Public Finance Quarterly

January-March 2010, Issue III

Editorial

Welcome to the third issue of 'Public Finance Quarterly', the quarterly newsletter of PwC India's Public Finance (PF) Practice. Through various means of resource mobilization and expenditure management like those of taxation and budgets, the effects of government's policies and measures are felt on us, both as individuals and collectively as part of institutions/ organizations operating in the economy. Thus it helps to be abreast of the latest developments and emerging scenarios in the public finance space. With this understanding, the third issue of our newsletter continues to provide our readers with information and updates on recent developments, experiences and good practices in the PF domain.

In 'Feature Article' section of this issue, the devolution of central taxes to states under the Central Finance Commissions has been explored in relation to the trends observed in states' non-plan revenue expenditure. An in-built incentive mechanism into the devolution formula has been proposed for consideration in future, which could encourage states to undertake measures to rationalize the growth of their respective non-plan revenue expenditure.

The 'Pick of the Quarter' section analyzes the most topical issue of the last quarter: hardening of food inflation. It examines the adequacy and effectiveness of the responses to address this issue and presents the writer's viewpoint on this.

News updates in the area of government finances and policies across the globe and key paper releases in public finance domain during the last quarter along with their reference links have been provided in our 'Round the Corner' section.

My continued thanks and gratitude to all our readers for their valuable support, suggestions and response to our second issue. With your invaluable inputs, we are continuously endeavoring to further improve this newsletter to ensure effective information sharing on Public Finance. Please feel invited to contribute actively by sharing experiences or discussing concepts. 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, whose coordinates are provided at the end of this Newsletter. Our Team and I look forward to your comments, suggestions, and contributions!
I hope you enjoy reading this issue and trust you will plenty of interest in this Newsletter.

Sincerely,
Latha Ramanathan
Executive Director & Head Public Finance

PRICEWATERHOUSECOOPERS

Inside This Edition

Round the Corner

Quarterly Stock of News Bytes and Releases

News Bytes

Report of the Thirteenth Finance Commission (FC-XIII)

Issued by Finance Ministry, India on Feb 25, 2010

The FC-XIII was constituted on 13 November 2007 to make recommendations for the period 2010-15 under the chairmanship of former Finance Secretary Dr. Vijay Kelkar. The Commission visited all the 28 states between June 2008 and July 2009 as part of consultations with the State Governments and other key stakeholders, and commissioned 29 external and two in-house studies. It submitted its report to the President, Smt. Pratibha Devi Singh Patil on 31 Dec 2009.

Link: http://finmin.nic.in/TFC/index.html

PFM Performance Measurement Framework Monitoring Report 2009

Issued by PEFA Secretariat on Feb 16, 2010

This is the third monitoring report prepared by PEFA Secretariat. It provides roll-out information up to October 2009 and analysis of trends in roll-out of application of the Framework since the previous Monitoring Report 2007. As regards analysis of compliance issues and a survey of resource use and cost of implementing PEFA assessments, it covers the period from April 1, 2007 to March 31, 2009.

Link: http://www.pefa.org/report_studies_file/Monitoring%20Report%20MR09%20-Final%20-%20Feb2010_1266426682.pdf

Opening of a new Object Head 'Grants for creation of capital assets' with Code number 35 in Indian Budget expenditure classification

Issued by Finance Ministry, India in on Feb 12, 2010

The decision to uniquely depict the expenditure on Grants for creation of capital assets at the level of primary unit of appropriation also necessitated amendment in the nomenclature of the existing Object Head viz. '31- Grants-in-aid' to read as 'Grants-in-aid General'. Both these are to be in effect from 1 April, 2010.

Link: http://finmin.nic.in/the_ministry/dept_expenditure/DFPR/grant_creation_capital_assets31.pdf

Releases

Determining Gender Equity in Fiscal Federalism: Analytical Issues and Empirical Evidence from India

Levy Economics Institute of Bard College Working Paper of March 2010, Author(s) – Lekha S. Chakraborty

This paper focuses on the plausibility of incorporating gender into financial devolution, with the Thirteenth Finance Commission of India as backdrop. The paper upholds that a simple method for accomplishing this could be to introduce some weight in favor of the female population of the states in the Commission's fiscal devolution formula. The message would be even stronger and more appropriate if the population of girl children only i.e., the number of girls in the 0– 6 age cohort, is adopted as the basis for determining the states' relative shares of the amount to be disbursed by applying the allotted weight. A special dispensation for girls would also be justifiable in a scheme of need-based equalization transfers. That being said, the paper mentioned that it is not plausible to incorporate more gender variables, say 'gender inequality index' in the Finance Commission's already complex transfer formula. While the paper acknowledges the fact that incorporating gender criteria in fiscal devolution could only be the second-best principle for engendering fiscal policy, it argues that newfound policy space for the feminization of local governance, coupled with an engendered fiscal devolution to the third tier, can lead to public expenditure decisions that correspond more closely to the revealed preferences ('voice') of women.

Link: http://www.levyinstitute.org/pubs/wp_590.pdf

Public Financial Management Performance Assessment Report - India

National Institute of Public Finance and Policy Report of March 2010, Authors – Pratap Ranjan Jena

The report assesses the current status of Government of India's PFM systems, procedures and practices at the union level using the Public Expenditure and Financial Accountability (PEFA) framework. The assessment at the central government level indicates both the strengths and weaknesses of its PFM system. This review presents an assessment on six critical dimensions provided

by the PEFA framework viz. credibility of the budget, comprehensiveness and transparency, policy-based budgeting, predictability and control in budget execution, accounting, recording and reporting, and external scrutiny and audit through 28 high level indicators.
Link: http://www.nipfp.org.in/annualreport/PEFA2010.pdf

A Public Financial Management Framework for Resources-Producing Countries

IMF Working Paper of March 2010, Authors – Teresa Dabán Sánchez and Jean-Luc Hélis

This working paper overviews the challenges posed by resource revenues management and the policy prescriptions to meet them, and focuses on the Public Financial Management (PFM) framework and reforms that resource-producing countries should adopt.
The paper outlines a PFM framework and reform path that take into account the institutional diversity of resource-producing countries. In the short term, the proposed reforms highlights the tools that can be implemented even where the PFM system is rather basic, while over the medium and long term they aim at converging with best international PFM practices.
Link: http://www.imf.org/external/pubs/ft/wp/2010 wp1072.pdf

Making Sector Budget Support (SBS) work for service delivery: wider policy implications

