Enabling Inclusive Development

Public Finance Newsletter

Issue X
December 2013

pwc

In this issue

Dear readers,

We have been sharing our views and experiences in the public finance domain across the globe through this Newsletter. Continuing with our efforts, I welcome you to the 10th issue of the Public Finance Quarterly. With your invaluable inputs, we are continuously endeavouring to make this medium a more effective and enriching channel for information-sharing.

The Feature article in this issue has been written taking into account the need for reform in the property tax systems in Indian municipalities. Recent attempts at reform have been based on shifting away from the age-old rental value based system of property taxation. The article highlights the challenges in annual rateable value (ARV) and capital valuation (CV) methods and explores the possibility of an effective unit area valuation (UAV) method for ULBs. It addresses the requirements for a transition to a transparent system that is in the interest of both property owners as well as the local government.

In Pick of the Quarter, the author has discussed the recently released report of the committee for evolving a composite development index of states and has presented the impact of suggested states' share in central devolutions on their fiscal profile.

Round the corner provides news updates in the area of government finances and policies across the globe and key paper releases in the public finance domain during the last quarter along with their reference links. "Our work" section showcases our recently concluded study on the development of a conceptual design for an integrated government financial information management system as part of the implementation of its overall PFM roadmap for the government of Philippines (GoP). The study covered the entire PFM lifecycle including fiscal planning, budget preparation, expenditure management, revenue management, debt management, auditing, accounting and reporting.

I would like to thank you for your overwhelming support and response. Your suggestions urge us to continuously improve this newsletter to ensure effective information-sharing.

We would like to invite you to contribute and share your experiences in the public finance space with us. Please write to me at ranen.banerjee@in.pwc.com.

Happy reading!

Sincerely,

Ranen Banerjee

Executive Director
Public Sector and Governance

Feature article

Property taxation in India

The rapid urbanisation in India has created immense pressure on infrastructure and services, especially over the last 10 to 15 years. Most of the urban local bodies (ULBs) are unable to meet the growing demand for better urban services due to the inadequate levels and slow growth of municipal revenues. Following the abolition of octroi in most states in India, ***property tax (PT) has become one of the key sources of revenue for ULBs in India***. PT in general includes a family of taxes within it (a tax for general purpose or house tax or holding tax, water tax, drainage tax, street lighting tax, sewerage tax, street tax, water benefit tax, sewerage benefit tax, education cess, fire cess, tree cess, etc.). The component and nature of PT varies from city to city depending upon the provisions of prevailing municipal legislation in the respective states in India.

The growth in PT revenue has not been commensurate due to inadequate policies, legal issues and inefficient administration. PT reforms have been a matter of debate in the country for a while. ***In the last 10 to 15 years, many cities across the country have introduced innovative practices in PT assessment and administration. This has been reinforced by the launch of the Jawaharlal Nehru Urban Renewal Mission (JNNURM)***, an incentive linked reform programme that provides central assistance for municipal infrastructure projects in return for a commitment from ULBs to walk the path of reform. PT reform is among the mandatory reforms under the Mission, which is enabling ULBs to have a full record of properties in the city and bring them under the tax net, leading to improved collections. In the long run, this will help ULBs to move towards a more user-friendly, simple and transparent PT system.

Assessment and valuation of property tax in India

Though PT structure in India differs from state to state, there are essentially three different methods for assessment and valuation of properties: annual rateable value (ARV) of lands and a building, capital valuation (CV), and unit area valuation (UAV) method.

In most Indian cities, the ARV based system of property taxation is in practice. But over the years, several lacunae in this system have surfaced. For instance, obtaining actual information on rent paid poses the greatest practical challenge. In case of rented properties, there is significant under-reporting of actual rent charged, while in the case of owner occupied or vacant houses, certain subjective criteria have been adopted to arrive at the ARV. Thus, there is always a gap between the actual rental value and the imputed one used to assess PT. Allowances and concessions given to certain properties widen these deviations even further.

In the CV based system, the assessment is based either on the actual value of transactions, on government fixed cost of construction or the cost of land. Again, this information is seldom easily available. Further, there is a tendency to under-report the property value to escape registration charges and stamp duty. In the absence of transactions data, capital value is estimated using construction cost, date of construction, etc. This makes the process data-intensive and also introduces a high level of subjectivity and lack of transparency.

Present PT systems have the following deficiencies which occur partly on account of the inbuilt inflexibility in the assessment systems (ARV and CV) noted above and partly due to poor administrative systems in place:

- Scope for subjective assessments in a corruption-prone environment
- Scope for excessive use of discretionary powers leading to possible collusion between the assessor and assessee
- Non-transparency in the assessment process
- Self-assessment not possible, and the onus of annual assessment on the local body required to issue demand notice every year
- Higher social costs due to litigation, and consequent delayed recovery of taxes
- Lack of a systematic computerised database–resulting in a large proportion of the properties being outside the tax net
- Lack of efficient mechanisms for detecting and follow-up on defaulters

To strengthen the financial autonomy of ULBs, a holistic reform of the PT system is essential. The government of India recommends that a system may be adopted which is objective and based on clearly enunciated parameters; formula based and capable of self-assessment; eliminating or at least minimising of discretion at the field level; and citizen friendly.

Based on the above recommended criterion, the UAV method has been widely recognised as a suitable method for valuation and assessment of PT. When combined with the self assessment system (SAS)[1] , the UAV method can bring in a high level of transparency by enabling the assessee to calculate and pay the tax without any involvement of tax inspectors or assessors.

Most of the JNNURM mission cities in India have switched over to the UAV method of property valuation. This involves categorising the city into relatively homogenous zones, grouping the buildings, roads and construction type into categories, use of multiplicative factors, fixation of unit area values for each zones, mapping of properties using GIS and implementation of SAS.

