Public Finance Quarterly

Enabling Inclusive Development

April-June 2009, Issue I

Editorial

Dear Readers

It is a pleasure to introduce the inaugural issue of 'Public Finance Quarterly', the quarterly newsletter of PwC's Public Finance (PF) Practice.

Public Finance Quarterly aims at sharing developments, experiences and good practices in the PF domain. It discusses the emerging issues and trends on the national and international fiscal landscape. It is planned to present one article on a contemporary subject in each issue. The newsletter will also contain a viewpoint on national or international experience on germane issues. Additionally, the newsletter will attempt to capsule updates in the area of government finances and policies across the globe and key paper releases during the quarter.

In our maiden issue, we have analyzed the impact of change in tax-sharing formula on entitlements awarded to individual States across XI and XII Finance Commissions in our 'Feature Article'. The 'Pick of the Quarter' presents the PF team's viewpoint on the Union Budget 2009-10.

With your help, we would like to further improve on this newsletter to ensure effective information sharing on PF issues. If you have an item to contribute for the next issue or want to subscribe to the newsletter, then please do not hesitate to contact the editorial team at latha.ramanathan@in.pwc.com. We look forward to your comments, suggestions, and contributions!

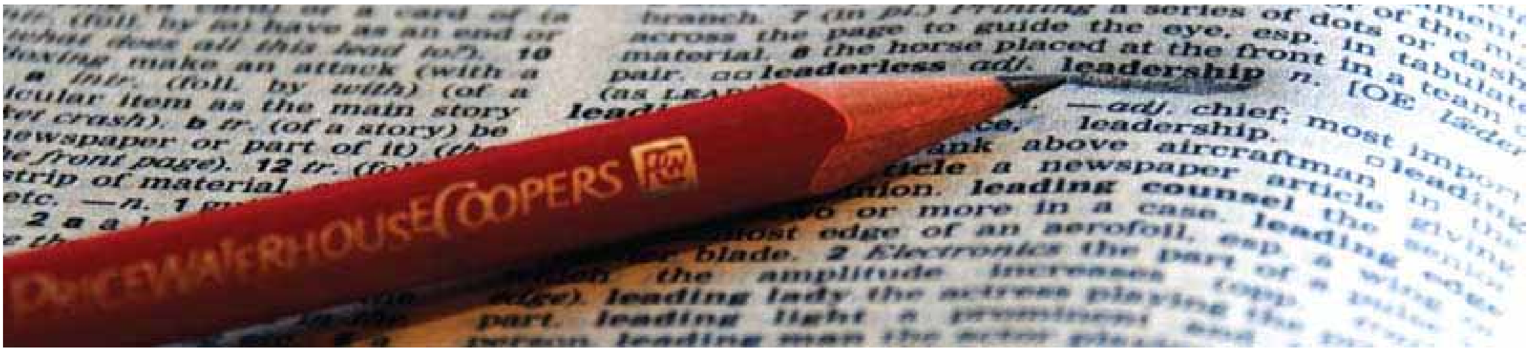
I hope you enjoy reading our first issue and trust you will find a number of items that will prove to be of interest.

Sincerely,
Latha Ramanathan
Executive Director & Head, Public Finance

Inside This Edition

Round the Corner

Quarterly Stock of News Bytes and Releases



News Bytes

Revised Guidelines for preparation of Outcome Budget 2009-10

Issued by the Ministry of Finance, Government of India on May 6, 2009

Link: http://finmin.nic.in/the_ministry/dept_eco_affairs/budget/guideline_outcome09-10.pdf

IMF hosts IPSASB Meeting

The International Public Sector Accounting Standards Board (IPSASB) held its 2nd meeting of the year in Washington, DC from May 18-21, 2009 at the Headquarters of the IMF. The IPSASB has been discussing the impact of the current global financial crisis on governments at each of its meetings since October 2008. This meeting focused on a number of public sector specific topics, including the conceptual framework, long-term fiscal sustainability and service concession arrangements.

Transcript of the speech by Mr. Murilo Portugal, Deputy Managing Director of the IMF is available at:

http://www. imf.org/external/np/speeches/2009/051809a.htm

ICGFM 23rd Annual Conference on Governmental Financial Management

Country Perspectives on Public Financial Management During Global Economic Uncertainty

From May 18-22, 2009 in Miami, Florida - USA, government leaders, Public Financial Management experts, international donors and program managers met at the 23rd Annual International Consortium on Government Financial Management (ICGFM) International Conference. The Conference demonstrated how the financial crisis is advancing Public Financial Management (PFM) reform.

Link: http://www.icgfm.org/23rdAnnualConference.htm

Releases

An Index of Devolution for Assessing Environment for PRIs in the States

NCAER report of March 2009

Report released in March 2009 by NCAER provides empirical assessment of the degree of decentralization and devolution for PRIs at the Indian State level captured in 'Devolution Index'.

Link: http://panchayat.gov.in/data/1237443054942~Index%20of%20Devolution%20for%20Assessing%20Environment%20for%20PRIs%20in%20States.pdf

Accrual Budgeting and Fiscal Policy

IMF Working Paper of April 2009, Author - Marc Robinson

Can an accrual budgeting system, a system in which budgetary spending authorizations to line ministries are formulated in accrual terms, serves the needs of good fiscal policy? If so, how should such a system be designed? What are the practical challenges which may arise in implementing sound fiscal policy under a budgeting system which is significantly more complex than traditional cash budgeting? These are the primary questions addressed in this paper.

