fiscal Responsibility and Budget Management (FRBM) framework or have not adhered to it, performance of all the states has been exemplary, although to varying degrees. Keeping this in mind, we do not feel the need for any base year normative correction for OTR for them, as was done by some of the previous Finance Commissions.

7.23 However, for the three states that have not been able to eliminate revenue deficit, we observe that the budget estimates for 2009-10 for OTR are higher than the projections arrived at using the buoyancies. The budget estimates of OTR for West

Bengal, Punjab, and Kerala exceed our projections by 0.9 per cent, 1.29 per cent, and 0.77 per cent of GSDP respectively. Thus, taking the higher of the two normalises the base year estimates of these three states.

Projections

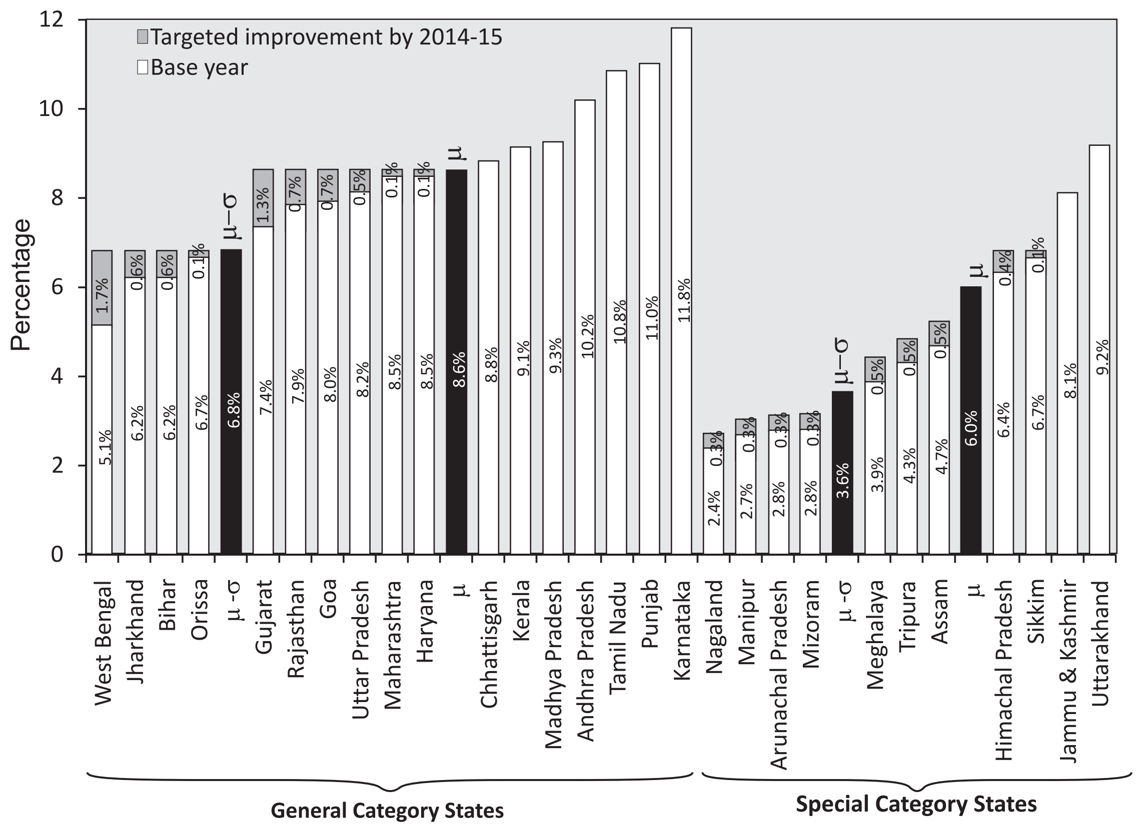
7.24 For the purpose of projecting Own Tax Revenues of the states we have defined an improvement path for the tax-GSDP ratio of the states. While the average tax-GSDP ratio has improved from 6.6 per cent in 2001-02 to 8.4 per cent estimated in the base year, the degree of performance varies across states. Thus, there is a need to link improvement in the tax-GSDP ratio over the base year level with an attempt to close the gap between states. For this purpose we have adopted different paths for the general and special category states.

7.25 For general category states, the mean tax-GSDP ratio and standard deviation are 8.6 per cent and 1.7 per cent respectively in the base year. Within these, the highest tax-GSDP ratio is 11.8 per cent and the lowest is 5.1 per cent. Depending on their respective tax-GSDP ratio estimates in the base year, each state has been given an improvement path over the projection period, keeping in mind the need to ensure that the targeted improvement is realistic and reduces the inter-state variation in tax-GSDP ratios. For this purpose the states have been divided into three groups: those with tax-GSDP ratio above the mean, those less than one standard deviation below the mean and those more than one standard deviation below the mean.

7.26 The states with tax-GSDP ratio more than one standard deviation below the mean, viz. West Bengal, Jharkhand, Bihar, and Orissa, have been projected to reach the 'one standard deviation below the mean level' by the end of the projection period with equal annual adjustments. Similarly, the states with tax-GSDP ratio less than one standard deviation below the mean, viz. Gujarat, Rajasthan, Goa, Uttar Pradesh, Maharashtra, and Haryana, have been projected to reach the mean level by the end of the projection period with equal annual adjustments. For the rest of the states, i.e., those with tax-GSDP ratios above the mean, the tax-GSDP ratios have been projected to remain at their base year levels during the projection period, thereby implicitly assigning a buoyancy of one. With this, the mean tax-GSDP ratio for general category states for the terminal year will improve to 8.9 per cent and the standard deviation will reduce to 1.4 per cent.

7.27 For special category states, the mean and standard deviation in the tax-GSDP ratio for the base year are 6 per cent and 2.3 per cent respectively, with the maximum at 9.2 per cent and minimum at 2.4 per cent. The special category states have a lower mean and higher standard deviation as compared to the general category states, since these states have wide variations in their tax capacities and composition of GSDP. All north-eastern states except Sikkim fall below the mean. The states with tax-GSDP ratio more than one standard deviation below the mean, viz. Nagaland, Manipur, Mizoram, and Arunachal Pradesh, are all hilly states with limited tax potential. These states have been projected to improve their tax-GSDP ratio by 0.3 per cent by the terminal year with equal annual adjustment. The states with tax-GSDP ratio less than one standard deviation below the mean, viz. Tripura, Assam, and Meghalaya, are slightly better off in terms of economic capacity and tax potential and have been projected to improve their tax-GSDP ratio by 0.5 per cent by the terminal year with equal annual adjustments. Of the remaining states, i.e., states with tax-GSDP ratio above the mean, those which are below the lowest level required to be achieved by any general category state (μ–σ of general category states) are projected to reach that level by the terminal year with equal annual improvement. The ratios for the rest of the states are projected to remain constant at their base year levels during the projection period. With this, the average

Figure 7.2: Tax-GSDP Ratio



tax-GSDP ratio will improve to 6.3 per cent and the standard deviation will reduce to 2.2 per cent by the terminal year. The levels of base year tax-GSDP ratios and the improvement envisaged may be seen in Figure 7.2. The state-wise projected tax-GSDP ratios for each year is given in Annex 7.3.

7.28 One of the upcoming tax reforms that will impact the tax structure at the state level is introduction of Goods and Services Tax (GST). With introduction of GST, various state level taxes will get subsumed in it. There would be major reshuffle in the tax bases of both the Centre and states consequent to introduction of GST. However, since the proposed GST will be revenue neutral, our projections shall not get affected by it.

Own Non-tax Revenues

7.29 Own Non-tax revenues of states comprise receipts from a variety of sources including interest on loans extended by the State Governments, return on investments made, royalty from minerals, forestry and wildlife, commercial operations undertaken by the states, user charges from irrigation and other services.

7.30 Most of the items have been assessed on trends based on data for the years 2001-08. This period has been chosen to avoid complexities due to bifurcation of three of the states.

7.31 For the purpose of estimating non-tax revenues in the base year, receipts under general, social and economic services have been disaggregated. Within these, items which are major contributors to the states' own non-tax revenues or those which do not follow the general pattern, have been further disaggregated and projected. These are interest receipts, dividends and profits, lotteries, miscellaneous general services, elections, royalty, forestry and wildlife and irrigation.

7.32 In the course of this exercise, we have made suitable adjustments in the data for the years 2001-08 to ensure uniformity across states as well as across years within a state. While some states have departmentally run power, transport and dairy utilities, some have statutory boards and yet others have corporatised entities for provision of these facilities. Thus, in some cases, transactions from power, transport and dairy enter the consolidated fund, while in other cases they don't. To ensure uniform comparability, receipts from power, transport, and dairy have been removed from the data series (the same as has been done for expenditure under these heads).