Methods of valuation in use in sample cities of India

S no	City	Valuation method
1	Shillong, Delhi, Hyderabad, Lucknow, Visakhapatnam, Patna, Rajkot, Bhopal, Indore, Jabalpur, Varanasi, Agra, Allahabad, Meerut, Vijaywada, Dhanbad, Coimbatore, Chennai, Chandigarh	UAV for estimating the annual rateable value of properties
2	Ahmedabad, Jaipur, Vadodara, Kochi, Surat	UAV per sq.m as a basis for taxation
3	Kanpur and Madurai	UAV for estimating the annual rateable value for residential. CVM for commercial properties.
4	Mumbai, Bangalore and rest of Karnataka	CVM
5	Kolkata	ARV/ CVM for estimating annual rateable value of properties
6	Faridabad, Durgapur, Nashik, Amritsar, Ludhiana, Jamshedpur	ARV (rent as the basis for estimating the annual rateable value of properties)
7	Pune	Market rent based UAV
8	Nagpur	ARV

Source: PwC Compilation from State Property Tax Ready Reckoner and NIPFP Report (2009)
Note: UAV = unit area value; CVM = capital value method; ARV = annual rateable value

However, for metros such as Mumbai and Bangalore, the UAV method seems over-ambitious, involving subjective judgements at every stage. Also, the real estate market in these cities, though not immune to speculation, is by and large quite well organised and information on the market value of properties is available from the revenue departments of the municipal corporations. Hence, the changeover from ARV to the CV system seemed feasible for these cities.

Tax base, rate and administration

Tax base: One of the important objectives of PT reform in India is to widen the tax base. The municipal tax base may be defined as the aggregate value of a municipality's taxable area in all real properties within its jurisdiction. Tax base consist of various types of property, including residential, commercial, industrial and institutional.

The common assumption is that a wider tax base will reduce the necessity of 'squeezing' those already paying taxes. However, the ultimate impact on taxpayers will vary depending on which category of tax bases are affected. Factors affecting the aggregate value of a tax base are innumerable: new construction and its impact on the mix of property types, changes in the market value of real property and the ability to account for these changes, non-taxable and for tax-exempt real property.

The revenue from PT can be raised by changing the weights associated with the various characteristics and/or by changing the tax rates, both of which would immediately bring in subjective elements. The ARV and CV systems lack a buoyant tax base since all their attributes are physical characteristics, which, once determined, are fixed forever. The UAV method, on the other hand, allows the changing of weights and removes arbitrary exemptions. Hence, the tax base can be widened by the adoption of the UAV method.

1. *Under SAS, the onus for filing property tax returns on a regular basis and paying the tax on/within a prescribed time schedule on the basis of the self assessment should be on the owner. To facilitate payment, arrangements should be made for accepting tax through designated banks, collection by the resident associations and group housing societies, and online through the municipality website.*

Tax rate: After the estimation of weights, the next step is to estimate the tax rate. The rate structure needs to be reasonable, fair and equitable. In the absence of periodic updation in ARV, some cities increase the tax rate in order to ensure that revenue generation does not decrease. This approach should be strongly discouraged as high tax rate results in citizen resistance and evasion. The rate structure needs to typically incorporate the following elements:

- ***Flat vs. progressive sliding scale:*** A progressive sliding scale connotes a sense of fairness as those with properties having higher ARV will have to pay progressively more tax due to higher ARV at a higher rate. Alternately, the system can be simplified by adopting a flat rate for all properties.
- ***Categorisation based on usage:*** A common approach is to categorise the properties based on usage viz., residential, commercial, institutional and industrial purposes. There is a further distinction made between owner occupied and rented properties.

A lower tax rate ensures compliance. Earlier, cities used to have a much higher tax rate on a small base. Now most cities have rationalized their PT rates.

Comparison of PT rates in select cities in India

S.No.	City	Property tax rate (% of ARV) or INR where indicated*	
		Residential	*Non-residential*
1	Delhi	7-12%	20%
2	Bangalore	20%	25%
3	Chennai	6.63% to 12.40% (Half year tax)	-
4	Kolkata	11% to 40%	-
5	Hyderabad	17-30%	30%
6	Ahmedabad	Rs 16 per sq m per annum	Rs 22 to Rs 28 per sq m per annum
7	Lucknow	15%	-
8	Visakhapatnam	25.88%	30%
9	Patna	7-9%	7-9%
10	Bhopal, Indore, Jabalpur	8-10%	-
11	Amritsar, Ludhiana	10%	15%
12	Kochi	15%	-

Source: PwC Compilation from State Property Tax Ready Reckoner and NIPFP Report (2009)

**Note - This data has been compiled for prevailing property rates in selected cities at the time of writing the article.*

Tax administration: Traditionally in India, the role of tax administration has been to enforce tax laws and provide at least minimal taxpayer services through a system of inspectors. This was understandable in the context of a small potential taxpayer base and the prevalent practice of administrative assessment. Over time, as the taxpayer base expanded, the UAV method has came into existence to curtail the discretionary powers of inspectors and introduce the self-assessment system to increase compliance.

Also, several steps have been taken recently to improve the tax administration system and plug the loopholes. These include complete mapping of properties, unique identification system for properties, GIS based system to prevent tax evasion or inaccurate self-reporting, system of incentives and penalties to ensure timely and accurate assessment, efficient system of tax collection using IT and bank based systems.

Pre-requisites for successful implementation of PT system

Reforms in a PT system will be successful only if improvements are carried out covering all aspects of PT administration. The amount of revenue raised depends on the cumulative performance of all processes–property identification, valuation, assessment, collection, discovery and enforcement. Therefore, some of the key pre-requisites for the successful implementation of the PT system in India are as follows:

- ***Comprehensive stakeholder consultations:*** Implementing SAS requires strong citizen interface mechanisms consisting of extensive stakeholder consultations and a feedback process right from the initial stages of reforming the PT system. A consensus has to be built across the board with all stakeholders including citizens, councillors, municipal staff, etc, as all of them will be affected by the changes in the system.
- ***Creating a GIS database of properties:*** The ULBs need to create GIS back-end support to have a full database of properties in the city and bring them under the tax net.
- ***Unique identification code:*** While building up the GIS database, it will be useful to introduce a unique number to identify the property. This code could locate the property uniquely in terms of ward, the colony and the block and perhaps floor or flat.
- ***Municipal valuation committee (MVC):*** The government needs to appoint an MVC consisting of experts and persons experienced in urban administration, taxation and representatives from the local body. The manner of constitution of this committee, their functions and the processes adopted to ensure fair consultation with citizens should be clearly laid down in the statute.
- ***Certified tax assessors:*** The ULBs need to appoint certified tax assessors to help taxpayers file their tax return much like CAs.
- ***Citizen education and awareness:*** During the period of design of the system, citizens should be made aware of the reasons for the reforms, what is being planned and the advantages of the new system.