Link: http://www.imf.org/external/pubs/ft/wp/2009/wp0984.pdf

The Miracle of Microfinance? Evidence from a Randomized Evaluation

Poverty Action Lab Paper of May 2009, Author(s) - Abhijit Banerjeey Esther Du.oz Rachel Glennersterx Cynthia Kinnan

Microcredit has spread extremely rapidly since its beginnings in the late 1970s, but how much and to what extent it helps the poor is the subject of intense debate.This paper reports on the first randomized evaluation of the impact of introducing microcredit in a new market carried out in Hyderabad, India wherein half of 104 slums were

randomly selected for opening of an MFI branch. The impact of access to microcredit on creation and profitability of small businesses, investment, and consumption was analyzed during this evaluation. Findings showed that the intervention increased total MFI borrowing.
The effects on the creation and the profitability of small businesses, investment, and consumption are analyzed. 15 to 18 months after the program, there was no effect of access to microcredit on average monthly expenditure per capita, but durable expenditure did increase though the effects are heterogeneous.
The study finds no impact on indicators of health, education, or women's decision-making power.

Link: http://www.povertyactionlab.org/papers/microfin.pdf

The Challenge of Reforming Budgetary Institutions in Developing Countries

IMF Working Paper of May 2009, Author - Richard Allen

The paper notes that development of sound budgetary institutions in countries such as France, U.K. and U.S. has taken a very long time (200 years or more) and is still evolving. It discusses Douglass North's prediction, which is supported by available data, that institutional reform is also likely to be very slow in developing countries since the budget is especially prone to rent-seeking influences.
Finally, the paper discusses the currently fashionable emphasis on complex, multiannual PFM reform strategies, which have been strongly promoted by the donor community; and advocates a simpler approach grounded on Schick's important principle of 'getting the basics right'.
The paper identifies several areas for further fruitful research.

Link: http://www.imf.org/external/pubs/ft/wp/2009/wp0996.pdf

Advanced Public Financial Management Reforms in South East Europe

IMF Working Paper of May 2009, Author(s) - Eivind Tandberg and Mia Pavesic-Skerlep

This paper aims to clarify possible systemic bottlenecks to the introduction of advanced PFM reforms in the SEE countries. It relates key fiscal developments to PFM reform processes over the last 15 years. PFM reform strategies must be realistic, with clear objectives and timetables, and with strong country ownership. Among the advanced reforms, some aspects of medium-term budgeting seems to be somewhat less challenging than performance-oriented budgeting, and it could be rational to make sure that there is solid progress in this area first.
When developing performance budgets, countries should consider focusing initial efforts on the areas that are most suitable for performance management, such as education and health.

Link:http://www.imf.org/external/pubs/ft/wp/2009/wp09102.pdf

Feature Article

Gaining an insight into Public Finance Arena

Sharing of Federal Pie: An Insight

Abstract

Various Finance Commissions (FCs) have been set up to make recommendations on distribution of the shareable pool of resources between the Union and States and subsequently among States.

Different tax sharing formulae suggested by FCs in the past have been based on various economic and fiscal indicators. Any change in these indicators or weights assigned to them would lead to a consequent change in share of individual States. This article attempts to analyze the impact of change in tax-sharing formula on entitlements awarded to individual States across XI and XII FC. For this purpose, the XI FC formula has been applied to XII FC's sharable pool to draw comparisons across commissions on tax devolutions that would have taken place had the XI FC tax sharing formula been continued with and the existing actual devolutions under the XII FC. The article observes that, if XI FC formula had been adopted by the XII FC, tax devolutions to low income States would have been higher than actually received by them during XII FC award period.

The article also observes that dropping the norm of "index of infrastructure" from the tax sharing formulae has penalized poor and backward States while increasing the share of relatively high income States. The article finally concludes that 'out of trend' interventions would be required from the XIII FC to support the poorer States for breaking out of their vicious cycle of low growth.

In a federal set-up, transfer of resources from the Centre to the States is an important process. Certain resources are best raised only at the Centre, both on equity and efficiency grounds. This invariably results in a mismatch between the costs of expenditure that State Governments are expected to undertake and the resources locally available to them.

Thus developing a productive and equitable intergovernmental fiscal transfer scheme is a critical issue in the arena of public finance and in a federal polity. These transfers are devolved to the States for both capital and current expenditure needs. They flow on as ad hoc and on normative basis. They are of statutory and non-statutory nature.

The transfers based on the recommended awards of Central Finance Commissions, which are constituted every five years by the President of India, are of statutory nature.They are composed of grants-in-aid and shares in central taxes.Each FC's endeavor has been to make recommendations and awards regarding the distribution of net proceeds of shareable taxes between the Union and the States and consequently among the federating States. FCs also lay down the principles governing grants-in-aid to the States from the Consolidated Fund of India. So far twelve FCs have given their recommendation and awards on issues relating to fiscal devolutions.

The Thirteenth Finance Commission has been constituted under the chairmanship of Dr. Vijay Kelkar to recommend the tax sharing formula and the consequent devolution shares for 2010-15.