ODI Project Briefings of February 2010,
Authors – Tim Williamson and Catherine Dom

There has been relatively little systematic evidence on how SBS works in practice, and how effective it is in helping countries improve the delivery of their basic services, such as health and education. ODI through its series of three Project Briefings fills this gap from its study on SBS in Practice, carried out for the Strategic Partnership with Africa. India@75 report designing

1.First Project Briefing provides an overview of the key findings:

- SBS is increasingly popular but under-researched;
- Access to basic services has improved, but not their quality and equity;
- Effective SBS requires less 'traceability' and more focus on downstream delivery

Link: http://www.odi.org.uk/resources/download/4609.pdf

2.Second Project Briefing focuses on good practice recommendations:

It finds that complementary SBS and general budget support (GBS) packages are the preferred modalities for support to service delivery, and that funding, dialogue, conditionality and capacity-building practices must change for SBS to attain its objectives. It concludes that the required focus on service quality at the front line will not happen automatically.
Link: http://www.odi.org.uk/resources/download/4610.pdf

3.Third and final Project Briefing examines the wider policy implications: It notes that incentives are the key to what SBS does well and what it does badly, and that strengthening service delivery incentives will involve substantial multi-level efforts by SBS donors and partners. It argues that these efforts must address the underlying causes, rather than the symptoms, of weak incentives.
Link: http://www.odi.org.uk/resources/download/4737.pdf

What Level of Public Debt Could India Target?

IMF Working Paper of January 2010, Authors – Petia Topalova and Dan Nyberg

This paper discusses possible medium-term public debt targets for India, based on evidence from the economic literature on prudent levels of public debt and the feasibility for the country to meet a particular target over the next 5-6 years.

While recognizing the challenges in determining an appropriate debt target, cross-country analysis and

simulations suggest that a debt ratio in the range of 60-65 percent of GDP by 2015/16 might be suitable for India. The paper notes that such a debt ceiling, while still above the average debt level for emerging markets, is within the range of debt ratios that would provide room for countercyclical fiscal policy and contingent liabilities. It would also send a strong signal of the government's commitment to fiscal consolidation by making a clear break with the past.
Link: http://www.imf.org/external/pubs/ft/wp/2010/wp 1007.pdf

Technical Notes & Manuals

Issued by Fiscal Affairs Department, IMF in January 2010
1.Reforming Budget System Laws Author/Editor: Ian Lienert, Israel Fainboim

This note addresses the following main issues:

- Why adopt a new law relating to the budget system?
- What is the relationship between the budget system law, the constitution and the wider legal framework?
- How should a budget system law be adapted to a country's political arrangements?
- How should the respective roles of the executive and legislative be reflected in the budget system law?
- What should be included in a budget system law, and what should be excluded, for the various stages of annual budget processes?

Link: http://www.imf.org/external/pubs/ft/tnm/2010/tnm1001.pdf
2.A Practical Guide to Public Debt Dynamics, Fiscal Sustainability, and Cyclical Adjustment of Budgetary Aggregates Author/Editor: Julio Escolano

The note derives three fiscal formulas, each for debt dynamics, cyclical and inflation adjustment of budgetary aggregates. It also discusses other relationships for special applications, and some practical implications and usage.
Link: http://www.imf.org/external/pubs/ft/tnm/2010/tnm1002.pdf

Incentivizing States to Rationalize Non-Plan Revenue Expenditure through Central Devolutions

In a federal set-up such as India, certain resources are raised by Central Government, which are then devolved to States based on the recommendations of Central Finance Commissions (FC) that are constituted every five years by the President of India. The transfers include 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. These transfers are devolved to states for meeting both their current and capital expenditure needs.

Expenditure of State Governments includes Plan revenue expenditure, Non-plan revenue expenditure (NPRE) and Capital expenditure. Non-Plan revenue expenditure includes expenditure that is obligatory in nature e.g. interest payments, pension, salaries; expenditure on maintaining assets created under plan schemes and expenditure on continuing services and activities at levels already reached in a plan period e.g. continuing research projects and others.

It has been observed that NPRE accounts for the major part of State Government's expenditure. For the year 2000-01, NPRE accounted for 72% of total state's expenditure which had reduced to 62% by 2007-08. Analyzed as a % of GDP, it is commendable to note that non-plan revenue expenditure of states has reduced from 10.85% to 9.88% between 2004-05 and 2007-08. However, it can be noted from Table 1 that NPRE accounts for the largest share of expenditure as compared to Plan revenue and Capital expenditure.

Table 1: Aggregate State Finances: Expenditure Indicators (per cent of GDP)

Year	Total Revenue Expenditure	Interest Payments	Pension	Plan Revenue Expenditure	Non-Plan Revenue Expenditure	Capital Expenditure
2004-05	12.74	2.75	1.18	1.89	10.85	1.88
2005-06	12.18	2.36	1.14	1.94	10.24	2.14
2006-07	12.21	2.29	1.13	2.17	10.04	2.32
2007-08	12.26	2.12	1.19	2.39	9.88	2.47

Source: Report of Thirteenth Finance Commission

Further, as per the projections given by the states to the Thirteenth Finance Commission (2010-15), NPRE of states as % of GSDP is expected to increase to 12.8% in 2014-15 from 12.3% in 2007-08. With revision of pay scale as per Sixth Pay Commission recommendations by various State Governments, there is a likelihood of further increase in the NPRE. This makes it imperative upon states to act consciously towards rationalization of the NPRE towards making funds available for plan and capital expenditure.

The Eleventh Finance Commission had suggested an "index of fiscal discipline" as one of the criteria for determining the share of state's in central taxes with a view to providing an incentive for better fiscal management. For this, improvement in the ratio of own revenue receipts of a state to its total revenue expenditure vis-à-vis average ratio for all states was used as the measure. It may be noted that an improvement in fiscal discipline as indicated by this parameter can be brought about by higher own revenues or lower revenue expenditure or a combination of the two. However, this criterion does not directly encourage states to control their NPRE as they can check the growth of revenue expenditure by reducing their plan revenue expenditure also and/or by cutting down on the maintenance expenditure on assets.

Taking this as the underlying theme, this article explores whether there is any observable relationship between devolution of central taxes to states and the trends in their Non-plan revenue expenditure. The article goes on to argue for a possible incentive mechanism being built into the devolution formula in future towards motivating the states in undertaking measures for control in the growth of NPRE.