Summary and way forward

Urban governments are likely to play an important role in economic development since they are responsible for the management of city level services. ULBs depend on a variety of resources such as property tax; cost based charging for services like water supply and waste management and; better utilisation of municipal assets. Among them, property tax is perhaps the most important. The PT system can be reformed with the right combination of political will, citizen participation and efficient administration. In recent years, we have seen significant reforms through the introduction of e-governance, online collection methods, use of GIS and other modern techniques.

The assessment method is a sensitive issue charged with political, economic and social considerations. A landmark decision by the Patna Municipal Corporation--to switch over from age-old rental value system to area-based system--proved to be a turning point and this system was soon adopted by others. The UAV method is simple, transparent, citizen-friendly and amenable to self-assessment, and provides scope to remove several current anomalies in PT administration. Use of this method can lead to revenue maximisation with equity and efficiency.

PT reforms are not impossible to achieve. They need patience and concerted efforts from stakeholders. The state government needs to ensure adequate provision for capacity building programmes for all stakeholders. It is proposed that in large urban programmes such as JNNURM, there needs to be separate fund allocation for capacity-building and implementation of key reforms such as PT to better equip the state and city urban agencies.

With India's growing urbanisation, it is important to increase the revenue base of ULBs for them to be able to service the urban population and maintain the quality of life for the residents. PT being one of the main revenue sources for ULBs, it is important to strengthen policies, processes and administrative efficiencies related to its collection.

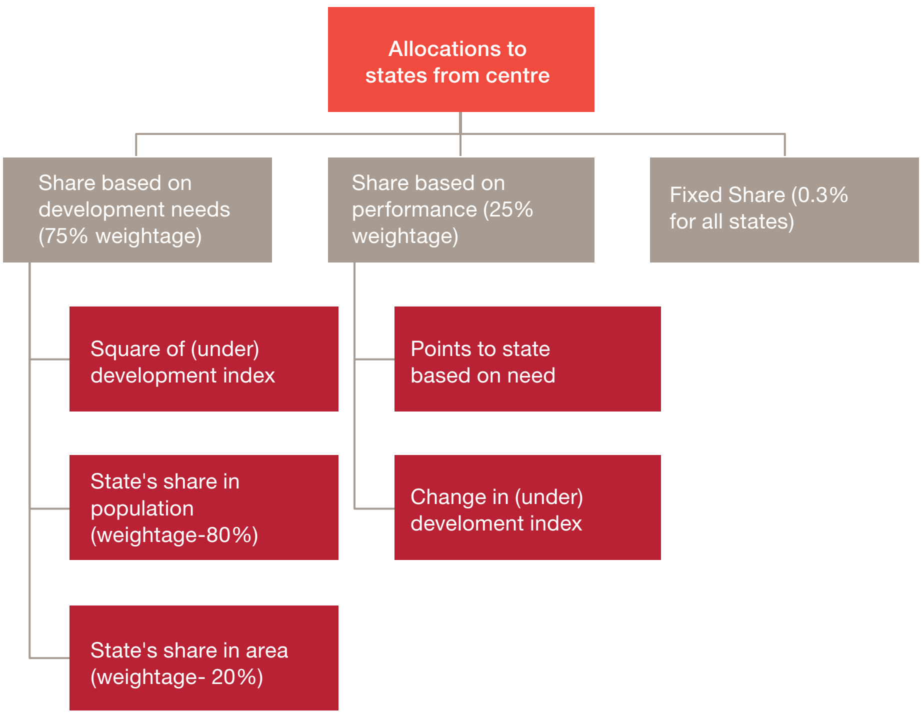
Pick of the quarter

Development of states and devolutions from centre

The Indian government has time and again shown its commitment towards reducing regional disparities in development between states and establishing a more egalitarian society. In its effort toward this goal, in May 2013, it decided to constitute an expert committee to consider the backwardness of the states for evolving a composite development index of states.

The key objectives of the committee included suggesting methods for identifying the backward states and how the suggested criteria may be reflected in future planning and devolution of funds from the central government to the states.

Method proposed by committee for allocating funds



- The committee has proposed a general method for allocating funds from the centre to the states based on both, the state's development needs as well as its development performance. In addition, the committee recommended a fixed basic allocation of 0.3% of overall funds to each state, which should be added to its share arising from need and performance criteria.
- Thus, 8.4% (28 states * 0.3 fixed allocation) of funds will be allocated as a fixed basic allocation. Of the remaining 91.6%, the committee recommended to allocate 3/4th of sharable funds based on need and 1/4th based on performance.
- To determine allocation based on the state's development needs, the committee has proposed a simple index of (under) development, which is an average of 10 sub-components:

