ADB

Performance Evaluation Report

Program Number: PPE: IND: 29051
Loan Number: 1717-IND
June 2007

India: Madhya Pradesh Public Resource Management Program

Operations Evaluation Department

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 11 June 2007)

Currency Unit	–	Indian rupee/s (Re/Rs)
Re1.00	=	$0.016
$1.00	=	Rs61.61

ABBREVIATIONS

ADB	–	Asian Development Bank
ADTA	–	advisory technical assistance
BOT	–	build-operate-transfer
CIP	–	core investment program
COSS	–	country operational strategy study
DFID	–	Department for International Development (United Kingdom)
DMF	–	design and monitoring framework
DPE	–	Department of Public Enterprises
DPEP	–	district primary education program
EA	–	executing agency
ECPR	–	Empowered Committee on Public Sector Undertaking Reform
EFC	–	Eleventh Finance Commission
EPA	–	Environment (Protection) Act, 1986
ERC	–	electricity regulatory commission
FRBMA	–	Fiscal Responsibility and Budget Management Act
GDP	–	gross domestic product
GoMP	–	Government of Madhya Pradesh
LGB	–	local government body
LTACC	–	Loan and Technical Assistance Coordination Committee
MCDD	–	mission on control of diarrheal diseases
MOU	–	memorandum of understanding
MPERC	–	Madhya Pradesh Electricity Regulatory Commission
MPHB	–	Madhya Pradesh Housing Board
MPPHC	–	Madhya Pradesh Police Housing Corporation
MPPRMP	–	Madhya Pradesh Public Resource Management Program
MPRDC	–	Madhya Pradesh Road Development Corporation
MPSAIDC	–	Madhya Pradesh State Agro Industries Development Corporation
MPSCB	–	Madhya Pradesh Slum Clearance Board
MPSEB	–	Madhya Pradesh State Electricity Board
MPSEC	–	Madhya Pradesh State Export Corporation
MPSFC	–	Madhya Pradesh State Financial Corporation
MPSFDC	–	Madhya Pradesh State Fisheries Development Corporation
MPSIC	–	Madhya Pradesh State Industries Corporation
MPSIDC	–	Madhya Pradesh State Industrial Development Corporation
MPSLandDC	–	Madhya Pradesh Land Development Corporation
MPSLDC	–	Madhya Pradesh Leather Development Corporation
MPSRA	–	Madhya Pradesh State Reorganization Act, 2000
MPSRTC	–	Madhya Pradesh State Road Transport Corporation

MPSTC	–	Madhya Pradesh State Textile Corporation
MPSTDC	–	Madhya Pradesh State Tourism Development Corporation
MTFF	–	medium-term fiscal framework
NABARD	–	National Bank of Agriculture and Rural Development
NBFC	–	nonbanking finance company
NPA	–	nonperforming asset
NSDP	–	net state domestic product
O&M	–	operation and maintenance
OCR	–	ordinary capital resources
OED	–	Operations Evaluation Department
OEM	–	Operations Evaluation Mission
PAT	–	profit after tax
PCB	–	Pollution Control Board
PCR	–	program completion report
PIA	–	poverty impact assessment
PPER	–	program performance evaluation report
PPMS	–	project performance management system
PRMC	–	public resource management committee
PPP	–	public-private partnership
PSU	–	public sector undertaking
PWD	–	Public Works Department
RRP	–	Report and recommendation of the President to the Board of Directors
SAL	–	structural adjustment loan
SBFAU	–	State Budget and Fiscal Analysis Unit
SBI	–	State Bank of India
SDP	–	state domestic product
SFC	–	State Financial Corporations Act
SFRF	–	states’ fiscal reforms facility
SIDBI	–	Small Industries Development Bank of India
SLR	–	statutory liquidity ratio
SME	–	small and medium-sized enterprise
SPFRC	–	State Public Finance Reforms Committee
SRC	–	Staff Review Committee
SRF	–	state renewal fund
SSA	–	Sarva Shiksha Abhiyan (national primary education scheme)
SSN	–	social safety net
TA	–	technical assistance
TCR	–	technical assistance completion report
TFC	–	Twelfth Finance Commission
UNDP	–	United Nations Development Programme
VAT	–	value-added tax
VRS	–	voluntary retirement scheme

NOTES

(i) The fiscal year (FY) of India and its government agencies runs from 1 April to 31 March of the following year. FY before a calendar year denotes the year in which the fiscal year begins, e.g., FY2000 begins on 1 April 2000.

(ii) In this report, "$" refers to US dollars.

Key Words

asian development bank, development effectiveness, indian finances financial reforms, indian public enterprises reforms, indian state owned enterprises reforms, lessons, madhya pradesh finances financial reforms, operations evaluations departments, policy evaluations, public resources management, social safety nets, technical assistance

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The guidelines formally adopted by the Operations Evaluation Department (OED) on avoiding conflict of interest in its independent evaluations were observed in the preparation of this report. Tapas Sen and Hari Sridhar were the consultants. To the knowledge of the management of OED, there were no conflicts of interest of the persons preparing, reviewing, or approving this report.