Devolutions and NPRE – Exploring Relations

Towards analyzing any possible relation between share in central taxes to various states and their respective NPRE, a trend analysis of devolutions of shareable central taxes to states and their NPRE has been undertaken for the period 1995-2008. Annual growth rate of share in central taxes as well as NPRE has been calculated for each state and is presented in the following scatter plot (Figure 1).

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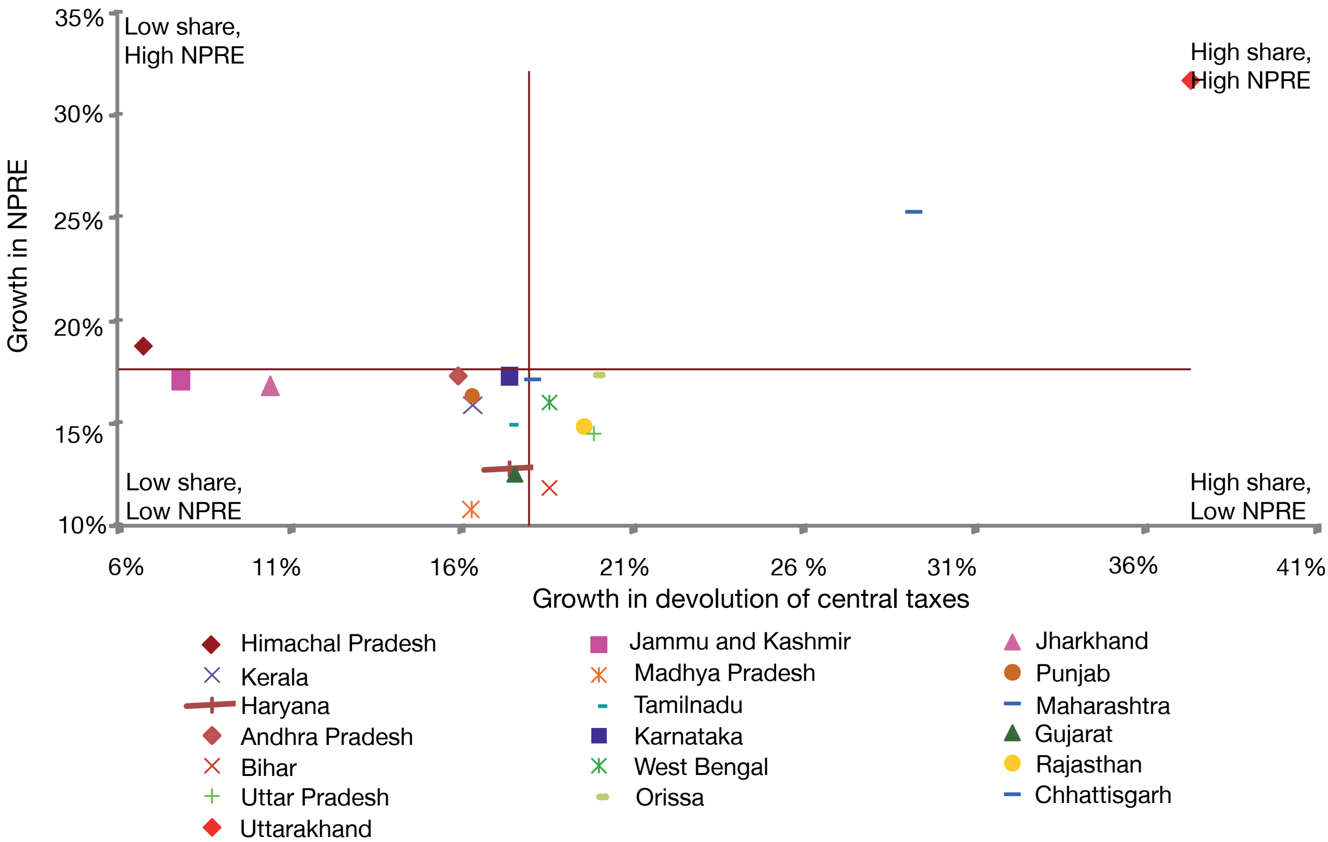
It can be observed that there are 9 states that achieved less than average NPRE growth but witnessed less than average growth of devolutions of central taxes. These states include Andhra Pradesh, Gujarat, Haryana, Jammu & Kashmir, Jharkhand, Madhya Pradesh, Maharashtra, Punjab, and Tamil Nadu. A conclusion from this observation could be that though these states are making efforts towards reduction in the growth rate of NPRE, they are possibly not getting any incentive for such efforts through the devolution mechanism. Similarly, it can be noted that 3 states, viz. Chhattisgarh, Orissa, and Uttarakhand have witnessed higher than average growth in NPRE coupled with higher than average growth in central tax devolutions. Thus, it can be inferred that there has also not been any disincentive or deterrent in the devolution mechanism for these states towards controlling their NPRE.

On the other hand, there are only 3 states (Karnataka, Kerala and Himachal Pradesh) where high growth of NPRE has been accompanied with lower growth in the share in central taxes and 4 states (Bihar, Rajasthan, Uttar Pradesh and West Bengal) where low growth of NPRE has been accompanied with higher growth in share of central taxes. Thus, it can be concluded that the devolution mechanism is not incentivizing or dis-incentivizing states towards controlling the growth in their Non-plan revenue expenditure. The majority of Indian states which are making an effort towards controlling their NPRE have witnessed less than average growth of share in central taxes that can actually be a disincentive for them in future towards curtailing the growth of NPRE.