(i) monthly per capita consumption expenditure,

(ii) education,

(iii) health,

(iv) household amenities,

(v) poverty rate,

(vi) female literacy,

(vii) percentage of SC-ST population,

(viii) urbanisation rate,

(ix) financial inclusion, and

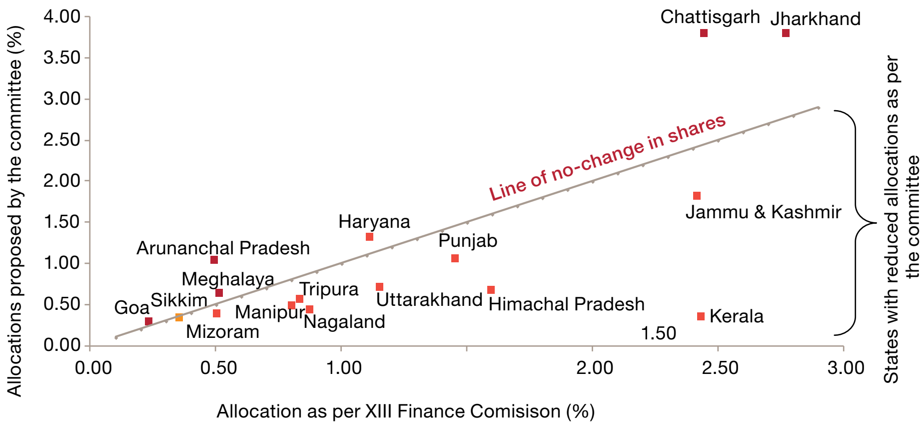
(x) connectivity

- Less developed states get a higher ranking on the index and thus will be entitled to larger allocations based on the need criteria.
- The committee has suggested to 'square the index', while using it to allocate funds to states. This will help introduce non-linearity to the devolution of funds so that more needy states get disproportionately more funds. This squared index will represent the need of an average individual in a state.
- The committee has suggested a weightage of 80% for a state's share in population and 20% to the state's share in area for determining the factor by which measure of state's need should be multiplied to get the allocation.
- To determine allocation based on the development performance of a state, the committee has suggested to use improvements to a state's development index over time (that is, a fall in underdevelopment) as the measure of performance[2]. Further, the committee has suggested to multiply this change in index by development need (points to states based on development need). This way, the proposed formula rewards underdeveloped states more for an improvement in the index.

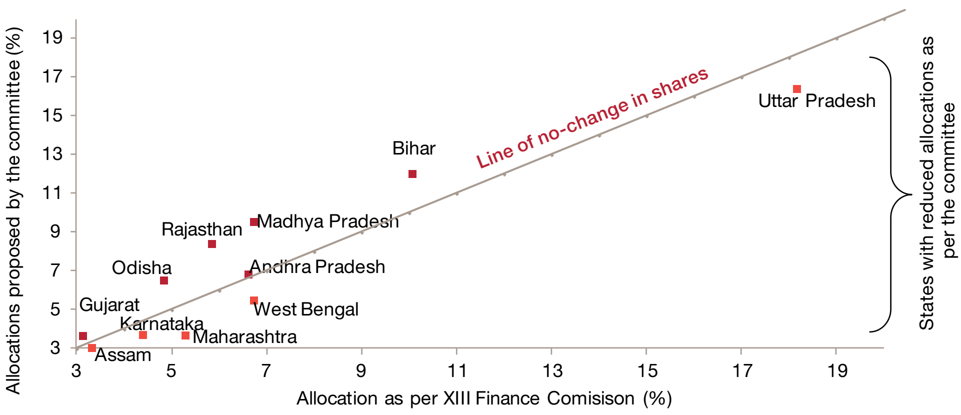
2. The committee has suggested to drop change in the fraction of SC/ST population while computing the performance index.

Allocations based on formula proposed by the committee

On the basis of proposed formula, the committee has estimated allocations for 28 Indian states. ***Allocations to states from centre based on recommendations of 13th Finance Commission and the committee (This diagram presents states with below 3% allocation as per 13th FC)***



Allocations to states from centre based on recommendations of the 13th Finance Commission and the committee (This diagram presents states with above 3% allocation as per 13th FC)



Note- Allocations as per the 13th FC are estimated based on actual releases of grants and share in central taxes for 2011-12

Comparison of state shares in central devolutions as proposed by the committee and the 13th FC

States (with reduced allocations as per the committee)	Allocations proposed by the committee (%)	Allocation proposed by the 13th FC* (%) (2)	Difference in allocation (%) (1-2)	State (with increased allocations as per the committee)	Allocations proposed by the committee (%) (3)	Allocation proposed by the 13th FC* (%) (4)	Difference in allocation (%) (3-4)
Tamil Nadu	2.51	5.01	-2.50	Sikkim	0.35	0.35	0.00
Kerala	0.38	2.45	-2.07	Goa	0.30	0.23	0.07
Uttar Pradesh	16.41	18.16	-1.75	Meghalaya	0.65	0.51	0.14
Maharashtra	3.94	5.28	-1.34	Haryana	1.33	1.11	0.22
West Bengal	5.50	6.72	-1.22	Andhra Pradesh	6.85	6.61	0.24
Himachal Pradesh	0.67	1.54	-0.87	Arunachal Pradesh	0.97	0.50	0.47
Jammu and Kashmir	1.83	2.51	-0.68	Gujarat	3.69	3.12	0.57
Karnataka	3.73	4.39	-0.66	Jharkhand	3.88	2.77	1.11
Nagaland	0.45	0.84	-0.39	Chhattisgarh	3.70	2.43	1.27
Punjab	1.07	1.45	-0.38	Odisha	6.53	4.83	1.70
Uttarakhand	0.79	1.15	-0.36	Bihar	12.04	10.06	1.98
Manipur	0.50	0.80	-0.30	Rajasthan	8.42	5.84	2.58
Tripura	0.52	0.81	-0.29	Madhya Pradesh	9.56	6.72	2.84
Assam	3.05	3.31	-0.26				
Mizoram	0.40	0.50	-0.10				

** These allocations represent actual releases of both grants and share in central taxes for 2011-12*

Based on above analysis, it can observed that allocations to the states of Tamil Nadu, Kerala, Uttar Pradesh, Maharashtra and West Bengal are reduced the most, by 2.50, 2.07, 1.75, 1.34, and 1.22% points respectively. On the other hand, states of Madhya Pradesh (2.84%), Rajasthan (2.58%), Bihar (1.98%), Odisha (1.7%) and Chhattisgarh (1.27%) gain the most in terms of allocations from centre. This seems fair given that the latter are relatively less developed states of India; however the share of Uttar Pradesh has also been reduced which is among the high poverty states.