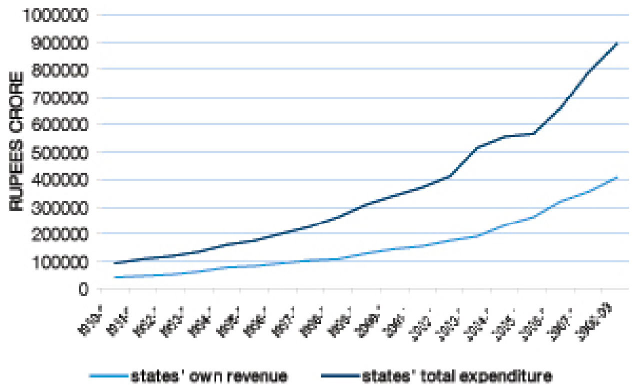
This article looks at the trend and pattern of fiscal transfers over the last two Finance Commissions, namely, the Eleventh (XI FC) and the Twelfth Finance Commission (XII FC), and assesses the impact of change in tax devolution formulae on devolution of resources to States.

The specific focus of this article is on analyzing the impact of changes in devolution formula from the XIth to the XIIth FC and deriving lessons for consideration by the XIIIth FC.

Measuring Vertical and Horizontal Imbalance

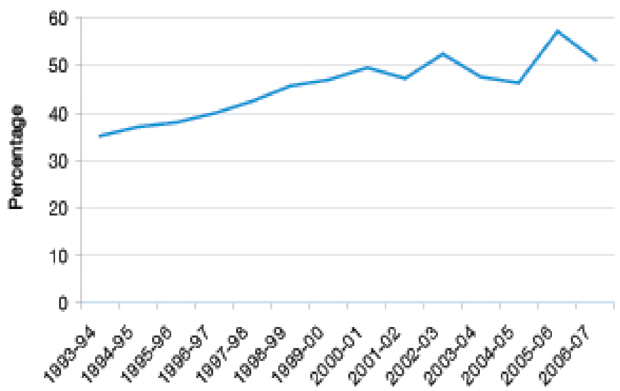
The dual objective of fiscal transfers is to correct both vertical and horizontal imbalances. The vertical imbalance arises since more resources, especially those which are income-elastic, have been assigned to the Central Government, while the States have been entrusted with larger responsibilities.
Correcting vertical imbalance calls for appropriate transfers from the Central Government to the State Governments.

Figure 1: Trend in all states' own revenue and total expenditure



Looking at the trends in the States' total own revenue receipts and total expenditure, we can get an idea about the mismatch in States' resources and responsibilities.
Figure 1 suggests that, overtime the gap between States' own revenue and States' total expenditure has been widening. Though States' revenues have increased over the years, State's expenditures galloped at a faster rate and hence fiscal dependence on the Centre has gone up.
On the other hand, horizontal imbalances arise due to inter-state disparities in revenue raising capacity and expenditure needs. States vary in terms of area, population, income, tax base, and mineral and forest resources.
This leads to differences in capacities to raise resources,expenditure requirements and costs of providing services.

Figure 2: Coefficient of variation for interstate disparities in per capita income



We can get an estimate of inter-state disparity in ability to raise revenue by observing the variation in per capita income (NSDP) across States. For this purpose, coefficient of variation in State's per capita NSDP has been calculated from 1993-94 to 2006-07 and is presented in Figure 2.It can be noticed that the coefficient of variation in per capita NSDP of the States has registered an increase over time rising from 35% in 1993-94 to 51% in 2006-07. In the initial years, the per capita income of richest State Punjab was 4.2 times that of poorest State Bihar while in 2005-06 it rose to 5.3 times. This is an indication of increasing horizontal imbalances among States which goes against the avowed principle of inclusive and broad based growth. If left dependent on own revenue sources alone, States with natural or inherent advantages will develop faster leaving behind the "not-so-endowed" States. Thus another important objective of fiscal transfer is adequate allocation of transfers among the State Governments to ensure a more equalized growth trajectory.
The prime function of a Finance Commission is therefore to recommend a scheme of transfers that could correct for both vertical and horizontal imbalances while serving the objectives of equity and efficiency. It is also important to emphasize that together with ensuring equitable growth, the transfers in the form of tax devolution and grants, should also be linked to tax effort and fiscal discipline of States and should not prove to be an incentive to remain backward.
The growing disparity clearly shows that Finance Commission devolutions have not been able to address this issue and there are possibly several other causes for this scenario. One of the important causes is the inability of these States to undertake capital expenditure as the devolutions are consumed by "committed expenditures" on salaries, pension and debt servicing. Since the poorer States have very low own tax revenue potential, they are unable to undertake capital expenditure to improve infrastructure and break out of the vicious cycle of low growth.