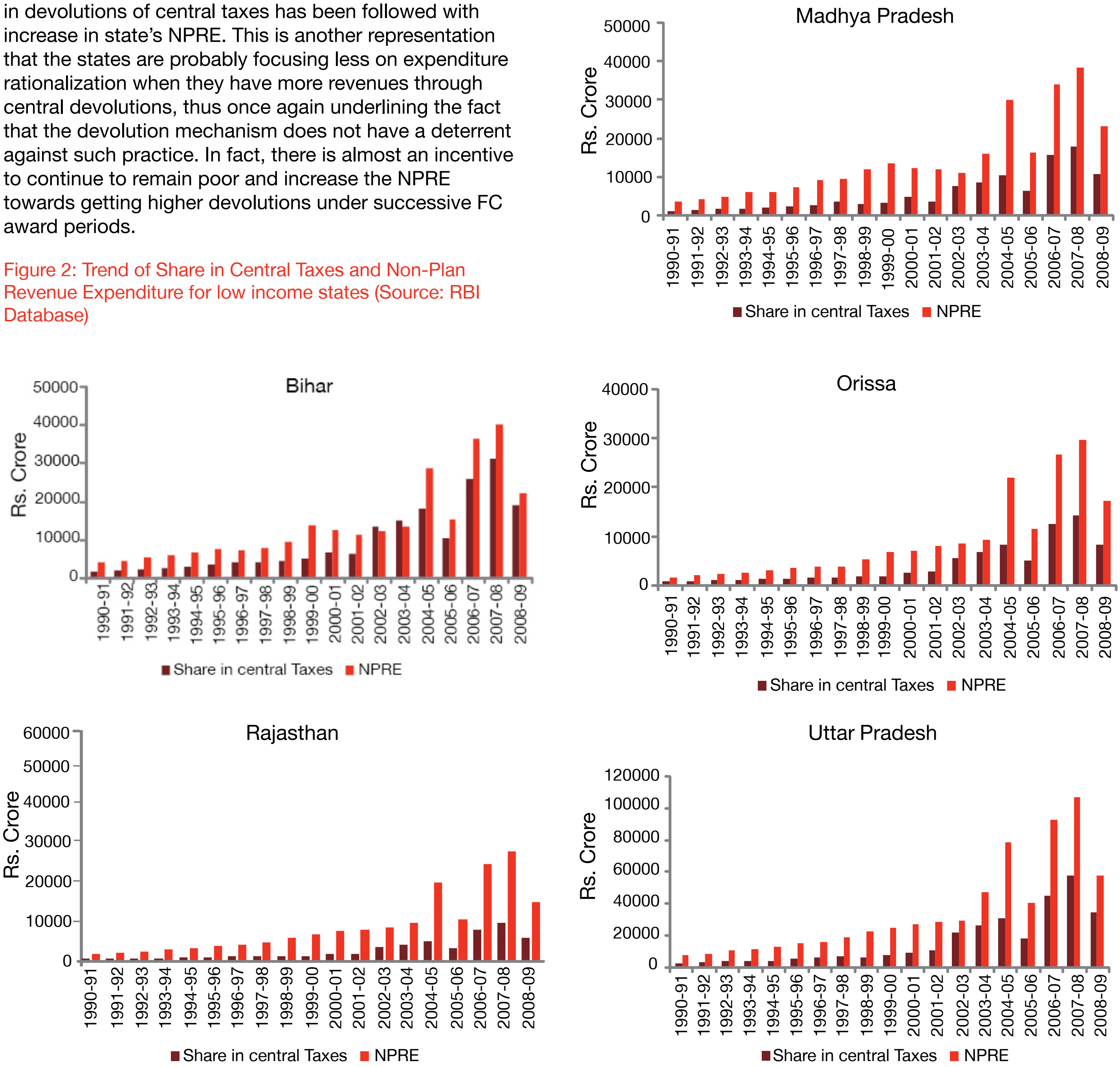


Source: RBI Database

Devolution of Central Taxes and Non-Plan Revenue Expenditure of low income states

For low income states like Bihar, Madhya Pradesh, Orissa, Rajasthan and Uttar Pradesh, it can be observed from Figure 2 that trend of share in central taxes and NPRE has been largely similar since last 2 decades. This might be due to state's deliberate effort to adjust NPRE according to fluctuations in transfer of central taxes. Thus increase in devolutions of central taxes has been followed with increase in state's NPRE. This is another representation that the states are probably focusing less on expenditure rationalization when they have more revenues through central devolutions, thus once again underlining the fact that the devolution mechanism does not have a deterrent against such practice. In fact, there is almost an incentive to continue to remain poor and increase the NPRE towards getting higher devolutions under successive FC award periods.

Figure 2: Trend of Share in Central Taxes and Non-Plan Revenue Expenditure for low income states (Source: RBI Database)



Devolution of central taxes and NPRE – Can they be linked?

Total devolution of central taxes to 18 major states has increased by 19% per year during 1995 to 2008. As against this, the total NPRE of these states has grown at an average annual rate of 16% per year during the same period. This reflects the fact that increasing part of central devolutions is being utilized for funding NPRE of states.

With increasing demand for economic and social infrastructure at state level, it is imperative for state governments to optimize their NPRE in order to increase availability of funds for capital and productive expenditure. For this, it will be useful to link devolution of central taxes with growth of NPRE. This can possibly be undertaken through making a part of the central devolution contingent upon achievement of a prescribed NPRE growth rate (with specification of heads of expenditure within NPRE on which the expenditure growth cannot show a decrease e.g. maintenance). In addition, there could also be a positive incentivization of the states by way of additional devolutions from a separate allocation for having NPRE growth under the prescribed limits. This may encourage the states to undertake adequate measures to control and optimize their NPRE. Such a "Carrot and Stick" policy using devolutions of central taxes as a lever may go a long way in ensuring fiscal discipline among states.

A possible mechanism for linking devolution of central taxes to growth of NPRE by future FCs is discussed in the following paragraphs. The percentages and other numbers stated in the mechanism are only indicative and intended to illustrate the mechanism.

Incentive Based Devolution

The underlying idea of this mechanism is to incentivize states that make a concerted effort towards controlling their NPRE growth within prescribed limits. The following measures could be considered towards making such a mechanism operational:

- Defining the expenditure heads within NPRE for which a minimum growth rate of expenditure has to be ensured: To prevent the rationalization of NPRE through curtailing expenditure on essential items like maintenance, the expenditure heads in which a reduction is not desirable will have to be defined with a prescription for minimum growth rate on those heads linked to a suitable index.

- Determining the upper/cap limit for NPRE growth: Firstly, a cap/upper limit for NPRE growth needs to be determined which should preferably be inflation linked with some concessions being given to states with special needs. The states could then be penalized by graded reduction in their devolutions for the subsequent year in the event they exceed the upper limit for the current year. The states can also be rewarded with graded increase in devolutions if their NPRE growth is less than the prescribed limit.

- Having two parts in the devolution fund available to states: Next, the available devolution of central taxes to states can be divided into two parts: (i) Assured Devolution (which will be passed on to the states irrespective of NPRE growth rate), and (ii) Contingent Devolution (which will be linked to the NPRE growth rate). For example, 90% of the available devolutions can be made assured while 10% of the available devolutions can be made contingent on NPRE growth rate.