Further, share of special category states like Himachal Pradesh, Jammu and Kashmir, Nagaland, Uttarakhand, Manipur, Tripura, Assam and Mizoram is proposed to be reduced, which is debatable given the difficult and critical geographical location of these states and issues of accessibility and consequent higher cost of delivery of services.

Impact assessment of allocations based on the committee's recommended formula

In order to analyse the likely impact of proposed allocations on finances of various state governments, we have computed quantum of transfers for states based on the recommendations of the committee assuming the total transferable pool to be the same as that for 2012-13 (BE). The above computed transfers were then compared to respective transfers of the states, as per 2012-13 budget allocations.

Comparison of central transfers to states based on 2012-13 budget allocations (in line with recommendation of the 13th FC and the Planning Commission) with those recommended by the committee (assuming the total transfers to remain the same)

States (with reduced quantum of allocations)	Difference as % RE	Difference as % of TE	States (with increased quantum of allocations)	Difference as % RE	Difference as % of TE
Manipur	-68.4%	-51.1%	Andhra Pradesh	1.7%	1.4%
Nagaland	-66.6%	-49.9%	Gujarat	4.1%	3.2%
Tripura	-53.3%	-40.7%	Goa	5.6%	4.4%
Mizoram	-50.5%	-41.6%	Uttar Pradesh	6.7%	5.7%
Jammu & Kashmir	-49.0%	-37.7%	Jharkhand	8.0%	6.3%
Sikkim	-40.0%	-28.4%	Chhattisgarh	24.9%	19.7%
Meghalaya	-35.4%	-28.7%	Bihar	31.1%	25.0%
Himachal Pradesh	-34.4%	-30.0%	Madhya Pradesh	31.2%	24.8%
Uttarakhand	-28.6%	-23.0%	Rajasthan	32.6%	28.2%
Assam	-24.5%	-21.4%	Odisha	33.6%	28.7%
Kerala	-20.1%	-17.6%			
West Bengal	-13.3%	-12.0%			
Tamil Nadu	-9.0%	-7.4%			
Arunachal Pradesh	-7.6%	-4.7%			
Maharashtra	-7.5%	-6.4%			
Punjab	-7.0%	-6.1%			
Karnataka	-6.6%	-5.5%			
Haryana	-2.8%	-2.5%			

Source: For data on RE and TE, RBI report on state finance for 2012-13

RE- Revenue Expenditure; TE- Total Expenditure

Based on the committee's recommendations, the quantum of decrease in allocations will be very significant for some states. The states of Manipur, Nagaland, Tripura and Mizoram will lose funds equivalent to more than 50% of their revenue expenditure with Jammu and Kashmir losing around 49%.

On the other hand, the states gaining in terms of quantum of transfers include Odisha, Rajasthan, Madhya Pradesh, Bihar and Chhattisgarh, with each receiving funds equivalent to more than 25% of their revenue expenditure.

Another noteworthy point of allocation proposed by the committee includes, in quantitative terms, transfers to 18 states will reduce while that of 10 states will increase. Thus, the proposed scheme of shares represent a major redistribution of central transfers among the states, with some states gaining significantly, while some losing critically [3].

Also, the states, currently categorised as 'special category' states which include Arunachal Pradesh, Assam, Himachal Pradesh, Jammu and Kashmir, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, Tripura and Uttarakhand- will be facing significant decrease in central allocations based on shares suggested by the committee. On the other side, relatively prosperous states such as Gujarat, Goa and Andhra Pradesh will be gaining allocations from the centre.

Thus, when analysed in quantitative terms, proposed share of states for devolutions from the centre seems debatable and further analysis can be conducted for identifying relevant indicators (under) the development and devolution formula.

This leads us to contemplate, Should devolutions from centre to states be based on a single formula? We understand that there are many considerations that the Finance Commission and the Planning Commission attempt to address while suggesting devolutions for the states. It may not be possible to include all those considerations in a single formula. Furthermore, these considerations are dynamic and change with shifting socio-economic conditions of the country and the states. These considerations are best addressed through sector and issue specific grants which are more targeted and can be linked to achievement of desired objectives.

"In our assessment, grants-in-aid are an important instrument which enables the Commission to make its scheme of transfers more comprehensive and address various issues spelt out in the ToR. Grants also allow us to make corrections for cost disabilities faced by many states which are possible to address only to a limited extent in any devolution formula."

13th Finance Commission Report

3. It can be noted that while devolution shares of 13 states has increased as per the committee's recommendations vis-à-vis shares recommended by the 13th FC, quantum of transfers have increased only for 10 states. This is so because transfers from the centre include grants for the state plan and central schemes which are largely recommended by the Planning Commission. These shares differ from the shares recommended by the 13th FC.

Factors forming basis for devolutions recommended by the 13th FC

Criterion for determining the state's share in central taxes	Detail and significance
Population (weight 25%)	Indicates expenditure needs of a state
Area (weight-10%)	States with larger area need to incur additional administrative costs to deliver a comparable standard of service to its citizens
Fiscal capacity distance (difference in per capita revenue) (weight- 47.5%)	To ensure that all states have the fiscal potential to provide comparable levels of public services to their residents, at reasonably comparable levels of taxation
Fiscal discipline (weight- 17.5%)	To provide incentives to states for managing their finances prudently
Criterion for devolution of grants	**Detail and significance**
Local bodies	To supplement the resources of the panchayats and municipalities in the state based on recommendations of respective SFCs and to incentivise states to decentralise further. (State-wise share based on the criteria of population, area, distance from the highest per capita sectoral income; index of devolution; SC and STs proportion in the population and FC local body grants utilisation index)
Disaster relief	To equalise disaster coping capacity of states as there are significant variations in the disaster prone profiles of states and their economic capacity to deal with these
Post devolution non-plan revenue deficit (NPRD)	Represents existence of vertical imbalance yet to be corrected
Elementary education	Equalising expenditure on elementary education across states; further implementation of the Right to Education act will put strain on state's resources
Environment	To allow states to manage environmental risks associated with growth and development including the following: • Preservation of forests • Incentives for states improving their renewable energy capacity • Water sector management
Improving Outcomes	To provide incentives to states that are improving the quality of public expenditure to obtain better outputs and outcomes. These include grants for the following: • Reducing infant mortality rate • Issuing UIDs to citizens • Improvement in administration of justice (like operation of morning evening courts, promotion of alternate dispute resolution (ADR) mechanisms, enhancing support to lok adalats, etc) • Setting up a centre for innovation in public systems (CIPS) • Creation of the district innovation fund • Improvement of statistical systems at the state and district level • Employee and the pension data base