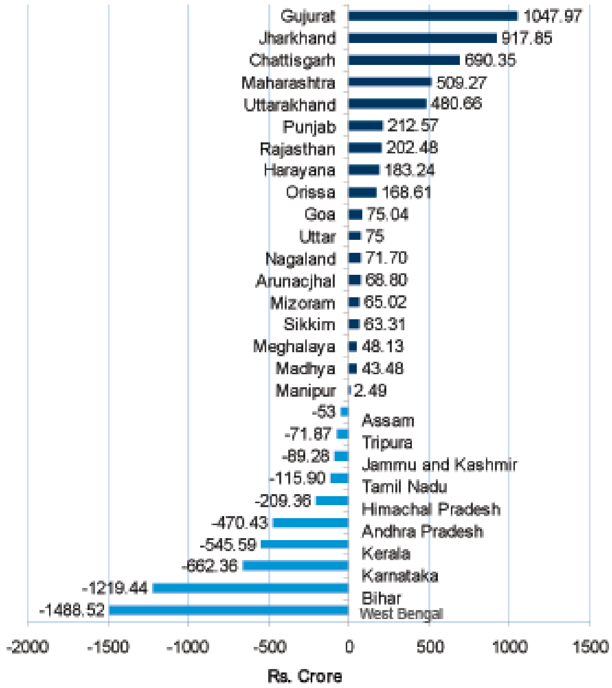
Tax Transfers and Criterion Used

Over time, successive Finance Commissions have recommended different percentages of various Central taxes to be transferred to the States and different shares of States in the total shareable pool. In determining inter se shares of States in aggregate shareable pool of Central taxes, there are three considerations taken into account - fiscal capacities across States, cost of providing public services and revenue effort. Due to heterogeneity in these three factors across the States, a mix of suitable norms is used so as to justify the task of correcting horizontal imbalances. Various economic indicators and weights assigned to them have been experimented with so far.The indicators along with their weights as used by XI and XII FC are presented in Table 1.

Table 1: Criteria and their weights as used by XI FC and XII FC

Criterion	Basis	Weights	
		XI FC	XII FC
Population	Measures need for public goods & services ensures equal per capita transfers across states.	10.0%	25%
Per capita GSDP (Income distance criterion)	Measures fiscal capacities of states – larger income distance for states with low per capita GSDP and thus require larger share	62.5%	50.0%
Area	Measures cost of delivering services to the masses	7.5%	10.0%
Tax Effort-Tax /GDP ratio	Reward the states utilizing its tax base efficiently	5.0%	7.5%
Index of fiscal Discipline:	Incentivize for better fiscal management	7.5%	7.5%
Index of infrastructure:	To support infrastructure development of state	7.5%	0.0%

Figure 3: Annual change in tax devolution for the states whose shares have reduced from XI FC to XII FC



Change in Tax Devolution Formula: Impact Assessment

The weights assigned to alternative criteria were different under XI FC and XII FC and hence the States' shares in sharable pool also differed between the two Finance Commissions. An impact assessment of change in tax-sharing formula has been undertaken by creating an alternative scenario and estimating each State's share for XII FC period (2005-06 to 2009-10) using XI FC formula.

A comparison of these alternative estimates with actual XII FC tax devolutions has then been undertaken to analyze the effect of change in tax-sharing formula on State's devolutions. Following are the observations from this analysis.

Change in tax devolutions: Annual absolute change

Figure 3 shows the annual gain (or loss) in tax devolutions for the States whose share in Central taxes has increased (or reduced) from XI FC to XII FC award period.A loss implies that, if the tax-sharing formula of XI FC had been used in XII FC award period (2005-10), the amount received by the concerned State would have been larger than what has been actually received during XII FC period. Similarly a gain would imply that if the XI FC formula had been used during XII FC award (2005-10), then amount received by the State would have been lower than what has been actually received during XII FC period. Thus the losses and gains mentioned here are of imputed nature for the States.

As can be seen from Figure 3, due to change in tax-sharing formula, Bihar and West Bengal emerged as the most disadvantaged States. Their share would have been larger by more than Rs.1,000 crore per annum (p.a.), had the XI FC formula been used for XII FC award period.

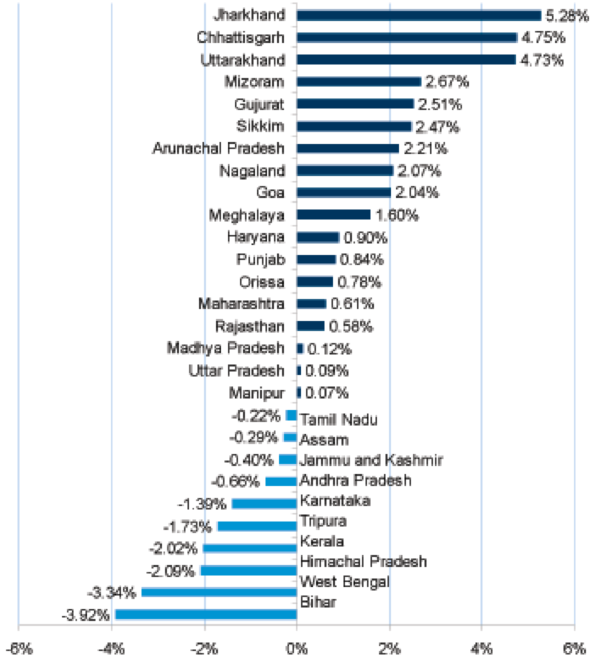
The shares of Himachal Pradesh, Andhra Pradesh, Kerala and Karnataka also registered a fall with devolutions decreasing by significant amounts. For the remaining States that were in the red, loss in tax devolution was less than Rs. 200 crore p.a.

It can also be noted from Figure 3 that States that gained noticeably with XII FC awards were Gujarat, Uttarakhand, Jharkhand, Chhattisgarh and Maharashtra with their tax transfers increasing by more than Rs.500 crore pa. These gains can be attributed to change in the tax devolution formula. Other States which received significant imputed gains in tax transfers are Orissa, Rajasthan, Punjab and Haryana. But for remaining States, change in tax devolution formula did not contribute much to their XI FC shares. This shows that the change in formula did not help all the disadvantaged States similarly. While Jharkhand, and Chhattisgarh gained, Bihar lost out heavily and there were no significant additional gains for States like Orissa, Madhya Pradesh and Uttar Pradesh.