- Calculating actual devolution based on NPRE performance: Thereafter, the NPRE growth rate would need to be calculated for each state for the concerned year. For states which achieve NPRE growth within the prescribed limits, full amount of Assured and Contingent Devolutions should be made. For states which have NPRE growth rates exceeding the prescribed limits, full amount of assured devolutions should be passed on but the contingent amount of devolutions should be withheld. Table 2 presents the proposed scheme under the alternative scenarios.

Table 2: Devolutions in alternative scenarios

Case	Assured Part	Contingent Part	Eligibility for Incentives
If NPRE growth rate < Prescribed Limit	Full	Full	Yes
If NPRE growth = Prescribed Limit	Full	Full	No
If NPRE growth > Prescribed Limit	Full	0 to 90% based on the extent of exceeding the limit (from 20 percentage points to 5 percentage points) i.e. states that exceed the limit by more than or equal to 20 percentage points will get 0% and those that exceed by less than or equal to 5 percentage points will get 90% with a pro rata basis devolution for other data points	No

Determination of Incentives

The states which would have managed to contain their NPRE growth rate under the prescribed limits could be made eligible for incentives. The resources for such incentives can be funded from the retention of the devolutions from other states based on the mechanism suggested above. The total percentage points by which NPRE growth has been collectively controlled by these states can be calculated and the share of incentive for each state from the total pool available for incentives could be on a pro-rata basis with a weight applied for the total plan expenditure of the state. This will also incentivize the states towards putting more resources under plan head.

The proposed mechanism is explained further through the following illustration.

Illustration

We assume 5 states viz. A, B, C, D and E with given allotment of share in central taxes. Prescribed limit for NPRE growth has been assumed to be 7% p.a. "Assured" and "contingent" parts of the devolution amount for each of the states have further been assumed to be 90% and 10% respectively. Table 3 illustrates the calculation of actual devolutions and Table 4 presents the estimation of incentives for each of the assumed states.

It can be observed from column 6 of Table 3 that NPRE growth of states A and D exceeded the prescribed target while that of B and C remained less than the limit. State E achieved exactly the prescribed NPRE growth target. Thus, based on incentive based devolutions, states A and D will be penalized through reduction in their contingent allocation while states B and C will be rewarded by providing pro-rata allocation from incentive pool. State E will get its prescribed share of central pool but will not be eligible for incentives as it has not achieved a NPRE growth of less than the prescribed limit.

For states A and D, contingent amount will be deducted by percentage points based on extent by which they have exceeded the prescribed NPRE limit. Recommended formula for imposing penalty on defaulting states could be as given below:

- Penalty of 10% of contingent amount if NPRE exceeds prescribed limit by 5 percentage points or less
- Additional penalty of 6% for every 1 percentage point excess beyond 5 percentage point i.e. penalty of 16% can be imposed on states exceeding prescribed NPRE limit by 6 percentage points, 22% on states exceeding prescribed limit by 7% and so on
- Penalty of 100% of contingent amount if NPRE exceeds prescribed limit by 20 percentage points or more.

Based on the recommended formula, 90% of contingent amount of State A will be provided to the state, while the remaining 10% amounting to Rs.10 crore will be deducted as penalty for exceeding the prescribed NPRE limit by less than 5%. State D's NPRE growth overshot the prescribed limit by 10% and hence based on pro-rata calculation, 40% of contingent amount amounting to Rs 160 crore will be deducted as penalty whereas the remaining 60% of contingent amount will be transferred to the state. Thus, actual devolution to states A and D will be Rs. 990 crore as against the allocation of Rs. 1000 crore and Rs. 3840 crore as against the allocation of Rs. 4000 crore respectively. The penalty amounts of Rs. 10 crore from State A and Rs. 160 crore from State D will be transferred to incentive pool.

Table 3: Illustration of Incentive-linked devolutions

Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7	Col. 8	Col. 9	Col. 10	Col. 11
State	NPRE (Baseline)	NPRE (First year of devolution)	NPRE growth	Prescribed limit for NPRE growth	Difference between Actual growth and Limit	Annual Allotment of share in central taxes	Assured Amount (90% of allocation)	Contingent Amount (10% of allocation)	Penalty	Actual Devolution
A	100	110	10%	7%	3%	1000	900	100	10 (10% of 100)	990
B	100	105	5%	7%	-2%	2000	1800	200		2000
C	100	103	3%	7%	-4%	3000	2700	300		3000
D	100	117	17%	7%	10%	4000	3600	400	160 (40% of 400)	3840
E	100	107	7%	7%	0%	5000	4500	500		5000

Since states B, C and E are assumed to have contained their NPRE growth within the prescribed target, full amount of their assured and contingent devolutions will be transferred to them. In addition, since states B and C have managed to achieve NPRE growth of less than the prescribed target, they will be eligible for reward from incentive pool.

For calculating reward amounts for states B and C, a "weighted average score" can be calculated for each of these states based on their NPRE growth rates and plan budget size. A three step process can be followed:

Step 1: Score for controlling NPRE

- Total percentage points by which states have controlled NPRE growth under the prescribed limit can be calculated. In this case, it works out to be 6% (2% for B and 4% for C)
- A score can be assigned to each state based on the proportion of reduction by a state in the total arrived at under Step 1(a) e.g. for B, the score can be 2%/6% = 0.33.

Step 2: Score for Plan Budget size

- Since the size of plan budget is also an important parameter for comparing the rationalization in NPRE, as a next step, plan expenditure to NPRE ratio can be calculated for each of the states eligible for incentives.
- The ratios calculated under Step 2 (a) will then be summed across the states to get a total. In this case, the total works out to be 1.2 (0.8 for B and 0.4 for C).
- A score can be assigned to each of the rewarding states based on the proportion of the state specific ratio in the total arrived at under Step 2(b) e.g. for B it will be 0.8/1.2= 0.67 and for C it will be 0.4/1.2 = 0.33.

Step 3: Calculating Weighted Score

- Further, a weighted score for each of the state eligible for rewards can be calculated using weights of 0.75 for "Score for controlling NPRE" and 0.25 for "Score of plan expenditure to NPRE". This weighted score will determine the share of each state from the incentive pool. In this case, it works out to 0.417 (or 41.7%) for State B and 0.583 (or 58.3%) for State C. Accordingly, State B will get Rs. 70.83 crore and State C will get Rs. 99.17 crore as incentives for controlling NPRE growth within the prescribed limit.