7.33 For lottery operations gross receipts are accounted as Own Non-tax Revenue of the states and gross expenditure is accounted as non-plan revenue expenditure. This leads to a notional increase in both receipts and expenditure of the states and also introduces year-to-year volatility. To ensure that these changes do not affect projections, net lottery receipts (receipts net of payments) have been taken under receipts.

7.34 The amount of debt waived under the Debt Consolidation and Relief Facility (DCRF) recommended by FC-XII has been accounted as non-tax receipts under 'miscellaneous general services' in the finance accounts. This item is not shown separately in finance accounts, but indicated as a footnote, and that too, not uniformly. Thus, instead of taking the figure of debt waiver from finance accounts of states, we have used the corresponding figure provided by the Ministry of Finance and deducted this amount to ensure that it does not get captured in either the trend or the base year.

Interest Receipts

7.35 We have observed that the current level of recovery on loans advanced by the states is extremely poor. Therefore, we have projected the interest receipts of states on a normative basis without linking it to the current level.

7.36 In order to project interest receipts, the loans outstanding at the end of 2009-10 have been estimated by adding the revised estimates and budget estimates of loans and advances made during the years 2008-09 and 2009-10 respectively, to the loans outstanding at the end of 2007-08 as reported in the finance accounts, and subtracting the recoveries made in these two years. The outstanding loans and advances at the end of 2009-10 have been projected as constant over the projection period. An interest rate of 7 per cent has been applied to these outstanding loans and taken as the interest receipt in each of the years.

7.37 The interest rate is chosen such that it is lower than the average cost of funds for the state, yet allows a positive real interest rate. This has been done because most of these loans have been extended to state PSUs, and in some cases the states may have decided to provide an implicit subsidy. In addition some of these could be short term loans bearing lower interest rates.

Dividends and Profits

7.38 Similarly interest receipts, dividends and profits on government investments have been projected normatively on the basis of level of investment. Past levels of return on investment, which have largely been dismal, have been ignored. We have projected dividends and profits at 5 per cent on the total amount of investment as at the end of 2007-08, including those in power utilities, as reported in the finance accounts and held constant over our award period.

Elections

7.39 Receipts from elections have been considered as a five-year block (2010-15). Projections for receipts for each year in this block have been made on the basis of receipts of the corresponding years in the previous block (2005-10) by applying a 5 per cent increase successively for five years. Thus, projections for 2010-11 were arrived at by assuming 5 per cent growth for five years over the receipts for the year 2005-06.

Lotteries and Miscellaneous General Services

7.40 Within general services, receipts under 'miscellaneous general services' do not include a uniform set of items across states. This head includes receipts from lottery operations for the states that have online or paper lotteries, and has, thus, been deducted and treated separately. For lotteries, the higher of net receipts in 2009-10 (BE) and average of 2006-07, 2007-08 and 2008-9 (RE) has been taken as the base year estimate and has been held constant, in nominal terms, over the projection period.

7.41 Receipts from 'other miscellaneous general services' also include the amount of debt waiver received by the states under the DCRF scheme, which has been deducted, as explained earlier. However, it is observed that the year in which these receipts have been booked in the finance accounts of a state may differ from the year in which MoF has made the releases. To nullify the effect of any mismatches we have taken the average of 2005-06 to 2008-09 (RE) as the base year estimate for 'other miscellaneous general services'. Since this covers the entire period during which debt relief has been provided, all entries get accounted for. For the projection period we have assumed a growth of 5 per cent.

Royalties

7.42 For the purpose of estimating royalties from minerals, we have taken the higher of 2009-10 (BE) and average of 2006-07, 2007-08 and 2008-09 (RE) as the base year estimate. There has been a major shift in the policy for levy of royalty on coal and lignite as well as on major minerals, changing from specific to partial/full *ad valorem* basis. The policy change for coal and lignite occurred earlier and its impact has been captured in the receipts of the states.

7.43 However, royalties on other major minerals may not have been accounted for in the 2009-10 (BE) figures as the shift to *ad valorem* regime took place only around mid-2009. For this purpose, estimates of receipts of royalties from major minerals, other than coal and lignite, were sought from the Ministry of Mines, GoI for the period 2009-15. The amount shown for each state in 2009-10 has been deducted from their base year estimates and the residual, including royalty from minor minerals and coal and lignite, has been projected to grow at the rate of 5 per cent. To this, the projections provided by the Ministry of Mines for all major minerals other than coal and lignite have been added under the relevant year. Further, the projections of receipts from royalties on upcoming on-shore oilfields and the share in profit petroleum as indicated by the Ministry of Petroleum have also been added.

Power

7.44 As stated earlier in this chapter, the power sector is run departmentally in some of the states, while in others, it is run through statutory boards/ corporations. To ensure uniformity across states, receipt and expenditure of the power sector has been removed for making projections. Some states have projected revenues from power sector for the award period; others have not provided these separately. We have projected these revenues on the basis of a detailed study sponsored by the Commission for the award period and added to the non-tax revenues of the relevant states. This revenue would accrue from sale of surplus power available to states after taking into account their own power requirements.

Forestry and Wildlife

7.45 Receipts from forestry and wildlife for the base year have been taken to be the higher of 2009-10 (BE) and average of 2006-07, 2007-08 and 2008-09 (RE). During the projection period, we have held the receipts constant at the base year level in nominal terms in order to take account of the current restriction on extraction of forest resources.

Irrigation

7.46 Receipts from irrigation have been estimated on cost recovery basis. The current level of recovery from irrigation projects is at 23 per cent of the non-plan revenue expenditure on irrigation, which is very low and needs to be improved in order to ensure viability of irrigation projects. Keeping this in mind, we have normatively enhanced receipts from irrigation from 25 per cent of NPRE on irrigation in 2010-11 to 35 per cent in 2011-12, 45 per cent in 2012-13, 60 per cent in 2013-14 and 75 per cent in 2014-15.

Other Non-tax Revenues

7.47 The residual items under each service have been projected together. To arrive at the base year estimates, the 2007-08 actuals have been projected to grow at the 2001-08 TGR for each service, for each state. These estimates have been compared with 2009-10 (BE) figures and the higher of the two has been taken as the base year estimate.

7.48 For the projection period, receipts under other general services, social services and other economic services have been projected to grow at 8 per cent, 12 per cent and 13 per cent respectively, which are the 2001-08 all-state Trend Growth Rate (TGR) of aggregate receipts under these categories after excluding certain outlying states.

7.49 All the above items have been added to arrive at the projections of non-tax revenues of the states.

Non-plan Revenue Expenditure

7.50 Non-plan revenue expenditure (NPRE) of the states has been projected in a manner similar to that of the non-tax revenues. Some of the significant items, viz. salaries, pensions, interest payments, food subsidy, committed liabilities and maintenance expenditure for roads and irrigation projects, have been projected separately while the remaining items have been projected in aggregate.

7.51 We have used expenditure data for 2001-08 (post-bifurcation of the three states) while estimating the NPRE of states.

7.52 Some adjustments have been made in the 2001-08 data series for NPRE to ensure uniformity in data across states. Expenditure on power, transport and dairy has been removed, as in the case of receipts, in order to ensure that states where these sectors are run departmentally are brought on the same footing as the states that have separate boards/corporations/companies providing services in these sectors. Further, in our assessment we have not taken into consideration any subsidies in these sectors. Only food subsidy has been projected on a normative basis. Expenditure on calamity relief has been removed as the needs of states on this account have been assessed separately.

7.53 'Contra-entries' and 'transfer from and to funds' are those entries in the accounts that do not have any cash outgo but are adjustments either between one head of account and another (within the consolidated fund) or from the consolidated fund to the public account. These entries, except those relating to Consolidated Sinking Fund and Guarantee Redemption Fund, have been removed from the NPRE series. These funds were created by most states as per the recommendation of FC-XII, and in order to ensure consistency, we have taken transfers to them into consideration in our assessment. However, in case the fund has been closed at any point of time, all transfers in this regard for the previous years have also been removed from the data series.

7.54 We have come across cases where receipts of states that should have been credited to the consolidated fund have been credited to funds maintained outside the consolidated fund. These resources have been used for activities that are primarily the responsibility of the respective State Governments. Such a practice is not transparent and should be discouraged. Hence, these receipts and expenditure have been treated as if they were taking place through the consolidated fund.