Change in tax devolutions: as % of Revenue Receipts

The average loss of revenue for States whose share has declined during XII FC period works out to be 2% of their total revenue receipts. Among these States, West Bengal suffered the highest (imputed) loss of 4.81% while Bihar lost 4.48% of its revenue receipts. Also, for Kerala and Himachal Pradesh, revenue receipts would have been higher by more than 2% each year had the XI FC tax-sharing formula remained unchanged. For remaining States with a loss like Tripura, Karnataka, Andhra Pradesh, Jammu & Kashmir and others, the imputed fall in Central tax transfers has been less than 2%.

Figure 4: State-wise change in tax devolution as % of their total budgetary expenditure



For the States gaining due to changed tax-sharing formula, the average gain is estimated to be 2.25% of revenue receipts. Jharkhand became the highest gainer with 7.54% increase in revenue receipts due to increased tax devolution. Chhattisgarh and Uttarakhand gained more than 5% each, while Gujarat gained 3% increase in revenue receipts. For States like Arunachal Pradesh, Nagaland, Goa, Sikkim and Mizoram, increase in tax devolution had been 2% to 3%. Thus, the change in tax devolution formula did not lead to a major gain or drop in revenues in percentage point terms owing to change in the devolution formula for majority of the States.

Change in tax devolutions: as % of Total Expenditure

For the States whose shares have reduced in XII FC period as compared to that in XI FC period, the average loss of tax transfers has worked out to be 1.61% of their total budgetary expenditure. For example, Bihar would have 3.92% more expenditure capacity if XI FC tax devolution formula was retained. Similarly, West Bengal and Himachal Pradesh could have spent 3.34% and 2.09% more if tax-sharing formula would have remained unchanged (Figure 4).

Similarly, for States whose share has increased in XII FC period, the average gain as percentage of total expenditure is estimated to be 1.91%. It can be seen from Figure 4 that Jharkhand's increased devolutions were sufficient to fund 5.28% of its total expenditure. Uttarakhand and Chhattisgarh gained more than 3% increase in their expenditure capacity.

On close observation, it can be noticed that low income States (Bihar, West Bengal, Andhra Pradesh) have generally lost with XII FC devolutions while newly formed States (like Jharkhand, Uttarakhand, Chhattisgarh) and high income States (Gujarat, Maharashtra, Punjab) have gained due to change in tax-sharing formula, which is somewhat contrary to the objective of equitable growth being pursued by the FC.

Inter-state Factor Analysis

A look at the inter-State ranking in respect of various economic and financial indicators has been undertaken to understand the factors contributing or constraining tax devolutions to various States. For this purpose, the top States in terms of imputed gains or losses have been analyzed.

Change in tax devolution formula from XI to XII FC and its impact on fiscal position varied from State to state based on their specific economic and financial indicators. For instance, under XII FC, with a decline in weight attached to income distance, low income States were mostly on losing end as their shares declined.

Similarly, with an increase in weight of Tax-GSDP ratio, well off States with higher tax collections gained. With the exclusion of infrastructure index criterion, States with poor infrastructure suffered. Tables 2 and 3 provides a brief view of factors accountable for change in tax transfers to major States.It can be observed from Table 2 that the losing States generally ranked high on income distance and population and low on infrastructure index. With decline in weights of income distance and infrastructure index from XI to XII FC, the share of these States reduced which could not be fully compensated by increase in weight attributed to population criteria. Increase in weight of area could also not neutralize their loss as some of these States do not rank high on area criteria.

Table 2: Inter-state factor analysis for top 5 losing states

States	Change in Share	Interstate ranking based on alternative economic indicators					Overall Impact
		Population	Income distance	Tax/GDP	Area	IOI	
West Bengal	-1.06%	4th	3rd	20th	13th	8th	Gains made on population and area norm were less than loss in share due to decline in income distance weightage
Bihar	-0.87%	3rd	2nd	19th	12th	15th	Its major share was resulting from large weight to income distance because it has low per capita GDP but with decrease in income distance weightage there was a decline in its overall share in central taxes
Himachal Pradesh	-0.15%	20th	21st	16th	17th	13th	With a poor infrastructure index, loss on this norm outweighed the small gains made with lower income distance weightage. Also, gains on population and tax effort norms were not significant.
Karnataka	-0.47%	9th	9th	2nd	8th	10th	Net Loss in share due to exclusion of infrastructure index as a norm was the principle reason for the decline in its share
Kerala	-0.39%	12th	14th	3rd	21st	3rd	Despite high infrastructure index and above average per capita income, losses incurred were more than small gains on population and area front.
Andhra Pradesh	-0.34%	5th	5th	7th	4th	11th	Gains on area, population and tax effort, were more than offset by loss on income criteria and index of infrastructure.