Critical Success Factors for Implementing the Proposed Mechanism

For implementing the proposed incentive linked devolution mechanism successfully, the following issues would need to be considered:

- Should the incentive-based devolution framework apply from first year of a FC award period or some concession period should be allowed to the states for achieving the prescribed NPRE growth rates e.g. the initial 1 or 2 years can be allowed as a grace period for allowing states to frame their expenditure rationalization strategies and let the incentive structure apply from third year onwards.
- Different upper limits for NPRE growth might need to be determined for different category of states taking into account special needs or status of states.
- Exceptional grounds need to be explicitly stated under which state Government's might be allowed to exceed the prescribed NPRE limits like unforeseen demands on the finances of the State Government arising out of internal disturbance or natural calamity or such other exceptional grounds "defined explicitly".
- The heads of expenditure for which the growth rates linked to a suitable index have to be achieved under NPRE must be identified and explicitly stated.
- In order to prevent accounting inconsistencies for estimating NPRE across states, a standard classification of NPRE for the incentive calculations should be prescribed.

The purpose of the suggested mechanism is not to provide definitive percentages and allocations as mentioned but to generate a debate on the feasibility of such a mechanism. A refined formula can be generated through such debate as an input to be considered by the Fourteenth Finance Commission.

Table 4: Illustration of incentives for states controlling their NPRE under the prescribed limit

State	Difference between Actual growth and Limit	Score for controlling NPRE	Plan Expenditure	Plan Expenditure/ NPRE	Score for Plan Exp./ NPRE	Weighted Score	Share in incentive pool	Reward
B	-2%	0.33	80	0.80	0.67	0.417	41.7%	70.83
C	-4%	0.67	40	0.40	0.33	0.583	58.3%	99.17
Total	-6%		120	1.2				170

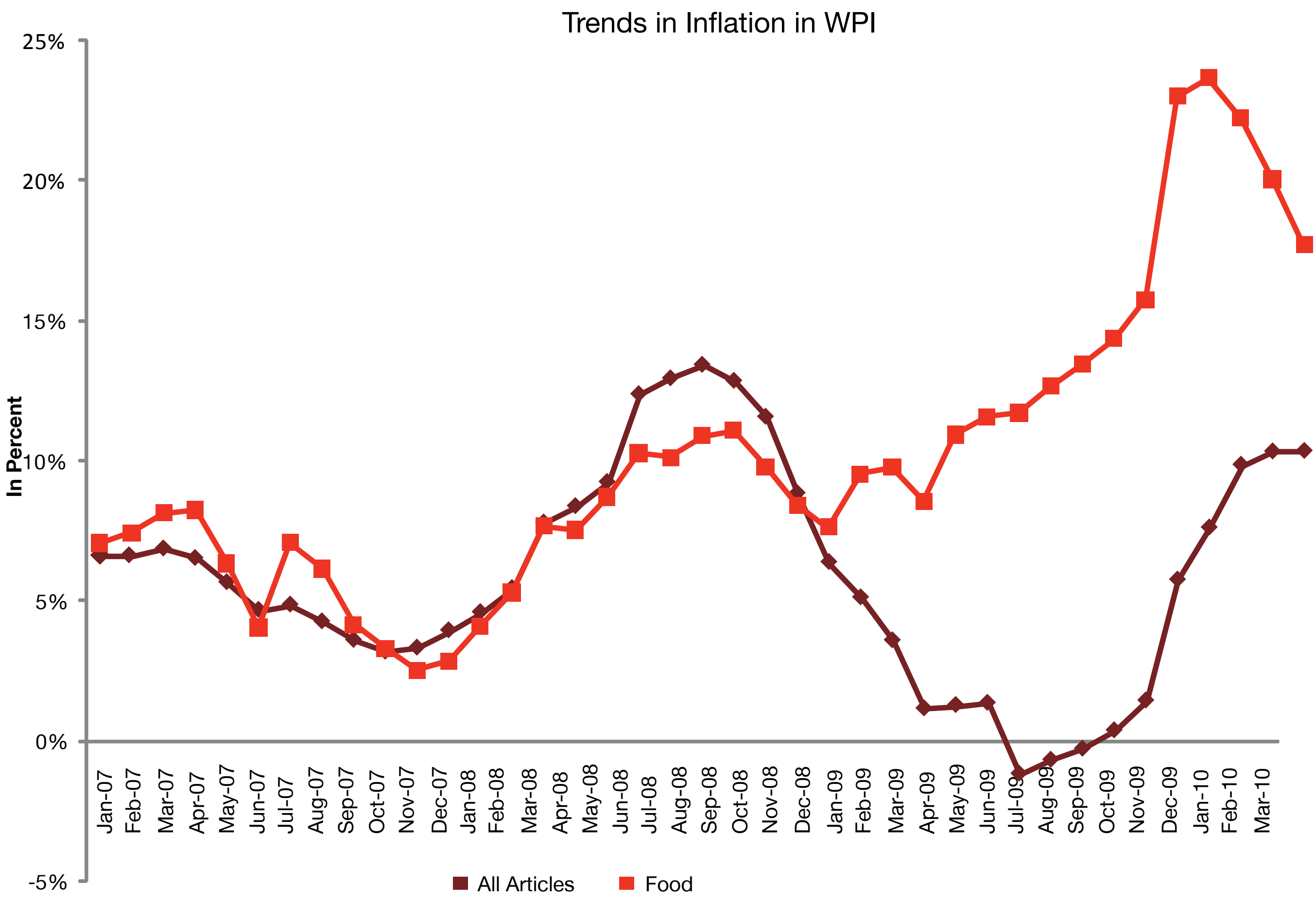
Pick of the Quarter
Sharing a Viewpoint

The Dynamics of Food Inflation

With a negative growth rate in agriculture output and double digit food inflation with surprisingly and unusually low inflation in the non-food sector, India, for the first time in its history, faces a dilemma with no established single sure shot solution. This article attempts to look into the special nature of this food inflation plaguing the nation – the contributing factors and the solutions. It also examines the strategy adopted by the government to address the issue.

Trends

Since 2009-10, inflation has been associated with an inescapable double digit rise in almost all food articles and products. The skewed nature of inflation, with food inflation of over 10 per cent, non food inflation negative and fuel, power light and lubricant inflation less than 10 percent is something that the nation has never experienced before. Significant positive variation between the rate of food inflation and general inflation was first observed in January 2009. Till June 2009, prices of food articles and products kept escalating while deflation was observed in the other components of WPI. Thereafter, the impact of high food prices spread to other sectors of the economy causing the overall inflation rate to shoot up from -5 per cent almost 10 percent by the end of 2009-10.