7.55 We have deducted the average non-plan grants other than FC grants received during the three year period (2005-08) from expenditure under 'other general services' since these grants are not projected on the receipt side. Of the Finance Commission grants, non-plan revenue deficit grant and grants for education and health were in the nature of gap filling grants, acknowledging that the current level of expenditure is low and needs to be augmented and, thus, have not been deducted from the data series. State-specific grants are for expenditure items that are more in the nature of capital projects and, in addition, are difficult to capture under the exact expenditure head, and have thus not been deducted either. Grants for local bodies have also not been deducted since these have not always been accounted for under the heads recommended by the Controller General of Accounts (CGA), a problem that we have addressed in Chapter 10. The remaining grants, as released from 2005-06 to 2008-09, have been deducted from the relevant heads in the 2001-08 data series of the states.

Salary

7.56 Salaries and pensions, two of the major items of expenditure of State Governments, are expected to be substantially impacted consequent to the award of the Sixth CPC. FC-XI had faced a similar situation in the context of the Fifth CPC. In its assessment, FC-XI had assumed that any change expected on account of implementation of the recommendations of the Fifth CPC had been captured in the base year expenditure, and hence, used the trend growth rate to make its projections. Further, FC-XI had recommended that there was no need to routinely appoint a Pay Commission at 10-year intervals. It had also observed that since the recommendations of the CPC had a bearing on the finances of states, they should be consulted on the ToR whenever such a Commission is appointed.

7.57 A strict interpretation of the role of the CPC and its impact would be that its recommendations are only for Central Government employees, which the states are not obliged to follow; the states have the freedom of option with regard to these recommendations in view of their own resources and their ability to pay. The joint memorandum of states presented to us, as well as individual memoranda of State Governments, strongly emphasised that the decisions of the Central Government with regard to the recommendations of the Sixth CPC would have immediate implications on the pay structure of State Government employees, and consequently, on state finances. The State Governments have urged that this Commission should provide assistance to the extent of at least 50 per cent of the additional financial burden on states on this account. On the basis of past trends as well as ground realities, we are persuaded by the argument that our assessment of states' expenditure needs to take into account the impact of the pay revisions across states arising out of the implications of the Sixth CPC. However, we do not recommend any specific grant for this purpose.

7.58 We have observed that the states have either followed the recommendations of the Sixth CPC or revised their pay scales in light of these recommendations. For the purpose of our projections, a uniform normative set of parameters has been adopted across all states. We have assumed that the revised pay scales have been implemented from 1 April 2009, with retrospective effect from 1 April 2006.

7.59 The most important aspect in this exercise is to capture the likely one-time increase in salary expenditure on implementation of the revised pay scales. To project the salary expenditure of states, the number of employees in each group (A, B, C and D) have been projected at a net attrition of 1 per cent per annum assumed on the basis of the observed trend over the past five years for select states and for the Central Government. Within each group, the mean pay for all scales has been assumed as the basic pay for the group. The median grade pay for all grades within a group has been assumed as grade pay for all employees in that group. This has been used to calculate the ratio of grade pay to basic pay over the projection period from the date of implementation. Allowances have been assumed to be at the rate of 18 per cent, taking into account the nature of allowances paid by the states. The Dearness Allowance (DA) rates, as announced by the Central Government, have been adopted in the assessment.

7.60 Based on the above parameters, it has been found that, on an average, the one-time increase in salary expenditure is 35 per cent in 2006-07. The growth in salary expenditure in subsequent years has been estimated at 6 per cent taking into account annual increment of 3 per cent, annual increase in DA rate of 6 per cent, and assumed attrition of 1 per cent. This has been used for projecting the revised salary expenditure of states for the projection period as well the notional pre-revised salary for 2006-10.

7.61 We find that there is a difference in the manner in which the salary of local body employees, to the extent to which it is borne by the states' budgets, is being accounted for across states. While some states show it as salary expenditure, others book it as grant-in-aid or other expenditure. To ensure uniformity, we have added the expenditure of State Governments on the salaries of local body employees, whatever may be the manner of accounting, to the government salary expenditures as reported in the finance accounts. While doing so, certain normative adjustments have been made to ensure that per employee, per month salary, is capped at the level of the average for all states.

7.62 FC-XII had recommended that the states should follow a recruitment policy such that salary expenditure does not exceed 35 per cent of revenue expenditure net of interest payments and pensions. We have limited the impact of pay revision to salary expenditure within this normative ceiling and the expenditure over and above the ceiling has been successively reduced by 10 per cent of the amount every year.

7.63 Our exercises in normalisation have attempted to capture state specific situations. Newly created states of Chhattisgarh, Jharkhand and Uttarakhand drew our attention to the fact that they have faced severe staff shortages since the bifurcation of the state cadres. Acknowledging this fact we have assumed a net increase of 1 per cent in the working strength for these states as against 1 per cent attrition in other states, while projecting their salary expenditure. Another exercise has been carried out for states such as Karnataka and Kerala, whose own Pay Commissions' recommendations were implemented during the period 2001-08. For these states, their last pre-State Pay Commission salary has been projected to grow at 6 per cent to arrive at the 2006-07 salary expenditure, whereafter, the common procedure outlined in Para 7.60 has been adopted.

Pension

7.64 Estimating pension payments by adopting the procedure used for salary is difficult because data on pensioners and their profiles is generally not available. We have calculated the impact of pension revisions post-Sixth CPC on state finances by assuming that the ratio of the impact would be the same as that in the case of the Fifth CPC between central and state pensions. The impact of pension revisions after implementation of Sixth CPC on central finances without arrears has been estimated at 23 per cent in 2008-09 over the pension bill of 2007-08. Applying the ratio thus worked out, the impact on state pensions is estimated to be 21 per cent.

7.65 Thus, pension payment for the base year has been estimated at 21 per cent over the 2008-09 pension payments, arrived at by applying TGR over the actual figure for 2007-08. Pension payments post-2009-10 have been projected to grow at 10 per cent. For states having their own Pay Commissions, a procedure similar to that adopted for salaries has been adopted.

Arrears

7.66 While the treatment of State Pay Commission (SPC) recommendations has been, more or less, uniform across all states, the treatment of arrears varies widely. Some states have decided to stagger payments, while the total amount of arrears has been paid in some other states. Further, the amount of arrears is a function, not only of the structural changes in pay, but also of the time lag between the effective and actual dates of implementation. While, payment of the arrears may fall partially within the projection period, these actually pertain to expenditure for a prior period. Due to these factors it is not possible to assess the liability of states on account of arrears on a uniform normative basis. We have, therefore, decided not to include arrears in our assessment of NPRE of states.

Interest Payments

7.67 Interest payments have been projected on the basis of the debt stock indicated in the fiscal reform path shown in Chapter 9. For the years 2008-09 and 2009-10 the lower of Revised Estimates (RE) or 3.5 per cent of GSDP and Budget Estimates (BE) or 4 per cent of GSDP respectively, has been taken as the fiscal deficit for projection of debt stock.

7.68 The debt stock has been divided into three components. The breakup of the outsanding debt stock at the end 2009-10 for each state is given in Annex 7.4. The first component, non-interest bearing loan, has been pegged at the 2007-08 levels in nominal terms on the assumption that the fiscal deficit will be financed only through borrowings.

Any increase in non-interest bearing debt would not be due to the fiscal deficit. This component has been deducted from the debt stock for purposes of projecting interest payments.

7.69 Out of the interest bearing debt, the borrowings with the highest cost are the loans from the National Small Savings Fund (NSSF). Within the outstanding debt stock of NSSF loans of Rs. 4.3 lakh crore, Rs. 4.1 lakh crore pertains to loans contracted till 2006-07, for which we have recommended an interest rate of 9 per cent (Chapter 9). The remaining stock of Rs. 20,000 crore carries an interest rate of 9.5 per cent, implying an effective rate of 9.02 per cent on the entire stock of NSSF loans. We have used this rate to estimate interest payments on the NSSF loans. Gross collection under NSSF has dropped in recent years and net collection for 2008-09 has been negative. In line with the institutional reforms recommended by us in Chapter 9, we have assumed that there would be no net addition to the debt stock of NSSF for the base year and the projection period.

7.70 The remainder of the debt stock comprises open market loans, loans from the Centre, and loans from financial institutions such as National Bank for Agriculture and Rural Development (NABARD), Life Insurance Corporations (LIC)/General Insurance Corporations (GIC). Central loans have been consolidated at 7.5 per cent by FC-XII, which is also the interest rate for most of the market loans. Rural Infrastructure Development Fund (RIDF) loans are cheaper, while some of the negotiated loans may carry an interest rate marginally higher than 7.5 per cent. Thus, for this component of the stock, we have assumed an interest rate of 7.5 per cent. Based on the projected debt stock and the interest rates assumed, the interest payments have been calculated for each state for each year in the projection period.