Table 3: Inter-state factor analysis for top 5 gaining states

States	Change in Share	Interstate ranking based on alternative economic indicators					Overall Impact
		Population	Income distance	Tax/GDP	Area	IOI	
Gujarat	0.75%	10th	10th	5th	7th	6th	Loss with reduction in income norms and IOI were less than gains on population, area and tax effort.
Maharashtra	0.36%	2rd	Benchmark	6th	3rd	7th	Gains on area and population criteria outweighed the small loss on income distance criterion and index of infrastructure.
Punjab	0.15%	15th	Benchmark	9th	19th	2nd	Minimal loss associated with income distance and index of infrastructure, but combined effect of other criteria was high.
Haryana	0.13%	16th	15th	4th	20th	5th	Primarily gained due to fall in income criteria weightage and increase in tax effort criteria.
Rajasthan	0.14%	8th	6th	11rd	1st	20th	It made significant gains on population and area norms despite reduction in income distance criteria and removal of infrastructure index.

A look at Table 3 indicates that gaining States generally ranked high on Tax/GDP ratio, infrastructure index and area and low on income distance criteria.
With decline in weight of income distance criteria and abolition of infrastructure index, part of the resources which was earlier going to low income States got redirected to these States through corresponding increase in weight of area and tax/ NSDP ratio.

Concluding Observations and Inferences

After analyzing the inter-se trend of transfers over last two finance commission award periods and looking at the factors responsible for the same, it can be inferred that broadly, low income States have suffered losses (imputed) while high income States have gained (imputed) in tax devolutions. If tax sharing formula of XI FC would have been used, then low income States would have received higher amounts than actually received during XII FC award period.Despite placing increased importance to needs and deficiency in fiscal capacity by XII FC, change in tax sharing formula resulted in penalizing poorer States. The actual devolutions to low income States like Bihar, West Bengal, Andhra Pradesh and Assam were lower in XII FC award period than those which would have been received if XI FC formula would have continued. The main reason for the same has been the dropping of index of infrastructure criterion and increasing the share of area, population and tax effort, which has proved to be disadvantageous for low income States with poor infrastructure.

Given the increasing income disparity among States (as reflected in increasing coefficient of variation among in inter-State per capita income) and need to give economic and social boost to the poor and backward States of our country, larger transfers would be required for these States. Out of trend Central transfers and special interventions from the XIII FC will be critical for enabling these States to come out of the vicious circle of poverty, low revenues, low developmental expenditure and hence low growth and achieve the broad based inclusive growth target of the government.

It is also observed that the change in receipts from devolution is quite insignificant compared to the total expenditure budget size of the States barring some outlier States. It is therefore debatable as to whether such detailed exercise and efforts put in by the FC, States and Union Government is of significance if the issue of low growth trap for disadvantaged States is not addressed through out of trend special interventions.

Pick of the Quarter

Sharing a Viewpoint

Union Budget 2009-10: A Reflection

India has witnessed a moderation in GDP growth in FY09 to 6.7%, after growing at an average of 8.7% over the previous 4 years. Since the downturn in the global economy is largely construed to be responsible for this moderation, the Union Budget 2009-10 presented on 6th July, 2009 by the newly formed government at the Centre has attempted to tackle the situation through domestic-demand driven growth model. In order to counter the negative fallout of the global slowdown on Indian economy as well as achieve the target growth rate of 9% at the earliest, Government of India (GoI) intends to provide three focused fiscal stimulus packages in the form of tax relief, increased expenditure on public projects and a number of monetary easing and liquidity enhancing measures adopted by RBI. The twin over-riding objective is to promote economic growth by committing significant investments to infrastructure and give an impetus to consumption by putting more money in the consumers' hands.On reflection, however, some of the major budget highlights seem either potentially threatening unless dealt suitably or self-defeating. These have been presented below:

1. Higher planned deficits not linked to expenditure on Capital Account

Fiscal accommodation led to an increase in central fiscal deficit from 2.7% in 2007-08 to 6.2% of GDP in 2008-09. However, this fiscal stimulus at 3.5% of GDP at current market prices amounting to Rs.1,86,000 crore did help as a countercyclical measure with the economy clocking a growth of 6.7%.Higher fiscal deficits can thus be considered as the key to achieving higher growth in periods of recession provided it is used for undertaking productive investments. Not surprisingly fiscal deficit for FY10 has been projected at 6.8% (adding state deficits of 4% plus extra oil and fertiliser subsidies if their global prices rise make total fiscal deficit to be in the range of 11-12% of GDP), which would rank the highest since 1994.

Though there seems to be no alternative to a rise in the deficit hole in the medium term, this countercyclical measure runs the risk of becoming an evil in the light of implementation of Sixth Central Pay Commission (CPC) recommendations and its adoption by majority of the states. The states have been allowed to have up to 4% fiscal deficits without any mention that the additional deficit has to be compulsorily on account of investments in infrastructure improvement. This has a risk of the state governments utilizing this additional deficit window to fund the payment of salary arrears on account of implementation of the Sixth Central Pay Commission (CPC) recommendations.

2. Timeframe for introduction of Goods and Services Tax (GST)

The Union Finance Minister, Pranab Mukherjee has reaffirmed the Central Government's commitment to implement dual GST on schedule on April 1, 2010. Few important considerations arise in implementation of this reform measure. One is deciding on the degree of fiscal autonomy of the Centre and States, which has been settled in favor of a dual GST structure. The Centre (CGST) and the States (SGST) are expected to legislate, levy and administer the CGST and SGST respectively with the former subsuming CENVAT and service tax, and latter VAT, CST and the other local taxes. However it is the issue of harmonization of tax laws in terms of tax rates, tax base and tax infrastructure (administration and compliance system) required for simplification of compliance and enforcement which is yet to be ironed out. Hence, given that the mechanism for achieving the desired degree of harmonization is yet to be built and its contractual framework yet to be developed, the announcement of the introduction of this much desired indirect tax reform measure on the decided date could prove to be a mere budget proclamation.