Source: Ministry of Statistics and Programme Implementation, Government of India

As the balance of risks in the economy shifted from 'growth slowdown' owing to the global recession to 'inflation' due to the food price escalation, several theories have been put forward with respect to the possible triggers of the price rise. Appropriate short term relief measures to bring the situation under control were intensely debated including those eventually adopted by the government; and most importantly, the demand for a long term strategy to ensure that such a calamity does not recur was made by interested stakeholders across the country.

Possible Causes

The unusual steep rise in food prices has been attributed to several supply-side factors such as the severe drought of 2009 which fuelled the downturn in food production, the surge in food exports driven by rising global food prices; and hoarding and speculation as reflected in the abnormal difference between retail and wholesale prices.

Another theory upholding the demand-driven perspective cites the phenomenon of the plethora of social sector schemes such as NREGS initiated by the government in recent years as the structural reason for the food price rise. It argues that with India's millions of small farmers already struggling to keep pace with the existing level of national food requirements, these schemes have compounded the situation by creating new demand for food in rural areas resulting in an upward push on food prices. This theory crucially hinges on the assumption that the segment of population targeted by these schemes have a higher than average income elasticity of demand for food.

Another important aspect of this argument is that while beneficiaries of these schemes, mostly households identified as lying below the poverty line (BPL Households), have the Public Distribution System to fall back on for regular and concessional supply of food articles, it is the households that either have no access to the ration shops; and/or do not have the required proof/documentation for qualifying as BPL Households; or are sufficiently close to the poverty line and are hence considerably vulnerable to price changes, which have been dealt the hardest blow by the price rise.

While all these events – the drought, increased exports, hoarding and increase in rural demand - have undeniably contributed to the current food inflation, they represent only the tip of the iceberg. The underlying cause for the stubborn price rise is possibly the long ailing and neglected agriculture sector. Agricultural growth slowed down to around 2 per cent a year in the last decade from around 4 per cent annually in the 1980s to reach the current state of negative growth. Public irrigation works have expanded at snail's pace, while agricultural extension services are quite inefficient. Wastage of agriculture produce worth millions takes place annually due to lack of post harvest infrastructure such as cold chains, transportation, and storage facilities. Government's fertilizer policy over the past years has distorted the trend in fertilizer consumption and therefore the mix of soil nutrients. Agricultural land holdings continue to be highly fragmented disabling resource-poor farmers from reaping economies of scale at both the production and post-harvest phases of farming. Farmers continue to remain vulnerable to adverse weather conditions and high levels of indebtedness.

These supply side constraints leading to the growing mismatch in domestic demand and supply over the years have contributed significantly to the present situation of sky rocketing food prices.

Long Term Strategy

Rising to the challenge, the Union Budget for 2010-11 has a focus on addressing the root cause for escalating food prices: the weak and long neglected agriculture sector that has failed to keep up with growing demands of the booming Indian economy. To ensure that a similar food crisis could be avoided in future, the Budget proposes a four pronged strategy to boost agricultural growth covering:

- Increase in agricultural production through extension of the green revolution to the eastern states, organization of pulses and oilseed villages in rain fed areas and enhancement in productivity of dry land farming areas;
- Reduction in wastage of produce resulting from the acute shortage of storage capacity faced by the Food Corporation of India (FCI) by encouraging through the

PPP model hiring of godowns from private parties for guaranteed periods;

- Improving credit support to farmers by extending loan repayment periods coupled with providing additional incentives to farmers for meeting their repayment schedules on time; and
- Providing a thrust to the food processing sector by setting up mega food parks.

However, other equally significant areas that require focused policy attention are:

- Formulation of an appropriate marketing model to overcome disadvantages of small scale farmers through adoption of latest technologies and modern practices;
- Facilitation of private sector investment in non-MSP crops through an appropriate incentive scheme ;
- Revisiting the mechanism currently adopted to provide fertilizer subsidies to farmers; and
- Design and implementation of a properly funded, efficiently functioning and accountable system of public delivery of food items through a network of fair price shops and co-operatives to address issues of access and adequacy.

Short Term Relief Measures

While the above measures are well aimed at curing the cause rather than treating the symptoms of current price rise in the economy, by virtue of the scale of impact and intensity of the price rise, effective relief measures capable of having an immediate dampening effect have also to be undertaken in the short term.

- Slow trickledown effect: Typical monetary tools used in such situations include tweaking interest rates or Cash Reserve Ratio (CRR) take a very long time to actually affect a drop in demand for food items, as food lies far down the chain from where monetary policy starts taking effect.
- Inability to impact the unorganized sector: The recent price rise, as argued in the previous section, to an extent has been pushed by the injection of new demand in the segment of population that primarily constitutes the unorganized sector of the economy. Any monetary measure proposed by the RBI has a direct impact on the organized sector. Moreover, the income elasticity for essential commodities such as food articles and products of those constituting the organized sector in the economy is lower than those in the unorganized sector. Hence, any attempt to reduce liquidity in the market would not have the desirable impact of lowering demand and thus food prices.

In view of the above limitations of the monetary policy to cause substantial impact, food prices in the short term would need to be addressed through supply side measures such as increased supply to not only enhance per capita availability but also to disincentivize hoarders. This can be achieved through:

- Offloading of FCI stocks: Releasing existing buffer stocks of foodgrains held by FCI into the market in a strategically controlled and planned manner can be a reasonable way of reducing the supply-demand mismatch. This can be achieved through a coordinated release of stocks through the public distribution system and/or open market sale of public stocks.
- Imports: Admittedly, to manage supply side pressure, food imports this time was not a readily available inexpensive option due to the recent surge in world food commodity prices. However, import decision still makes for a good case considering its immediate effectiveness in reining in food prices by augmenting supplies and restraining hoarding tendencies. This would have certainly entailed a fiscal cost as global prices have for sometime been above domestic prices for foodgrains; however, it presents a lesser evil as compared to widespread high levels of food inflation and the resulting vulnerability of a large segment of the population.

Though the government refrained from taking drastic steps initially towards reining in the soaring food prices, it went for stabilization measures after the crisis became full blown and the impact of the high food prices began to be felt in the other sectors of the economy. Some of the measures undertaken by the government are:

- Towards the end of 2009, the government eased up of imports of relevant foodgrains and sugar by cutting down on import tariffs. However, having failed to pay heed to the early warnings on developments in the domestic markets regarding supply and demand conditions, by the time the government decided to step up imports, the international market had taken into account India's demand and had adjusted its prices accordingly, leaving the government little choice but to settle for the worst of both worlds.