Criterion for devolution of grants	Detail and significance
Maintenance of Roads and Bridges	To allow states to undertake proper maintenance of roads and bridges, a vital infrastructure. Also required to ensure maintenance of the PMGSY roads- high priority rural roads
State-specific grants	To address state specific issues. A few of these issues include the following: • The government of Andhra Pradesh had requested grants for provision of drinking water in fluoride affected areas and in inaccessible tribal areas • The government of Assam had requested funds for border area development • The government of Bihar had requested funds for heritage development including Nalanda Heritage development plan and for development and conservation of archaeological sites, etc
Implementation of model GST	The grant will be used to meet the compensation claims of state governments for revenue losses on account of implementation of GST

Thus, it may be optimal to address the concern of under-development through (under) development linked grants, instead of linking the formula of devolutions to (under) development index (which has been debated to have scope for improvement).

This will prevent significant reshuffling of central devolutions, which can arise, in case devolutions are based on (under) development index based formula.

The (under) development index proposed can possibly be used to provide other (additional) forms of support to the states that are particularly underdeveloped, provided the index can be improved to gain larger consensus.

Round the corner

News bytes

IFC launches a 1 billion USD offshore bond programme

Ministry of Finance, India: 10 October 2013

The International Finance Corporation (IFC), a member of the World Bank Group, has launched a 1 billion USD offshore bond programme, the largest of its kind in the offshore rupee market, to strengthen India's capital markets and attract greater foreign investment during prevailing economic uncertainty across the world. Under the programme, the IFC will issue rupee-linked bonds and use the proceeds to finance private sector investment in the country.

Dr. Arvind Mayaram, Secretary, Department of Economic Affairs spoke on the occasion and said that they see IFC as an important development partner. It has been contributing significantly in financing private sector projects, including public-private partnerships, in several key developmental areas. He said that with the launch of a rupee bond in the global markets, IFC is set to turn a new corner. He further said that it will also help deepen capital markets in India and establish an Indian rupee benchmark in the global markets.

Source: http://www.finmin.nic.in/press_room/2013/IFC_Bond10102013.pdf

Setting up of the Tax Administration Reform Commission (TARC)

Ministry of Finance, India: -21 October 2013

In order to review the application of the tax policies and tax laws in India in the context of the global best practices and to recommend measures for reforms required in the tax administration to enhance its effectiveness and efficiency, the government has set-up a Tax Administration Reform Commission (TARC).

The key terms of reference for the commission include reviewing the existing (1) organisational structure and business processes of tax governance (2) dispute resolution process (3) capacity building measures (4) system to enforce better tax compliance (5) taxpayer services and taxpayers education programme (6) Database and inter-agency information sharing system and processes (7) other areas of tax policies and administration and recommend measures to strengthen these.

The term of the Commission is 18 months and it will work as an advisory body to the Ministry of Finance. The Commission will give its first report within six months and thereafter submit periodic reports after every three months. The Chairman of the Commission is Dr. Parthasarathi Shome, in the rank of a Minister of State.

Source: http://www.finmin.nic.in/press_room/2013/TARC21102013.pdf

India's External Debt: A Status Report 2012-13

Ministry of Finance, India: 6 September 2013

The Department of Economic Affairs, Ministry of Finance has released the nineteenth issue of the annual publication titled 'India's External Debt: A Status Report 2012-13'. The report presents a detailed analysis of India's external debt position at the end of March 2013, based on the data released by the RBI on 27 June 2013. Apart from analysing trends, composition and debt service of India's external debt, the report provides a comparative picture of India's external debt vis-a-vis other developing countries.

Source: http://www.finmin.nic.in/press_room/2013/Press_ExtDebt_Status_Report_201213E.pdf

Paper releases

The International Monetary System: Where are we and where do we need to go?

Working Paper from IMF, November 2013

Prepared by Rakesh Mohan, Michael Debabrata Patra and Muneesh Kapur, this paper focuses on the global financial crisis of 2008-2009, the follow-on Great Recession and the euro area sovereign debt crisis which has spurred renewed interest in reforming the international monetary system (IMS). Large and volatile capital flows have promoted greater volatility in financial markets, leading to recurrent financial crises. The renewed focus on the broader role of the central banks, away from narrow price stability monetary policy frameworks, is necessary to ensure domestic macroeconomic and financial stability. Since the international monetary cooperation might be difficult, though desirable, central banks in major advanced economies, going forward, need to internalise the implications of their monetary policies for the rest of the global economy to reduce the incidence of financial crises.

Source: http://www.imf.org/external/pubs/ft/wp/2013/wp13224.pdf

Fiscal Consolidations and Growth: Does Speed Matter?

Working Paper from IMF, November 2013

This paper is written by Steven Pennings and Esther Pérez Ruiz. It explores whether the speed of fiscal adjustment can improve our understanding of fiscal multipliers. The empirical question at stake is, for a given size of fiscal retrenchment, does it matter to proceed hastily versus more deliberately? In other words, once the overall consolidation needs have been pinned down, should the pace of fiscal consolidation be an additional concern? Specifically, is it the case that fast consolidations display higher multipliers as opposed to slow episodes?