3. Enhanced allocations for government programs of NREGS, NRHM & JNNURM

To deepen the process of inclusive development, significant investments have been committed for government programs. For example, allocations for National Rural Health Mission (NRHM), Jawaharlal Nehru National Urban Renewal Mission (JNNURM) and National Rural Employment Guarantee Scheme (NREGS) have been stepped up considerably by 23%, 87% and 144% respectively in FY10. However, analysis of past actual expenditure of these Centrally Sponsored Schemes indicates gross underutilization, particularly in NREGS where the utilization rate is less than even 10%. This raises the question on the justification of further increases in these schemes in a situation where prior level of allocations has seen such low utilization. Moreover considering the poor track records of many such initiatives, no monitoring mechanism has been suggested to ensure the successful implementation of these schemes. Also, any enhancement in the allocation under these schemes by the Centre will also have implications on State's finances. These schemes usually require States to provide for matching allocations in their budgets thereby imposing burden on their already ballooning deficits.

4. Personal Income Taxes: Increase in threshold exemption limits and abolition of 10% surcharge

On the surface, it seems that these measures would result into lesser tax outgo for individuals resulting in increase in disposable incomes, boosting overall demand in the economy. However, upon closer examination, the increase in threshold limits of exemption (Rs.15,000 for senior citizens and Rs.10,000 for other individuals) coupled with removal of 10% surcharge on personal income tax would marginally increase the disposable income (around Rs.1,000 per annum) for a taxpayer earning between Rs. 1,50,000 - 10,00,000. However, for taxpayers having more than Rs.10 lakh taxable annual income, saving would be about Rs.22,000 per annum at the minimum.
Hence, in effect we believe that apart from widening the gap between haves and have-nots, these twin measures would not impact consumption trends positively to contain recession in short-run. They will essentially put more money at the disposal of smaller group of higher-income individuals having lower marginal propensity to consume. These measures can at best be considered as signaling. For raising demand in the recessionary phase, it should have done otherwise.

5. Duty Cuts

As far as excise duties are concerned, reductions in excise duties effected over the past six months were expected to be partly reversed. However, the FM has refrained from increasing duties across-the-board with a view to maintain consumption levels. As an exception, products in the 4% duty slab will now attract 8% excise duty, with few exemptions. Also, there is no change in the peak customs duty, which remains at 10%.A closer look reveals that custom and excise duties have been reduced on items catering to higher-income segment of households which can be branded as lifestyle goods rather than income-induced per se, like halving of custom duty on LCD panel from 10% to 5%, full exemption from 4% special CVD on parts for manufacture of mobile phones and accessories to be reintroduced for one year, customs duty on un-worked corals reduced from 5% to Nil, and branded jewellery fully exempted from excise duty, and excise duty reduction for large cars/utility vehicles of engine capacity (2000 cc and above).

6. Absence of financial discipline measures in the budget announcement

There has been a revision in pay scales and allowances retrospective from April 1, 2006 as part of implementation of the recommendations of the Sixth CPC. The implementation of the recommendations in an election year was expected and possibly politically acceptable.
The Sixth CPC in its report had remarked that "All recommendations to be treated as an organic whole as partial implementation will bring in several anomalies and inconsistencies". The Commission had estimated an additional burden of around Rs. 12,000 crore on the budget from the recommendations related to pay increase while it had also estimated savings of over Rs.4000 crore from its other recommendations. Some of the key expenditure rationalization recommendations included:

- Performance orientation – It was recommended that 80% of employees to get increment of 2.5% while 20% high performers being allowed increment of 3.5%
- Introduction of Performance Related Incentive Scheme replacing ad hoc bonuses
- Revision of commutation table for pension – with life expectancy going up in India significantly, the existing commutation table for calculation of commutation value of pensions needs to be revised
- Steps leading to improvement in service delivery mechanisms by more delegation, placing more emphasis on outcomes rather than processes

The FM may have missed an opportunity to introduce these hard to implement recommendations in the first budget of a new five year term as implementing them in subsequent years turn more difficult owing to political compulsions.

Overall View on the Budget

The media in India seems to judge the budget content from the reaction of the stock market. The BSE benchmark Sensex suffered the biggest fall on any budget day and in the current year till date by plunging over 869 points after the budget speech. In our opinion, the FM should not be too worried about the stock market response to the budget as the market is still not that mature and is not representative of the sentiment of the mass population as the trades and sentiments are determined by a handful of large traders with retail investors having little influence on it.

We feel that the FM has tried to present a budget balancing between good economics with politics in the current circumstances. However, it could have been better if the above mentioned issues/ concerns were addressed in it. We also feel that many of the above difficult to implement points could be addressed as off-budget proclamation and need not be included in the annual budget that is scrutinized too closely by the media making the issues go out of control.

PwC Updates

PwC's contribution towards the sector

Know our Work

The Public Finance (PF) Unit is a specialized practice of Government Reforms and Infrastructure Development (GRID) SBU of PwC in India. The unit specializes in providing services relating to public expenditure management, revenue administration, budgetary policy development, financial restructuring, performance improvement, institutional strengthening & capacity building, accounting & financial management systems.