Elections

7.71 As in the case of receipts, expenditure on elections does not follow an annual trend, and has been projected as a five year block (2010-15). Projections for expenditure in each year for this block have been made on the basis of the expenditure in the corresponding year of the previous block (2005-10) by providing 5 per cent increase compounded annually for five years. Thus, projections for 2010-11 were arrived at by assuming 5 per cent growth for five years over the receipts for the year 2005-06.

Compensation and Assignment to Local Bodies

7.72 Compensation and assignment to local bodies pertain to one major head of account, namely 3604. This item contains transfer of funds from the states to their local bodies and, in most cases, is governed by the decision on implementation of award of the respective State Finance Commissions (SFC). Thus, we have assumed that the budget estimates would be as per the decisions taken regarding SFC awards and have thus been adopted as the base year estimate. To enable real increase, 8 per cent growth has been projected on the base year over the projection period.

Committed Liabilities

7.73 Para 6(ix) of the ToR requires the Commission to consider the following while making its recommendations: '.... the expenditure on the non-salary component of maintenance and upkeep of capital assets and the non-wage related maintenance expenditure on plan schemes to be completed by 31st March, 2010 and the norms on the basis of which specific amounts are recommended for the maintenance of the capital assets and the manner of monitoring such expenditure.'

7.74 The expenditure on operation and maintenance of plan schemes completed by the end of a plan period becomes a 'committed' liability on the non-plan account from the following year. As per the guidelines of the Planning Commission, maintenance expenditure of completed plan schemes is transferred to the non-plan revenue account at the end of the relevant Five-Year Plan. States find it difficult to incorporate this expenditure in their projected non-plan revenue expenditure since: (i) Finance Commission award and Five-Year Plan periods are not co-terminus; (ii) the task of identifying completed schemes and estimation of their committed liabilities across various departments of a state is an elaborate and time consuming exercise and (iii) there is a perceived risk of resources for the plan shrinking and the plan size coming down. Thus, there is a need for separate assessment of these liabilities.

7.75 On the lines of previous Finance Commissions, we have estimated maintenance expenditure for capital works, i.e., on maintenance of irrigation projects, and roads and bridges separately in paras 7.82 to 7.85 of this chapter and discussion in this section is confined to maintenance expenditure arising out of plan revenue expenditure.

7.76 The important parameters in estimating the maintenance expenditure of completed plan schemes are the relevant years of the award period for which such expenditure needs to be provided, norms for projecting the expenditure, treatment for special category states and liabilities arising out of maintenance of assets created under Centrally Sponsored Schemes (CSS).

7.77 The ToR require us to take into consideration the non-wage related maintenance expenditure on plan schemes to be completed by 31 March 2010. As the Eleventh Plan will conclude in 2011-12, we feel there is no need to factor in the maintenance expenditure for the first two years of our award period. We, therefore, propose to take into account the requirement of states for maintenance of plan schemes to be completed during the Eleventh Plan for the period 2012-13 to 2014-15. Such an approach is consistent with that adopted by the previous Commissions.

7.78 Assessing the expenditure on committed liabilities of the completed plan schemes has been problematic due to lack of accurate information from the states. The information received from the states was widely varying and, *prima facie*, not reliable. Thus, we have adopted the norm of 30 per cent of the plan revenue expenditure of states assessed for the year 2011-12 to estimate the committed liabilities in accordance with the practice of recent Finance Commissions. For assessing the plan revenue expenditure of the states for 2011-12, the last year of the Eleventh Plan, the plan revenue expenditure in 2008-09 (RE) has been projected to grow at 10 per cent, which broadly reflects the long term trend growth rate of plan revenue expenditure of the states. Thirty per cent of this plan revenue expenditure has been adopted as maintenance expenditure for 2012-13, which has been projected to grow at 5 per cent in 2013-14 and 2014-15.

7.79 Special category states have highlighted the problems faced by them in transferring maintenance expenditure of completed schemes to the non-plan account, mainly due to low provision of committed liabilities while assessing their non-plan revenue expenditure in the past. The decision of previous Finance Commissions in this regard was based on the fact that these states are allowed to divert 20 per cent of the Normal Central Assistance (NCA) under the plan to meet non-plan expenditure. The current practice of meeting the committed liabilities by way of utilisation of 20 per cent of NCA under state plans is non-transparent and has led to many states often not transferring the committed expenditure to the non-plan side and has also led to a lower real plan expenditure of these states. Further, not providing for committed liabilities in these states results diversion of their legitimate allocated plan assistance for non-plan purposes making the entire planning process less transparent. Therefore, we have treated these states on par with general category states for the provision of committed liabilities. We also recommend that, with adequate provision for committed liabilities, the practice of diversion of plan assistance to meet non-plan needs of special category states should be discontinued to leave these states with adequate plan expenditure.

7.80 States are mandated to not only share the cost of implementing the CSS, but also to maintain such schemes upon completion. We feel that committed liabilities arising out of these schemes should be included in their NPRE to ensure that the gains of these schemes are not lost. However, as noted by some previous Commissions, there is need to make suitable adjustments for those CSS which are likely to continue in the next plan and, therefore, have no significant implications for non-plan expenditure. The major schemes in this category are Sarva Shiksha Abhiyan (SSA), National Rural Health Mission (NRHM), Indira Awas Yojana (IAY) and Integrated Child Development Scheme (ICDS) which have a long term development perspective and are likely to continue during our award period. Only the states' contribution is reflected in the state budgets for SSA, NRHM, and IAY while the central share towards these schemes flows directly to the executing agencies. In case of ICDS the entire scheme allocation is reflected in the state budgets as central funds are also routed through the states' consolidated funds. Budgetary allocations for 2008-09 for the four schemes mentioned above have been excluded from the plan revenue account of 2008-09 (RE) of each state for projections as detailed in Para 7.78. The projected committed liabilities for each state is given in Annex 7.5.

7.81 The ToR require us to consider only non-wage related expenditure for the completed plan schemes. The states have expressed the view that with emphasis on social infrastructure, plan schemes in this sector involve large wage related expenditure and that the states would not be able to afford maintenance expenditure for such schemes. They have also drawn our attention to the fact that no distinction is made between the wage and non-wage components of the committed liabilities of the Centre. After due consideration of the matter, we have decided not to make a distinction between the wage and non-wage component of maintenance expenditure of the states in order to ensure that the sustained delivery of public services created under the plan schemes is not disrupted. Such an approach would also ensure symmetry in treatment between the Centre and the states on this issue.

Irrigation

7.82 For projecting the maintenance expenditure on irrigation schemes (major heads 2700, 2701 and 2702), norms were obtained from the Ministry of Water Resources (MoWR). The ministry suggested an amount of Rs. 1500 per hectare for major and medium surface irrigation and Rs. 3000 per hectare for lift irrigation schemes for the utilised potential as maintenance expenditure. While the ministry suggested separate norms for maintenance of surface and lift irrigation schemes, the breakup of irrigation potential into these two categories of schemes was available only for two states. Thus, it would be difficult to adopt norms separately for flow and lift irrigation schemes. Given the need for adequate provision for maintenance of irrigation schemes, we have adopted the norm of Rs. 1175 per hectare for the utilised potential and Rs. 588 per hectare for the unutilised potential for major and medium irrigation schemes respectively, in the base year, implying a step-up of 52 per cent from the norms adopted by FC-XII. After adjustment for inflation, with an annual growth of 5 per cent thereafter, these would reach the level of Rs. 1500 per hectare for utilised and Rs. 750 per hectare for unutilised potential in the terminal year of our award period.

7.83 For minor irrigation works, the ministry suggested an expenditure norm of two-thirds of that for major and medium irrigation schemes. We have restricted this to half, in pursuance of the practice adopted by previous Finance Commissions. Accordingly, we have provided the norm of Rs. 588 per hectare in the base year for only the utilised potential of minor irrigation schemes and have ignored the unutilised potential as being insignificant. For special category states, the ministry had suggested a step-up of 60 per cent on the maintenance norms. However, drawing upon the practice of our predecessors, we have allowed a 30 per cent step-up on these norms for the special category states.

7.84 We have used state-wise utilised and unutilised potential, as reported by the MoWR at the end of the Tenth Plan, to work out maintenance expenditure. For each state, the norm-based estimates for 2009-10 have been compared with those of 2009-10 (BE), and the higher of the two has been adopted as the base year estimates to ensure that the current level of expenditure is retained in the case of states that are spending more. An annual growth rate of 5 per cent has been applied over the base year estimates so worked out to generate projected expenditure levels in the forecast period. The projected NPRE on irrigation for each state is given in Annex 7.6.