Source: http://www.imf.org/external/pubs/ft/wp/2013/wp13230.pdf

Making Monetary Policy More Effective: The Case of the Democratic Republic of the Congo

Working Paper from IMF, November 2013

This paper, written by Felix Fischer, Charlotte Lundgren, and Samir Jahjah, looks at the challenges of conducting monetary policy in a context of high dollarisation of the banking system and weak institutions in the Democratic Republic of the Congo. The empirical analysis confirms the limited effectiveness of the Central Bank of Congo in controlling inflation, despite a rapid policy response to inflation shocks. There are limited options available to enhance the effectiveness of monetary policy. After exploring the pros and cons of different exchange regimes, they conclude that strengthening the current monetary policy framework remains the first-best option, given the country's exposure to frequent terms-of-trade shocks.

Source: http://www.imf.org/external/pubs/ft/wp/2013/wp13226.pdf

Report of the Dr. Raghuram Rajan Committee for Evolving a Composite Development Index of States

Ministry of Finance, India: 26 September 2013

Dr. Raghuram Rajan Committee's report for Evolving a Composite Development Index of States has been submitted to the Finance Minister. The Committee has proposed a general method for allocating funds from the centre to the states based on both a state's development needs as well as its development performance. The Committee has recommended that each state may get a fixed basic allocation of 0.3% of the overall funds, to which will be added its share stemming from need and performance to get its overall share. The Committee has also come up with a multi dimensional index of backwardness based on the per capita consumption as measured by the NSSO, the poverty ratio, and a number of other measures which correspond to the multi dimensional approach to defining poverty outlined in the 12th Plan. The Committee has recommended that states that score 0.6 and above on the index may be classified as 'least developed' states that score below 0.6 and above 0.4 may be classified as 'less developed' and states that score below 0.4 may be classified as 'relatively developed'.

Source: http://www.finmin.nic.in/press_room/2013/Report_CompDevState_press.pdf

Fiscal Multipliers for India

Working Paper from NIPFP, September 2013

This paper, prepared by Sukanya Bose and N R Bhanumurthy, attempts to present a framework for the estimation of fiscal multipliers for Indian economy in the structural macroeconomic modelling tradition. Empirical estimates of short-run multipliers are obtained by giving shocks to a range of fiscal instruments - expenditures and taxes. As per their estimates, the values of capital expenditure multiplier, transfer payments multiplier and other revenue expenditure multiplier are 2.45, 0.98, and 0.99, respectively, while the tax multipliers are in the range of -1. These estimates point to the strong multiplier effect of capital expenditure on output, and underscore the need to prioritize capital expenditure.

Source: http://www.nipfp.org.in/media/medialibrary/2013/11/WP_2013_125.pdf

Potpourri

Accounting reforms

Public Financial Management (PFM) reforms are guiding transformation from compliance to performance-oriented systems which necessitate comprehensive information requirements on various dimensions. Accordingly, these transformations need to be accompanied with progressive reforms in accounting systems, which essentially involves transition from cash based to accrual[4] based system for government accounting.

Cash based accounting measures the flow of cash resources (revenues and expenses only) by recognising transactions and events only when the cash is received or paid. Accrual based accounting recognises and maintain, in addition, both financial and non-financial assets and liability accounts, i.e. transactions and events embodied in assets, liabilities, revenues and expenses are recognised when they occur, irrespective of when cash is paid or received.

In this way, accrual accounting provides more complete information on fiscal stance, and hence facilitates in gauging the longer term sustainability of public finances. It also infuses strong managerial efficiency by requiring capture of full costs of government activities.

As the experience worldwide suggests, it takes considerable time and resources to effect transition of the accounting regime from cash to accruals, particularly depending on the availability of technical expertise and a modernised government financial management information system (GFMIS)[5].

The evolutionary path charted by the countries suggests that the transition passes through intermediate phases of modified cash based, to modified accrual based accounting before adopting full accrual based accounting and budgeting systems. These modified systems are like intermediate solutions, with one or more components of accrual based accounting missing.

This is so because the requirements of a fully functioning accrual based accounting system are highly sophisticated; e.g. assets will need to be progressively depreciated according to their useful life, which in turn would involve detailed asset registration and updating systems; agreed rules for depreciation and maintenance allowances; procedures for managing inventories, etc.

PwC recently conducted a global survey on accounting and reporting practices of central governments of over 100 countries. The survey provided useful insights into current practices and expected trends in the field of government finance and accounting from around the world.

4. *Accrual means revenues reflecting the amounts that became due during the year, whether collected or not; and expenses reflecting the amount of goods and services consumed during the year, whether or not they are paid for in that period*

5. *Reference: Guidelines for Sequencing PFM Reforms (Background Paper- 1), Jack Diamond, July 2012*

Key findings of the PwC's global survey on accounting and reporting practices of the government

Key findings	Details
There is great diversity in accounting practices but the trend towards accrual accounting is clear	• 54% of the countries surveyed reported to follow cash or modified cash basis of accounting, while only 46% follow accrual or modified accrual basis. • 37 countries express an intention to move to accrual accounting over the next five years.
A major shift to accrual accounting is expected in developing countries, with the international public sector accounting standards (IPSAS) serving as a common reference point	• 50% of non-OECD countries surveyed plan to make transition to accrual accounting over the next five years • International organisations are contributing to the adoption of accrual accounting and IPSAS by laying down reporting requirements for their members or funding recipients and by including financial management reforms in their financial assistance and capacity development programmes
Budgets remain largely on a cash basis	• 89% of the countries surveyed use cash budgets • Accrual budgeting provides better insight for decision-making, considering the long-term impact of political decisions • Accrual budgeting is viewed as complex and politicians are unwilling to change given their understanding of and familiarity with, cash budgeting systems. • Comparison of budgets against actual results is difficult, when accounting and budget documents are prepared on different financial reporting bases (e.g. cash versus accrual)
More than three years is required on average to make transition to accrual-based IPSAS (or similar)	• Transition to accrual accounting concerns the entire organisation, through system changes, process reengineering, and redefinition of roles and responsibilities • The conversion project does not end with release of the first set of government financial statements but requires that accrual practices and related systems, processes, policies and behaviours are adapted to report efficiently under IPSAS (or equivalent) on an ongoing basis, which takes time
The lack of trained staff and IT system requirements are the main challenges	• Trained staff is required for understanding accrual concepts and complex accounting areas such as financial instruments, employee benefits, property valuation and consolidation. • Right IT systems are required to record and report data required for accrual accounting. For e.g.: add details of goods and services received in the expense work-flow, develop new ways of reporting and communicating financial information, etc • A well-designed project and effective change management strategy that considers people and systems requirements are crucial for successful implementation