BASIC DATA

Loan 1717-IND: Madhya Pradesh Public Resource Management Program

Program Preparation/Institution Building

TA No.	TA Name	Type	No. of Person-Months	Amount ($'000)	Approval Date
2943	Support for the Government of Madhya Pradesh Public Finance Reform and Institutional Strengthening	ADTA	62[a]	780[b]	15 Dec 1997
2944	Strengthening Local Government in Madhya Pradesh	ADTA	42	700	15 Dec 1997
3338	Capacity Building for Public Enterprise Reform and Social Safety Net in Madhya Pradesh	ADTA	52[c]	600[d]	14 Dec 1999

ADTA = advisory technical assistance, No. = number, TA = technical assistance.

Key Program Data	As per ADB Loan Documents	Actual
Total Program Cost ($ million)	250.0	250.0
ADB Loan Amount/Utilization ($ million)	250.0	250.0

ADB = Asian Development Bank.

Key Dates	Expected	Actual
Reconnaissance		30 Nov–12 Dec 1997
Fact-Finding		23 Mar–6 Apr 1998
Appraisal		17–30 Jul 1998
Loan Negotiations		14–16 Apr 1999
Board Approval		14 Dec 1999
Loan Agreement		14 Dec 1999
Loan Effectiveness	13 Mar 2000	15 Dec 1999
First Tranche Release	16 Dec 1999	16 Dec 1999
Second Tranche Release	30 Sep 2000	27 Feb 2002
Third Tranche Release	31 Mar 2002	17 Mar 2003
Program Completion	31 Mar 2002	17 Mar 2003
Loan Closing	30 Sep 2002	17 Mar 2003
Months (effectiveness to completion)	24.5[e]	39.0

Borrower India

Executing Agency Finance Department of the Government of Madhya Pradesh

Type of Mission	No. of Missions	No. of Person-Days
Reconnaissance	1	61
Fact-Finding	1	64
Appraisal	1	75
Review	10	220
Consultation/Project-Specific Contact	2	110
Program Completion	2	28
Operations Evaluation	1	40

[a] Of the 62 person-months, the Asian Development Bank (ADB) financed 44 person-months of domestic consultants and 9 person-months of international consultants. The state government provided the services of a domestic economist/public finance expert as economic adviser to the State Budgeting and Fiscal Analysis Unit (SBFAU) for 9 person-months.

[b] The amount pertains to ADB amount only.

[c] Of the 52 person-months, ADB financed 33 person-months of domestic consultants and 10 person-months of international consultants. The state government was to provide the services of an expert as head of a technical secretariat for the full duration of the public enterprise reform process to be implemented over 9 months.

[d] The amount pertains to the ADB amount only.

[e] These dates come from the ADB project performance management system (PPMS) program performance report. Although the Program lasted 3 years, the report and recommendation of the President (RRP) recorded the loan as commencing in March 1999, and being completed in March 2002. The Loan Agreement became effective on March 2000 and the Program closed in September 2002. The PPMS was not changed to reflect the dates based on the approval in December 1999.

EXECUTIVE SUMMARY

With gross domestic product (GDP) growth averaging about 3.5% per annum for almost four decades after independence, the slow pace of economic growth was of increasing concern to the Government of India. As a result of reforms to liberalize the economy in the early 1980s, economic growth was stimulated to some 5% per year. However, the gross fiscal deficit of the Government and state governments almost doubled through the 1980s, to reach 9.4% of GDP by FY1990. Economic reforms created a competitive environment for domestic manufacturers, and began to put pressure on the large number of central government and state level public sector undertakings (PSU) that had been proliferating in commercial as well as social development fields, under the Government's socialist policies. Containing the fiscal deficits of the central and state governments became the focus of structural adjustment reforms initiated in the 1990s. At the state level, this included the need to improve the efficiency of public expenditure and create an environment to encourage private sector participation in economic growth—in particular, for infrastructure development.

In 1996, the Asian Development Bank (ADB) revised its India country operational strategy and agreed with the Government, for the first time, to support state governments to: (i) broaden and deepen economic and administrative reforms that were lagging behind at state level, (ii) accelerate infrastructure development and industrial restructuring, (iii) maximize synergy and the multiplier effect of ADB's policy dialogue and project interventions, and (iv) improve ADB operational efficiency. ADB's state level strategy of supporting public resource management reforms—particularly fiscal consolidation, PSU reform, and enabling private sector participation—to establish conditions for sector specific loans, was first implemented in Gujarat with the approval of the two-year, $250 million Gujarat Public Sector Resource Management Program (GPSRMP) loan in December 1996.