Roads and Bridges

7.85 Maintenance of roads and bridges has been projected for the base year as part of the overall economic services, i.e., expenditure in 2007-08 has been projected to grow on the basis of TGR to arrive at the 2009-10 estimates. While doing so, the grants provided by FC-XII, as released in each of the relevant years, have been deducted from the expenditure to eliminate their impact on expenditure. The base year amount has been projected to grow at 5 per cent for general category states and a higher rate of 7 per cent for special category states.

Food Subsidy and Other Non-plan Expenditure

7.86 As stated in Para 7.52, we have not taken the states' expenditure on subsidies in our assessment. However, a normative amount of food subsidy has been added to the NPRE of states. Food subsidy has been provided at Rs. 20 per capita per year for each of the years in the projection period, calculated on the basis of the population projected for 2008.

7.87 Other non-plan revenue expenditures under each service have been projected at the respective 2001-08 TGR or 7.5 per cent, whichever is higher, to reach the base year level.

7.88 We have deliberated upon the question whether to give differential rates of growth for each service or a common growth rate for all services during the projection period. The line between expenditure booked under different services is becoming blurred and high priority expenditure sectors are uniformly spread across services. For example, while items like police and judiciary fall under general services; education and health are under social services. Similarly, while urban development is under social services; rural development, agriculture and related services are booked under economic services. We have also noted that many items of expenditure are not uniformly booked under the same head of account across states and that the practice varies from state to state.

7.89 Therefore, we feel that it would be proper to aggregate all the residual items and project them to grow at a rate of 8 per cent, which is higher than the assumed price rise but less than the nominal GSDP growth rate.

Summary of Assessment

7.90 Based on our assessment of revenue and expenditure of states, the pre-devolution non-plan revenue deficit has been worked out for each state. The summary of the assessed revenues and expenditure of states is given in Annex 7.7. The all-state picture of the assessed revenue and expenditure is given in Table 7.2.

Table 7.2: Summary of Assessment

(*per cent of GSDP*)

	2010-11	2011-12	2012-13	2013-14	2014-15
ORR	10.10	10.13	10.14	10.17	10.19
NPRE	10.62	10.15	10.57	10.06	9.59
Gross Pre - devolution Deficit	1.76	1.45	1.61	1.31	1.06
Gross Pre - devolution Surplus	-1.24	-1.43	-1.18	-1.42	-1.66
Net Pre - devolution Deficit	0.52	0.02	0.43	-0.11	-0.6

7.91 The aggregate pre-devolution non-plan revenue deficit of the states reduces from 0.52 per cent of GSDP in 2010-11 to -0.6 per cent in 2014-15. This has primarily been on account of overall improvement in the tax-GSDP ratio and reduction of NPRE as a percentage of GSDP. We have based our recommendations for grants-in-aid to cover the post-devolution non-plan revenue deficit in Chapter 12 on this assessment.

B. Structural Reforms at the State Level:

7.92 Para 6 (iv) of our ToR requires us to consider the objective of not only balancing the revenue account but also generating surplus for capital investments. In addition, Para 6 (x) of the ToR requires us to consider the need for ensuring commercial viability of certain important sectors such as irrigation and power, and of departmental undertakings. There are certain areas that urgently need reforms to ensure that their impact on the economy and state finances is positive. Reforms in these areas are critical for any fiscal reform programme to succeed. Issues relating to irrigation have been covered by us in this chapter in our projections for receipts and expenditure, and also in chapters 4 and 12. In this section we elaborate on the current status of State Public Sector Undertakings (SPSU), the power sector and other aspects which impact state finances.

Performance of State Public Sector Undertakings

7.93 The total turnover of 1160 State PSUs was Rs. 3.07 lakh crore in 2007-08, representing abut 6 per cent of GDP. The aggregate investment in these PSUs is about Rs. 3.69 lakh crore comprising Rs. 1.41 lakh crore in equity and Rs. 2.28 lakh crore in loans from all sources. They employ over 18 lakh persons. They thus occupy an important place in the national economy. However, their operations have not been encouraging. They incurred an aggregate loss of Rs. 5930 crore in 2007-08. Their accumulated loss stands at Rs. 65924 crore. PSUs of only nine states have earned aggregate profits. Some states have been reporting losses of more than Rs. 2,000 crore per annum on account of PSUs. States need to assess the viability of their loss making PSUs and identify those functioning in non-core areas for closure.

Finalisation of Accounts

7.94 An essential requirement for identification of viability is the availability of audited financial accounts of state public sector undertakings as well as other companies which get substantial support as grants-in-aid from the government. During our visits to the states, we have come across certain disturbing features. Despite their statutory obligations to finalise their accounts and lay them before the Annual General Meetings (AGMs) within six months of the close of the financial year, there is a huge deficit in compliance. More than 70 per cent of the state PSUs have their accounts in arrears. There were 2329 annual accounts in arrears from 607 working state PSUs as of September 2008. It is disturbing that the accounts arrears in respect of working PSUs is increasing, indicating their inability to finalise at least one account per year. A more disquieting feature is that state governments continued to invest significant sums (Rs. 49,237 crore as on September 2008) in working PSUs whose accounts were in arrears without any assurance in the form of audited accounts that their continued investments were being properly utilised and accounted for. The position in respect of non-working companies is worse. In one state, audit of PSUs is pending from as early as 1992-93. We have come across a public sector undertaking whose accounts have not been finalised for the past 37 years. Such a position is extremely detrimental to financial accountability as well as fiscal transparency. Keeping in mind the contingent liabilities of the State Governments on account of these PSUs, any future switchover to accrual accounting will be dependent upon such a problem being tackled upfront.

7.95 We therefore recommend that:

i) All State Governments should proactively ensure clearance of the accounts of all PSUs through focused assistance and close monitoring of progress. If necessary, they could, in consultation with the Comptroller and Auditor General of India (C&AG), outsource the preparation of accounts to qualified personnel.

ii) States should use the flexibility provided by C&AG to clear the backlog in their accounts. Statutory auditors could take up audit for succeeding years before the accounts for a particular year are laid before the AGM, and provide certification after the relevant accounts are approved. The company can hold a series of general body meetings (GBMs) within a short period to clear the arrears in its accounts.

iii) All State Governments should draw up a road map by March 2011 for closure of non working companies in consultation with the Accountant General. All pending commercial and other disputes should be resolved promptly–if necessary by empowering the Board to approve a settlement scheme. States could consider setting up of a holding company which would be responsible for the liquidation of all non-working PSUs. Such a holding company could employ legal, management, and accountancy experts, thereby obviating the need to appoint individual liquidators for each company. This company would also take over the assets and liabilities of the non working PSUs, thus simplifying the process of closing them down.

iv) The Ministry of Corporate Affairs should closely monitor the compliance of state and central PSUs with their statutory obligations. It could also consider introducing ways to assist companies prepare long overdue accounts. Earlier initiatives like the Simplified Exit Scheme which permitted the use of the latest available balance sheet to arrive at the current balance sheet could be considered for revival.

Measures to Enhance Financial Viability of SPSUs

7.96 There is need to ensure that all working enterprises, except those in the welfare and utility sectors, become financially viable. A minimum dividend of 5 per cent on government equity should be paid by all such enterprises. Our estimation of resources for the states has been premised on this basis (Para 7.38). For loans given, the states should ensure that the effective rate of interest paid by all State Public Sector Enterprises (SPSEs) should not be below 7 per cent, which has also been assumed by us for estimation of resources of the states (Para 7.36). Rating of enterprises by an accredited rating agency should be made mandatory as this will result in an independent assessment of the financial health of the enterprise. Setting up of independent regulatory authorities will also help the enterprises to enhance viability as the prices will be fixed on actual commercial considerations.

Restructuring/Divestment/Privatisation

7.97 The State Governments should actively consider withdrawal/reduction of SPSUs in non-welfare and non-utility sectors. There is an immediate need to reduce the number of SPSUs in most of the states as the large number of such enterprises not only engages the productive assets of the government, but also promotes inefficiency due to lack of proper monitoring by the State Governments. Divestment and privatisation should also be considered and actively pursued.

Institutional Mechanism

7.98 In order to design suitable strategy and policies and oversee the process of restructuring, including disinvestment/privatisation, a task force may be constituted. This task force should suggest unit-wise specific steps to be taken for restructuring with regard to both working and non-working companies. A Standing Committee on Restructuring under the Chairmanship of the Chief Secretary may also be constituted to operationalise the recommendations of the task force. To advise the Finance Department on restructuring/ divestment proposals an independent technical secretariat may also be set up by the states.