The PF Unit has been working closely with various Governments in India including Governments of West Bengal, Assam, Uttar Pradesh, Madhya Pradesh, Andhra Pradesh and Orissa.

The PF Unit also has undertaken international projects in Sri Lanka, Nepal, Bhutan, Bangladesh, Vietnam, Indonesia, United Arab Emirates and the Maldives.The unit works closely with development cooperation agencies like DFID, World Bank, ADB, JBIC and KfW.

The PF team comprises of qualified professionals from different streams ranging from economics, finance, public policy, business administration to IT and engineering with national and international work experience and understanding of best practices in public finance management.

The team has been involved in implementing public finance tools like Medium Term Fiscal Framework (MTFF), Medium Term Expenditure Framework (MTEF), Macro-economic forecasting models and decision-support toolkits. The PF team also has experience in design of fiscal management reform programs including tax reforms and administration support, debt and guarantee management, treasury computerization, human resource planning and capacity building.

The team has also undertaken several public expenditure and financial accountability (PEFA)/ fiduciary risk assessments, FRA), and program implementation assignments. The team has also assisted State Governments in preparation of their submissions to the Finance Commission.

Humor: Field Anecdote

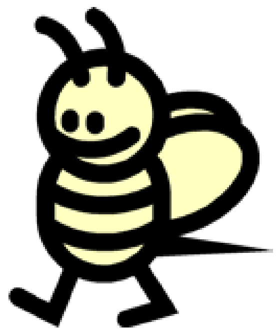
Double Trouble

On a field visit to hinterlands, three members of our team Ranen, Gunjan and Harsh were provided with locally packed snacks for lunch. As they sat down to eat, Gunjan felt her snacks pack vibrate almost as if something was buzzing inside the box. Bewildered, she looked towards the other team members to see if they were facing the same situation with their boxes as well.

When she saw that this was not the case, she became unsure of what to do next. While she wasn't keen on opening her box of snacks, she also knew that telling others that her box was shaking on its own would be greeted with mockery and disbelief. However, when the shivers did not stop, she gathered her courage and told the others. As expected, Ranen and Harsh burst out laughing in obvious disbelief. But after a while, seeing Gunjan's obvious discomfort, they suppressed their laughter and Harsh offered to exchange the pack of snacks. On receiving the new box of snacks, Gunjan felt the vibrations only stronger this time.

She requested Harsh to open his box to find out what was causing it to vibrate. As Harsh peeled out the cover of his box, a bee shot out buzzing around celebrating its freedom. As they stared in amazement, Gunjan opened her box as well….and this time there were two bees that whooshed past Gunjan much to everyone's amazement.

Moral of the story: if you exchange trouble…you get double trouble.



Know our People

Latha Ramanathan
Executive Director & Head, Public Finance, PwC

Latha is Executive Director in PricewaterhouseCoopers Pvt Ltd, India. She has extensive experience in India, Bangladesh, China, Nepal, Middle East, Sri Lanka and Vietnam in areas covering Budget Reform, Expenditure Management, Public Resource Management, Fiscal management Reforms and Restructuring of PSEs.

Educational Background
B.Com, Chartered Accountancy

Job Experience

Latha was the Engagement Director for the ADB funded Fiscal Management Reform Program, Strengthening of the Fiscal Management Institutions Project, and the Modernization of Revenue Administration Project for the Government of Sri Lanka. As Project Director in the ADB funded Assam Governance and Public Resource Management project and Assam Budget Procedure Reform, Computerisation and Expenditure Management project, Latha led the team in preparation of an action plan for the state's departments, estimating costs for restructuring of debt of PSEs and assisting the Government in implementing its Medium-Term Fiscal Reform Program.

Latha has acted as an International Public Restructuring Specialist for the ADB funded West Bengal Development Finance project. She was the Engagement Director in the Amendment of Labour Laws and Dispute Resolution Mechanism component of the Modernising Government Program of the Government of Kerala. Latha was the Quality Review Partner for the DfID supported Single Window Facility for Industries Department project, Government of Orissa.

Latha was an Expert Adviser for the modernization of the budget procedure programme for Government of Abu Dhabi. Latha has also been involved as Project Manager in the Restructuring of Neyveli Lignite Corporation (NLC), Ceylon Petroleum Corporation in Sri Lanka, Preparation of Strategic / Restructuring Plan for MECON Limited, Dredging Corporation of India (DCI), AP State Warehousing Corporation and Business Restructuring of Coal India Ltd (CIL), Tata Projects Ltd and Electrosteel Castings.

Public Finance Practice

The Public Finance SBU of Government Reforms and Infrastructure Development (GRID) Practice of PwC in India has been closely working with clients in public sector and at all levels of Government as well as key donors such as DfID, JBIC, World Bank and ADB. A team of more than 15 persons with associates and qualified professionals provide services in areas that include public expenditure management, revenue

administration, budgetary policy development, financial restructuring, performance improvement, institutional strengthening & capacity building, accounting & financial management systems, human resource development, etc.

PwC has been providing advisory services to Governments, Multilateral and Private Sector Clients in the area of public finance. The work has broadly included, budget reform, revenue augmentation strategies, automation/computerization, and debt management. Most of these projects included training and capacity building of the Government counterparts working with PF team on the specific modules. In addition, the team has gained a lot of traction in the PEFA/FRA area with many assignments across south Asia.

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