- Along with liberalization of imports, the government also released wheat and rice from the stocks held by the FCI into the open market. However given the failure to bring down prices, the increased supply appeared to be in inadequate quantity and had limited reach.
- As additional measures, state governments were instructed to pick up their full quotas of wheat and rice meant for PDS that were lying idle with the Centre as well as revise their tax structures so as to reduce the price of imported food commodities. State governments were also advised to ensure strict enforcement of anti-hoarding measures on food commodities under the powers of the Essential Commodities Act.

Trends in WPI exhibit that not only did these measures fail to bring down food inflation substantially, but the trickledown effect of the high food prices on other commodities could also not be controlled as evident from the rise in the general inflation rate in the last 10 months. Having failed to nip the price rise in the bud, the government needs to immediately make bold interventions towards addressing the food inflation issue.

PwC Updates
PwC's contribution towards the sector

Know our Work

PwC was engaged by Government of Madhya Pradesh to provide support in the preparation of the state's memorandum to the Thirteenth Finance Commission. Article 280 of the Constitution provides for appointment of a Finance Commission once in five years (or earlier) to make recommendations towards maintaining vertical and horizontal fiscal balances between centre and state and among states. For the purpose, states are welcomed to put forward their suggestions for maintaining fiscal balance and also highlight their weaknesses or strengths which form the basis for non-plan grants recommended by Finance Commission. As part of this assignment, some of the specific analyses and studies undertaken were:

- Macro Fiscal and Economic Analysis of the state of Madhya Pradesh
- Analysis of debt profile of the state, debt servicing schedule and liability. Also included was the study of guarantees provided by the state and trends in overall liabilities over past few years.
- Analysis of the current status of forestry in MP and study on Government's effort to preserve forest and environment. Also estimated was the grants requirement for preserving forest and environment.
- Analysis of finances of local bodies and need for resources by them corresponding to their functions and functionaries transferred in Madhya Pradesh
- Impact and cost estimate of the new nation-wide disaster management mechanism including National Disaster Management Authority
- Analysis of the current status of physical infrastructure in the state and estimation of maintenance requirements

Field anecdote - Communication Gaffes

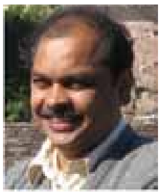
"I know that you believe you understood what you think I said, but I am not sure you realize that what you heard is not what I meant."
Consultancy and Communication. Any association with the first ensures that the latter follows along. The importance of choosing the right channel for getting the desired message across to the client becomes more pronounced in international projects where being conversant in English may not come to one's rescue.

This was proved true yet again in a project where our team was dependent on an interpreter for communicating with the client. During the course of the assignment, an occasion arose when the client requested for a high stake presentation to be prepared by the consultants within a span of half a day. The team felt that the presentation deserved a more thorough research and consultation and hence required more time for preparation. To convey the same they requested a meeting with the client on an urgent basis. Tragedy struck when right before the scheduled meeting, the interpreter took ill and the team had to go ahead without him.

The client, a senior government official, fortunately had some basic understanding of English. The meeting began on a pleasant note with exchange of greetings in English and the team felt confident of being able to put their point across without any glitches. As the meeting progressed, the consultants spoke slowly and used gestures extensively fervently hoping that what speech couldn't convey, their body language would. Throughout the next half an hour each reason for not being able to deliver the presentation on the same day was greeted with a nod of agreement or a smile by the official. Feeling assured and happy that they had successfully managed to convince the official that they would require more time for preparing the presentation, the team stood up to leave. As they shook hands before departing, the client made a remark that led the team to learning a lesson on importance of clear communication, albeit the hard way –"Look forward to the presentation this evening".

K L N Rao

Retainer (Public Expenditure Management Expert), Public Finance, PwC



KLN Rao has been associated with state level Public Financial Management reforms for the past five years with focus on Public Expenditure reforms at sub-national level. He has worked with the Finance Department of Government of Andhra Pradesh (GoAP) and is currently involved in DFID funded project in Madhya Pradesh and ADB funded project in Assam in the area of Public Expenditure Management. He is closely associated with preparation and institutionalization of Medium Term Expenditure Framework (MTEF) at sub-national level.

Job Experience

Rao started his foray into Public Finance area with his involvement in preparation of MTEF for Health and Family Welfare Department, GoAP in the year 2005. Reform measures suggested and resource gap estimated under MTEF Health had been used as the base for DFID funding the Health Sector Reforms in AP.

Rao was part of DFID funded SPIU (Strategy and Performance Innovation Unit) that was set up under APPMSDIP (Andhra Pradesh Public Management and Service Delivery Improvement Programme-2006-09) for suggesting various measures for improving the efficiency of the governmental services and ensuring that the services reach the poor. In SPIU Education, Rao was involved as the Finance and Monitoring Expert and worked with Head of Department level officials in School Education and Finance Department, GoAP. He provided expert inputs to various projects such as ICT in Schools through PPP mode, Strategic Review of School Education Department, e-tool for Distribution of Free Text books and Strategic Review of Vocational Education in Andhra Pradesh. Further he was also involved in conducting workshop on Financial Management for officials of School Education at Centre for Good Governance, AP, India.

Currently Rao is working as MTEF Module Leader in the DFID funded Strengthening Performance Management in Government in Madhya Pradesh. As part of the project, MTEF has been developed for five departments- Farmers Welfare and Agriculture Development, Tribal Welfare, School Education, Water Resources and Public Works Department. For each of these departments, sector and expenditure reviews have been done on the basis of which future resource requirement has been projected by linking it to certain ‘critical’ performance indicators. Further a top down estimate of likely future resource flow to the five departments has been estimated for creating consciousness about resources constraints that would be faced by them in future.

Also working on ADB funded Assam Governance and Public Resource Management Program (II) as Expenditure Management Specialist, Rao is responsible for developing procedures and guidelines for introducing Outcome-based budgeting, outlining mechanisms for data capture over time for monitoring identified outcomes and outputs, preparing strategy document to ensure sustainable Operation & Maintenance (O&M) expenditure in all departments and assisting Government of Assam to prepare O&M expenditure estimates in select departments.

Public Finance Practice

The Public Finance Practice of Government Reforms and Infrastructure Development (GRID) SBU 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 large dedicated team of full time professionals and associates 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.

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.

MTEF Training Program organized for Department of Health, Medical and Family Welfare, Government of Andhra Pradesh

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