Power Sector

7.99 The deficit in power supply in the country, in terms of peak availability and of total energy availability during 2008-09, was 12 per cent and 11 per cent respectively. The National Electricity Policy envisages the demand for power to be fully met by 2012. Electricity is in the Concurrent List in the Constitution, and though both the Centre and the states have a decisive and positive role to play in the development of the sector, the primary responsibility of structuring its availability and distribution is that of the states.

7.100 The Electricity Act, 2003 (the Act) was enacted to address some of the core issues that affect the power sector. The Act aims to bring in new capacity across the electricity value chain through introduction of competition in the sector. Simultaneously, institutional reforms like utility unbundling and independent regulation have been mandated in the Act.

7.101 Since one of the fundamental triggers for introduction of market reforms was the bankrupt finances of the State Electricity Boards (SEBs), progress in expansion of power supply and introduction of market reforms needs to be accompanied by corresponding improvements in utility finances to prevent competitive markets from adversely impacting utility finances so as to enable adequate availability of power generation capacity with the utilities.

7.102 We have noted the impact of power sector performance on the finances of the states. This is likely to become even more crucial in future with increasing exposure of the sector to market forces. We sponsored a study for a detailed analysis of the finances of state power utilities, their impact on the overall finances of states and the future roadmap. The following section highlights the critical issues raised in the study and our recommendations for improvement of the sector.

Projected Finances of State Power Utilities

7.103 The losses of state power utilities across the country and the subsidy provided for the period 2005-06 to 2008-09 (BE) are given in Table 7.3.

Table 7.3: Net Losses of State T&D Utilities

(*Rs. crore*)

	2005-06	2006-07	2007-08 (RE)	2008-09 (BE)
Financial Loss	6634	13398	9985	9206
Subsidy	11741	13277	16950	18111
Total	18375	26675	26935	27317

7.104 The projected aggregate losses of state T&D utilities at the 2008 tariffs are given in Table 7.4. These financial projections assume a reasonable reduction in transmission and distribution (T&D) losses in each state, based on their reported levels of T&D losses at present, and a trajectory for reduction of such losses, derived from the historical performance of some of the better performing state-owned power distribution utilities in the country. Other elements of cost have been appropriately projected. Power purchase costs have been estimated for each utility through a detailed modelling exercise. The employee expenses estimated reflect the impact of the Sixth CPC on the utility payroll costs. These projections are exclusive of the subsidies extended by state governments to the utilities.

Table 7.4: Net Losses of State T&D Utilities at 2008 Tariffs

(*Rs. crore*)

2010-11	2011-12	2012-13	2013-14	2014-15
68643	80319	88170	98664	116089

7.105 As against the enormous financial losses indicated above, subsidies in 2007-08 were of the order of Rs. 16,950 crore. Thus, there is a large and burgeoning uncovered gap. The key reasons for the increasing gap can be summarised as follows:

i) Inability of the state utilities to enhance operating efficiencies and reduce T&D losses adequately.

ii) High cost of short term power purchases. Several utilities have not planned capacity addition in time and are relying on short term purchases at high rates (an average of Rs. 7.31 per kwh as compared to Rs. 4.52 per kwh in 2007-08). The inability to reduce T&D losses has increased the purchase levels and supply costs.

iii) Absence of timely tariff increases has increased the gap and has impaired utility operations further. Some states have not raised tariffs for the past eight to nine years in spite of increasing deficits.

7.106 Tariff increase requirements to bridge the gap, even in the better performing states, are as much as 7 per cent per annum on an average (considering the 2007-08 subsidy levels). In some of the poorly performing states the increase in requirements is as much as 19 per cent per annum, which is indeed difficult to achieve. Table 7.5 indicates the period for which the various states have had tariff revisions.

Table 7.5: Status of Tariff Revision in States

Tariff last Revised	No of states
1 year	9
1-2 years	3
2-3 years	2
3-5 years	2
> 5 years	5

7.107 It also needs to be noted that in several states where tariff revisions have taken place, the gap has been reduced by not recognising the true extent of the costs, eventually resulting in large financial deficits.

Financial Exposure of States to Power Utilities

7.108 In addition to direct subsidies and subventions as referred earlier, equity investments made in the state utilities by the respective governments amounted to Rs. 71,268 crore as on 31 March 2008. Barring isolated instances, these investments have not been earning financial returns for the State Governments. Similarly, there is considerable debt financing to the power utilities by the states, aggregating to Rs. 70,652 crore as of March 31 2008. Interest on this is generally adjusted against subsidy and subventions, and is rarely paid for in cash. Much of this debt is used for financing current deficits. Over and above this, the utilities carry large accumulated losses, which ultimately devolve on the state.

7.109 The states have also been extending very substantial guarantees to state utilities. The overall outstanding guarantees extended by the states to power sector utilities as on 31 March 2008 amounted to Rs. 88,385 crore. Total financial exposure of the states to power utilities is summarised in Table 7.6.

Table 7.6: Financial Exposure of the States to Power Utilities

(*Rs. crore*)

	As of March 31, 2008
Equity Investments	71268
Outstanding Loans	70652
Outstanding Guarantees	88385

Projection of Total Financing Requirements of Power Sector

7.110 As already noted, there is a huge gap between demand and supply of power in many states, calling for large investments in the sector. Development and operation of the T&D network across the country is, for the most part, in the hands of state-owned utilities. Apart from investments required for generation from the states, financing of T&D investments presents considerable additional burden on state finances. The investment requirements are indicated in Table 7.7. (These figures refer to only the equity component funded from state budgets. In addition, utilities would require other funds for financing power generation/ transmission projects).

Table 7.7: Future Equity Investment Requirements of Generation, Transmission and Distribution

(*Rs. crore*)

2010-11	2011-12	2012-13	2013-14	2014-15
19802	21455	20717	19824	17739

7.111 As against the deficit financing requirements indicated in Table 7.4 and capital investment financing requirements indicated in Table 7.7, the states also have some income through interest earnings against loans extended, electricity duty and sale of surplus power as given in Table 7.8. After adjusting for these factors, the net financing requirements of the states are indicated in Table 7.9. (Difference in figures in table 7.9 and those arrived by simple summation/substration of figures in tables 7.5, 7.7 and 7.8 is due to computation of financial losses and investments respectively on accrual and cash basis).

Table 7.8: Projected Income from Power Sector

(*Rs. crore*)

	2010-11	2011-12	2012-13	2013-14	2014-15
Electricity Duty	12872	14046	15373	16868	17776
Interest on State Government Loans	1567	1567	1567	1567	1567
Sale of Surplus power	1251	1682	1968	2075	2909
Total Income	**15,690**	**17295**	**18908**	**20510**	**22252**

Table 7.9: Total Financing Requirements of Power Sector

(*Rs. crore*)

2010-11	2011-12	2012-13	2013-14	2014-15
75880	88529	93604	101271	115637

7.112 Clearly, this presents a very large exposure for the states, impacting their overall finances. For some of the states, these pose a high risk to the stability of their finances. Urgent measures need to be taken to bring about efficiency in the functioning of utilities in the states.

Recommendations

7.113 Notwithstanding the poor overall picture of state utilities, some states have made better progress than others. These states have been able to add substantial capacity in recent years. Of these, the hill states have benefited from free power from hydro projects. Such states have to rely to a much lesser extent on purchase of power, especially from spot markets. However, a majority of the states continue to suffer severe shortages and, therefore, continue to rely on power purchases, thereby placing their finances under severe stress.

7.114 Reduction in T&D losses and collection efficiency remain key concerns for the sector. Even utilities with a very high proportion of industrial consumption have very large T&D losses and low collection efficiency levels. The unmetered supply component of power (primarily to agriculture) in many of the states is increasing rapidly. In the absence of measurement, these estimates of agricultural and rural power supplies tend to essentially obfuscate the levels of T&D losses. Efforts need to be made towards feeder separation, introduction of High Voltage Distribution Systems (HVDS), metering of distribution transformers and control of supply as per policy. Large amounts of energy are wasted in agricultural pumpsets on account of poor equipment efficiency as also wasteful use caused by unmetered tariffs. These need to be checked urgently. Distribution franchising and Electricity Services Company (ESCO)-based structures for efficiency improvement need to be considered by the utilities on a large scale.