PwC updates

Our work

Conceptual design of Government Integrated Financial Management Information System (GIFMIS), Government of Philippines

Government of Philippines (GoP) has launched a comprehensive Public Financial Management (PFM) reform programme in 2011 for strengthening and modernisation of PFM across the civil service. The objectives and coverage of the reform programme are enunciated in the Philippine Public Financial Management Reform Roadmap. This is a strategic plan for a whole-of-government approach to PFM reforms and aims to clarify, simplify, improve and harmonize the financial management processes and information systems of the civil service. AusAID, through Philippines – Australia Public Financial Management Program (PFMP), is assisting GoP in implementation of PFM reform roadmap.

Reengineering and modernisation of businesses processes across PFM lifecycle is at the core of the GoP's PFM reform agenda and is among the key priorities of the government. It is aiming towards phasing out disintegrated processes and systems through implementation of a common and Integrated Financial Management Information System (GIFMIS). This is expected to play a crucial role in achieving the stated objectives of PFM reforms roadmap.

From international experiences in developing a modern financial management information system, AuSAID and GoP are aware of complexities, efforts and investments in such system implementation. Accordingly, the GoP took an initiative towards development of a conceptual design for the GIFMIS, which is envisaged to provide guidance and roadmap for implementation of the system.

PwC India was engaged to support GoP in development of GIFMIS conceptual design, which included the functional study for various PFM functions and processes of the government, process reengineering, defining scope of GIFMIS, functionality, institutional structures and roles and responsibilities for system implementation, implementation approach, timelines, critical success factors and other key recommendations to support in system implementation. The study conducted by PwC India covered entire lifecycle of PFM including fiscal planning, budget preparation, expenditure management, revenue management, debt management, auditing, accounting and reporting. Development of conceptual design has been completed successfully and government is moving towards implementation of the conceptual design.

Our people

Amit Tiwari

Designation: Manager, Public Sector and Governance, GRID

Age: 30 Years

Education:

- Chartered Accountant (Nov, 2004), Institute of Chartered Accountants of India (ICAI)
- Diploma in Information Systems Audit (July 2012), Institute of Chartered Accountants of India (ICAI)
- Diploma in International Trade Laws and WTO-I, Institute of Chartered Accountants of India (ICAI)
- Bachelor of Commerce (2002), Kanpur University

Professional Experience: More than 8 years

Worked in: India, Philippines, Sri Lanka

Amit is a Manager with the Public Sector and Governance team of the Government Reforms and Infrastructure Development (GRID) SBU of PwC India. He is a Chartered Accountant and holds diploma in Information Systems Audit. He has 8 years of experience in providing advisory services for public finance management, system study, process documentation, business process reengineering and Public Private Partnership for government clients. He has rich experience of working with development agencies such as Asian Development Bank, World Bank, DfID and UNDP.

Amit had supported development of a conceptual design for Integrated Financial Management Information System (IFMIS) for Government of Haryana. Further, he led the consulting assignment for implementation of IFMIS in Government of Madhya Pradesh under DFID assisted "Strengthening Performance Management in Government" (SPMG) Program. He had also advised GoMP on roadmap for cash to accrual accounting.

He was involved in designing conceptual model framework for accrual accounting at state government level, wherein, he led preparation of annual financial statements for two pilot offices in Government of Andhra Pradesh. He also supported development of Finance and Accounts Manual for Satluj Jal Vidyut Nigam Limited.

Amit has provided advisory support to Pension Fund Regulatory Development Authority, for setting up an implementation mechanism for providing pension to economically disadvantaged persons with low investment potential. He has also advised Controller General of Defence Accounts (CGDA), Ministry of Defence for one of their major computerization initiative.

Recently, he has been involved in development of a conceptual design for Government Integrated Financial Management Information System (GIFMIS) for Government of Philippines, aimed at supporting in effective management of public finances including tax revenues. Currently, he is providing advisory services to Government of Sri Lank in implementation of Integrated Treasury Management Information System (ITMIS).

About us

The public sector and governance practice of the Government Reforms and Infrastructure Development (GRID) SBU of PwC in India has been working closely with clients in the public sector and at all levels of the government as well as key donors such as DfID, JBIC, World Bank and ADB.

A large team of full-time dedicated professionals and associates provides services in public expenditure management, revenue administration, budgetary policy development, financial restructuring, performance improvement, institutional strengthening and capacity-building, accounting and financial management systems and 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 or computerisation and debt management. Most of these projects include training and capacity-building of government counterparts working with the public finance team on specific modules. In addition, the team has gained traction in the public expenditure and financial accountability (PEFA)/fiduciary risk assessment (FRA) areas with assignments across South Asia.

Field visit: Utakramit Madhya Vidyalaya- Documenting the impact of the ADB funded project 'Bihar state highways I for the publication 'India - ADB Development Partnership'

Contacts

Ranen Banerjee
Executive Director, PwC

PricewaterhouseCoopers Pvt. Ltd.,
Building No. 10, 17th Floor,
Tower C, DLF Cyber City,
Gurgaon, India 122002

Telephone: + 91 124 3306 009 (Direct)
Fax: +91 124 3306999
Mobile: + 91 9818886207
E-mail: ranen.banerjee@in.pwc.com

Editorial Team

Aashima Verma
Email: aashima.verma@in.pwc.com

Gunjan Bansal
Email: gunjan1.bansal@in.pwc.com

Contributors for this issue

Ajit Agarwal
Amit Tiwari
Chaithanya Chava
Gautam Naresh
Gunjan Bansal
Karan Mundhra
Pragya Sharma

PD 134 - December 2013 Public finance quaterly Dec 2013.indd
Designed by Brand and Communication, India