7.115 For improvement of operating efficiency, GoI has launched a comprehensive Restructured Accelerated Power Development Reforms Programme from September 2008, which should help in arresting losses in urban areas. In rural areas some of the states have themselves undertaken significant measures in this regard like feeder separation, HVDS and franchising in urban and rural pockets. Such measures need to be scaled up significantly in all states.

7.116 The electricity transmission sector has been witnessing positive developments after unbundling on account of specific focus on transmission investments and efficiency. Most states have shown appreciable reduction in transmission losses after unbundling. The remaining states that are yet to unbundle their boards should consider it at the earliest. Open access to transmission needs to be strengthened and governance needs to be improved through the State Load Despatch Centres (SLDCs). Eventually the load despatch function needs to be made completely autonomous with improved functioning on the lines suggested by the Pradhan Committee set up by GoI.

7.117 On the resource development front there are certain key concerns. Development of hydro projects has been slower than desired. Less than half the anticipated hydro capacity is expected to come on stream during the Eleventh Plan period. There are several reasons for the delayed development, including:

i) Lack of quality Detailed Project Reports (DPRs) for projects.

ii) Inadequate facilitation of the projects by the Central/State Governments.

iii) Inadequate institutional framework for development at the state level.

iv) Delays in consents and clearances.

v) Infrastructure and access issues.

vi) Lack of peak pricing and market access.

7.118 Hence, a strong implementation focus needs to be brought about with regard to these. The states have a particular role to play since the free power that accrues can result in substantial benefits to them.

7.119 On the thermal power front, there is a need to locate the projects more efficiently. As a rule, transmission of power over long distances is preferable to transportation of coal. While the private sector, in general, has been looking at more efficient siting of their projects, several states, located far away from the resources, are still focused on developing plants within the state. These states need to evaluate joint ventures (JVs) in or near the coal-rich states to reduce their costs.

7.120 The states also need to initiate more competitive procurement processes. In spite of sustained deficits in supply, only a handful of states have completed Case-1[1] bid processes till date. This leaves them vulnerable to high-cost market purchases. There is urgent need to float more Case 1 tenders since the prices ought to be much more competitive than those for short term procurement. The states also need to initiate appropriate demand forecasting and portfolio optimisation exercises.

7.121 In addition, regulatory institutions need to be strengthened and following are required:

i) The regulatory institutions, in general, lack sufficient capabilities, which is evident from the fact that even routine tariff increases have not taken place in the recent past. There is need for massive capacity building efforts to strengthen them and help them discharge their functions effectively. There is also need to promote consumer education to apprise consumers on the imperative for such increases. Tariffs should be linked to service levels and performance improvement. Tariff reforms (including Multi-year Tariff implementation as required by the Act) need to be expedited.

ii) Institutional strengthening and corporate governance of utilities needs reinforcement. Unbundling of utilities, a statutory requirement, should not be deferred any further.

iii) Public sector companies, whether they have raised funds from the market or not, should follow the provisions of the Company Law in finalising accounts, appointment of independent directors, appointment of audit committees, and implementing the Guidelines on Corporate Governance issued by the Department of Public Enterprises.

New Pension Scheme

7.122 The Government of India introduced a defined, contribution based New Pension System (NPS) with effect from 1 April 2004 to cover all new entrants to government service. Twenty-three states have notified adoption of the NPS for their employees. The interim Pension Fund Regulatory and Development Authority (PFRDA) has set up the institutional architecture of the NPS. The National Securities Depository Limited (NSDL) has been selected as the Central Record-keeping and Accounting Agency (CRA) while three pension fund managers, a custodian, and a trustee bank have also been appointed. However, despite the formal announcements by states, implementation of NPS has been slow across states. Only 12 states have executed agreements with the CRA and eight states have entered into agreements with the NPS Trust, since states face administrative difficulties in identification of eligible employees and implementing a pay-roll linked arrangement for periodic transfer of individual and government contributions to PFRDA-regulated service providers. Thus, while GoI has transferred over Rs. 1,117 crore to the pension fund managers, as on 31 March 2008, only two State Governments have transferred a total amount of Rs. 133 crore so far. The contributions of state employees are lying in the state public accounts earning a return equal to the interest rate allowed for the General Provident Fund. The migration to the NPS needs to be completed at the earliest. In order to facilitate such migration, we have recommended a grant to assist states to build the database of their employees and pensioners (Para 12.108).

Cash Management

7.123 We have examined the cash balances held by the states in the form of Treasury Bills. With

[1]Guidelines issued by the Ministry of Power for procurement of Power by distribution licensees refer to Case-1 as the bidding process for procurement of power where, location, technology or fuel is not specified by the procurer. The Case-2 bidding process is for location specific projects where the procurer assists the bidder in securing land, necessary clearances and fuel, etc.

reduction in fiscal deficits of the states and improved liquidity, states have mostly been in cash surplus in the past few years. Such balances are not uniform across states; at the end of 2007-08 about half the states had cash balances exceeding the total expenditure for one month. While states require some float for smooth expenditure at the implementation level, accumulation of cash beyond a level can be treated as inefficient, as it would lead to avoidable interest burden.

7.124 The primary reason for accumulation of these balances is borrowing more than the fiscal deficit. While the difference between the net increase in debt and fiscal deficit in 2001-02, 2002-03, and 2003-04 was Rs. 3,998 crore, Rs. (-) 490 crore, and Rs. 353 crore respectively, this difference increased steeply to Rs. 10,926 crore in 2004-05 and then to Rs. 25,992 crore in 2005-06. The difference, reduced to Rs. 16,873 crore in 2006-07 and further to Rs. 11,116 crore in 2007-08, but still remains unnecessarily high. These excess borrowings can be partially attributed to high inflows from NSSF but the role of sub-optimal debt management cannot be ignored.

7.125 Other factors also contribute to cash balances at the state level. One of them is the mechanism of release of central assistance wherein, the grants are released to the states leading to a temporary build-up of cash balances that get used up only in due course of time. The total amount of plan grants and loans to the states in 2007-08 was of the order of Rs. 0.78 lakh crore. Although, these transfers are linked to utilisation of previous releases, there have been capacity constraints on implementation in many states. Transfer of unspent funds to deposit accounts maintained in the public account at the end of the financial year by states leads to build-up of cash balances. In addition, flows from the Centre not budgeted by the states and end of the year releases in CSS, also leads to increase in cash balances.

7.126 Another important factor is the accumulated balances in the public account of the states, especially under Reserve Funds and Deposits and Advances. The total amount outstanding under these heads has increased from Rs. 99,868 crore in 2000-01 to Rs. 1.85 lakh crore in 2007-08. Of course, the entire accumulation under these heads does not lead to increase in cash balances. Sinking funds, guarantee redemption funds and CRF investment accounts are invested in longer term instruments. The public account needs to be examined and reconciled by the states. The public account should not be treated as an alternative to the consolidated fund and government expenditure should be directly incurred from the consolidated fund as far as possible, avoiding transfers from consolidated fund to the public account.

7.127 Efficient debt management is an essential part of cash management. Inefficiencies either way can lead to higher interest costs, whether it is accumulation of cash due to unnecessary borrowings or availing of ways and means advances. With reduced fiscal deficits, it is essential that states follow the practice of borrowing on requirement rather than on availability. Amongst different sources of debt, the only source of borrowing on which states have free control is the open market loans. Most of the negotiated loans and external aid (received through Central Government on back to back terms) are tied to projects, and thus, do not have much flexibility. Parameters controlling flows from NSSF are also beyond the control of states. We have indicated the need for essential reforms in NSSF in Chapter 9. Overall, there should be a directed effort by states with large balances towards utilising their existing cash balances before resorting to fresh borrowings. Many states would be facing larger than usual bullet repayments of market borrowings during the next few years due to bonds raised for debt swaps during the period 2002-05. While estimating the gross borrowing limits for this purpose, we would encourage states to attempt to use the cash balances, if these remain substantial at that point in time. The proposed National Debt Management Office can offer their expertise to the states in their debt management strategies.

Accounting Reforms

7.128 Article 150 of the Constitution mandates that the accounts of the Union and the states shall be kept in such form as the President may, on the advice of the Comptroller and Auditor General of India, prescribe. The finance accounts of the states provide details of receipts and expenditure for the consolidated fund, the contingency fund, and public account. These accounts usually consist of 19 statements and a number of appendices. Allowing for significant variation between budget estimates and actuals, these accounts form the bedrock for examination of the fiscal performance of states. Our analysis of state finances is primarily based on these accounts. However, during the course of our exercise, we have found that there are still many areas where reforms are required to make these accounts more meaningful as well as comparable across states.

Uniform Adoption of the Coding System in Accounts

7.129 FC-XII had recommended that a uniform classification code for all states upto the object head level be adopted. Such uniform application would facilitate comparison across states while ensuring consistency. Further preparation of financial statements under economic classification would also require that information on primary allocation basis, i.e., object head level, be uniform. However, the flexibility in the operation of object heads at state level continues. We, therefore, recommend that the Government of India ensure uniformity in classification code across all states.

Uniform Booking of Expenditure under Different Heads

7.130 The treatment of expenditure on similar schemes is often not uniform across states. For example, while most states book NREGS expenditure in the revenue account, at least one state books it in the capital account, citing the practice adopted during the earlier Food for Work Programme (FWP). Some states show local body grants as capital expenditure. Such divergences in the finance accounts across states make it difficult to analyse whether these programmes have been implemented as mandated including payment of states' share.

Contra - Entries

7.131 Contra - entries (refer to Para 7.53) in the accounts impede the estimation of the true revenue and expenditure of a State Government. Similarly, funds transferred between the consolidated fund and the public account are merely book transactions without any cash import. The frequency of these entries varies across states. For an objective and normative comparison of the performance of State Governments across the country, it is necessary that such entries be identified in every state's accounts and then be filtered out. Unfortunately, there is no easy way to detect contra entries in the finance accounts. We, therefore, recommend a separate annex be provided to the finance accounts giving details of contra entries as well as a summary of transactions between the public account and the consolidated fund.

Funds Outside the Budget Framework

7.132 An undesirable trend noticed is the tendency to divert public expenditure from the budget to nominated funds which are operated outside the authority of the legislature. In one state, four such funds have been created outside the budget. These funds were ostensibly set up to promote sectors which should have been legitimately taken up within the budget. The total amount transferred to these funds was significant. The expenditure incurred through these irregular arrangements not only bypassed the oversight of the state legislature but also the audit of the C&AG and hence should be discouraged.

7.133 Another common practice is the transfer of budgetary allocations from the consolidated fund to civil deposits in the public account at the end of a financial year to avoid lapse. These deposits inflate the state's total liabilities. It also appears that audit scrutiny by the C&AG of expenditures incurred from civil deposits is not consistent across states. We recommend that such funds and transactions be brought under the audit jurisdiction of the C&AG as the responsibility for the funds should also eventually be towards the State Legislature.

Appendices to Finance Accounts

7.134 The finance accounts of all states contain clarificatory appendices. Finance accounts of most states contain nine appendices which provide details of government investments and instances where verification of balances has been delayed, list incomplete capital works costing Rs 1 crore and above, and provide expenditure on salaries and subsidies, etc. In addition, FC-XII has recommended inclusion of seven additional statements in the finance accounts. However, a significant number of finance accounts do not provide all the appendices. For example finance accounts of 16 states do not provide the appendix on 'instances where verification and acceptance of balances involving large amounts has been delayed'; finance accounts of 10 states do not provide information on details relating to reconciliation of balances; finance accounts of four states do not provide a statement of incomplete capital works costing Rs 1 crore and above, and finance accounts of four states do not provide details of expenditure on subsidies. We recommend that the list of appendices to the finance accounts be standardised keeping in view the recommendations of FC-XII and be followed in all states.

Statement of Subsidies

7.135 Appendix VI of the state finance accounts is a statement of subsidies disbursed during the relevant year. This statement is expected to bring out all expenditures of the states in the nature of subsidy, rather than only those that are classified as subsidy. There are instances where states have classified subsidies as 'other expenditure' or 'grant-in-aid' and which have, thus not been reflected in the finance accounts as subsidies. In many cases, the accounts of the recipient of assistance show it as subsidy, and thus, it has been accounted as subsidy by the Audit report (Commercial) of the C&AG but not in the finance account. Thus, in some cases, the statement does not provide a true reflection of the aggregate subsidies provided. To be relevant, it is essential that these statements provide comprehensive data on all subsidies.

Statement of Salaries

7.136 The salary statement presently included in the state finance accounts provides expenditure details major head-wise, but does not provide the number of employees under each major head. It also does not provide the number of employees in each category and the expenditure on each category. A number of State Governments conduct employee census where they list out the number of employees in each grade as well as department-wise. As per Section 4 (x) of the Right to Information Act, each public authority is required to publish the monthly remuneration received by all its employees including the system of compensation, as provided in its regulations. Fiscal Responsibility Legislation adopted by a number of State Governments requires them to provide a statement giving details on the number of employees in the government, public sector and aided institutions, and related salaries and pensions as part of the disclosure criteria. There exit a number of independent silos with partial information on the number of employees at each level, and the commitment on their salary. The statement on salary expenditure needs to be made more comprehensive.

7.137 There are certain expenditure items of states that are not strictly salary expenditure, but are in the nature of assistance for salary to bodies such as autonomous organisations and local bodies. To make the statement of expenditure on salary more comprehensive, it is recommended that a statement on the expenditure of State Governments on assistance for salary also be separately incorporated.

Statement of Maintenance Expenditure

7.138 Neither the Central Government nor the various State Governments provide this information. It is understood that the Controller General of Accounts has identified six major heads– public works; housing; major irrigation; medium irrigation; minor irrigation and roads and bridges. The CGA has issued instructions that maintenance expenditure under these heads should be divided into the two sub heads–work charged expenditure and other maintenance expenditure. However, State Governments (and Union Ministries) are yet to carry out these changes in the budget documents. In view of the insight such information will provide into the quality of the maintenance being undertaken, we recommend that these changes be brought into the State and Union Budgets and finance accounts immediately.

Summary of Recommendations

7.139 To summarise, our recommendations are as follows:

i) The practice of diversion of plan assistance to meet non-plan needs of special category states to be discontinued (Para 7.79).

ii) With reference to public sector undertakings:

   a) All states should endeavour to ensure clearance of the accounts of all PSUs (Para 7.95).

   b) States should use the flexibility provided by C & AG to clear the back log of PSU accounts (Para 7.95).

   c) All States need to draw up a roadmap by March 2011 for closure of non-working companies. Divestment and privatisation of PSUs should be considered and actively pursued. (paras 7.95 and 7.97).

   d) Ministry of Corporate Affairs to closely monitor the compliance of state and central PSUs with their statutory obligations (Para 7.95).

   e) A task force may be constituted to design a suitable strategy for disinvestment/ privatisation and oversee the process. A Standing Committee on restructuring may be constituted under the chairmanship of Chief Secretary to operationalise recommendations of the task force. An independent technical secretariat may be set up to advise the Finance Departments in states on restructuring/disinvestment proposals (Para 7.98).

iii) With reference to power sector:

   a) Reduction of T&D losses should be attempted through metering, feeder separation, introduction of High Voltage Distribution Systems, metering of distribution transformers and strict anti-theft measures. Distribution franchising and Electricity Services Company based structures for efficiency improvement should be considered (Para 7.114).

   b) Unbundling should be done on priority and open access to transmission should be strengthened. Governance should be improved through state load dispatch centres and this function should eventually be made autonomous. (Para 7.116).

   c) Proper system should be placed to avoid delays in completion of hydro projects (Para 7.117).

   d) Instead of putting up thermal power plants far away from coal sources, states should consider JVs in or near the coal rich states (Para 7.119).

   e) Case 1 bid process should be extensively used to avoid vulnerability to high cost purchases during peak demand periods (Para 7.120).

   f) Regulatory institutions should be strengthened through capacity building, consumer education and tariff reforms like multi - year tariff. Best practices of corporate governance should be introduced in power utilities (Para 7.121).

iv) The migration to the New Pension Scheme to be completed at the earliest (Para 7.122).

v) States with large cash balances to make efforts towards utilising their cash balances before resorting to fresh borrowings (Para 7.127).

vi) With reference to accounting reforms:

a) GoI to ensure uniformity in the budgetary classification code across all states. List of appendices to the finance accounts of the states be also standardised (paras 7.129 and 7.134).

b) Details of contra-entries as well as summary of transactions between public account and Consolidated Fund to be provided as a separate annex to finance accounts of the states (Para 7.131).

c) Public expenditure through creation of funds outside consolidated fund of the states needs to be discouraged. Expenditure through such funds and those from civil deposits be brought under the audit jurisdiction of the C&AG (paras 7.132 and 133).

d) Following statements to be provided with finance accounts of the states.

- Comprehensive data on all subsidies (Para 7.135).
- Consolidated information on number of employees at each level along with the commitment on salary. This statement to also include information of employees and their salary where such expenditure is shown as grants booked under other expenditure head (paras 7.136 and 7.137).
- Details of maintenance expenditure (Para 7.138).