In early 1997, a second ADB state selection mission visited six states, and recommended Madhya Pradesh as the next state for ADB to apply its state level strategy. Unlike Gujarat, Madhya Pradesh was India's most populated state, with high levels of poverty, poor infrastructure, and a limited industrial base. However, a strong and long-standing political commitment to social development in the state developed urgency for fiscal reform. Design of a proposed loan to support the government of Madhya Pradesh (GoMP) reform agenda began with two technical assistance (TA) projects approved in late 1997, to assist ADB and the GoMP design, and then implement the loan. Although the design was finalized to meet the originally scheduled approval in late 1998, a combination of international sanctions against India in response to its nuclear tests, and the holding of state elections in late 1998, resulted in approval being pushed to late 1999. This decision was to have a deleterious effect on ADB-GoMP relations, which required a sensitive response through 1999.

In early 1999, GoMP published a white paper outlining the scope of its reform agenda, which was consistent with the proposed $250 million Madhya Pradesh Public Resource Management Program (MPPRMP). The 3-year loan, including an attached TA, was approved by ADB's Board of Directors in December 1999, funded by ordinary capital resources. Although there were some abstentions, the Board agreed that the MPPRMP met the basic human needs sanctions criteria imposed in response to India's nuclear tests.

The MPPRMP's expected impact was improved social development and sustainable economic growth through improved public resource management, and increased public expenditure to social sectors for the benefit of the people of the state. The Program's three outcomes remained consistent with ADB's state level strategy of 1996: (i) a well-managed sustainable medium-term public finance framework enabling enhanced resource allocation to social sectors, (ii) PSUs restructured to contribute to the economy by efficiently and effectively using state resources, and (iii) private sector investment developing key sectors of the state economy. Reflecting in part the state context, the MPPRMP explicitly proposed that the fiscal space created by reform would enable increased resource allocation to social sectors.

The GoMP Department of Finance was the Program's Executing Agency, with a policy level public resource management committee (PRMC), chaired by the chief minister, overseeing GoMP's reform agenda. Two empowered committees chaired by the chief secretary—on public finance reform and PSU restructuring—managed reform implementation and reported to the PRMC. A technical secretariat was designed to provide guidance on technical aspects of the PSU reform but it was not established during the life of the Program because of exogenous resource constraints. The PRMC also took on the role of the program steering committee.

The program loan had three tranches: $100 million disbursed on effectiveness, followed by two tranches of $75 million each. The release of the second tranche was delayed by 5 months while ADB, the Government, and GoMP sought assurance that GoMP's legal status was unaffected by the bifurcation of the state in November 2000. Bifurcation affected both fiscal targets and PSU reform, as the division of assets and liabilities between the two states was extremely difficult to resolve, and in some cases unresolved as of 2006. In spite of these delays, the Program was completed in 39 months—3 months later than planned. The completion date of ADB's project performance management system (PPMS) was 9 months less than the time required for a 3-year program based on the Board approval date, and the Loan Agreement closure date was 3 months less.

The MPPRMP was rated "relevant," as it was consistent with the reform agenda of both the Government and GoMP, and ADB's country strategy. The program had strong political support, and momentum was maintained through changes of government. The overall program logic was sound with respect to the three outcomes, but the minimal support to local body fiscal reform, and the extremely limited social service interventions, had a token appearance. Generic risks were assessed, but there was no explicitly reference to the possibility of the state being bifurcated nor to the impact of the Government's Eleventh Finance Commission awards, even though these were being prepared at time of the design. Some feasible mitigation measures were proposed but failure to ensure the institutional arrangements for PSU reform were in place compromised their achievement. Lessons in the program design were drawn from the Gujarat program, other agency subnational programs, and international experience.

The Program was rated "less effective," as two of the three outcomes were not achieved. There was a marginal but not sustained reduction in the fiscal deficit during the program, despite the effect of bifurcation. Social sector expenditure did not increase, although the state's allocation was not generally adversely impacted by fiscal reforms, primarily because of the Government's significant vertical programs in health, education, and poverty alleviation. Interventions to simplify taxes and computerize tax administration and treasury accounts were successful, and the benefits began to be seen in 2006. A study of the counterfactual position, noted the limited analysis period, but found that the loan did not lead to any significant improvement in the overall fiscal situation in Madhya Pradesh in the short term.

Overall PSU reforms remain unfinished, with eight PSUs operationally closed. However, as they are not yet financially closed, the treasury is yet to receive any benefits. Corporate governance reforms have not positively affected management performance. Difficulties in settling the division of assets and liabilities between Madhya Pradesh and the new Chhattisgarh state remain after 6 years, further hampering reform of PSUs selected for divestment.

Reforms to create an enabling environment to attract private sector investment were more successful. The establishment of an independent electricity regulatory authority and the unbundling of the state electricity board had a positive effect in the power sector. ADB has furthered reforms with two loans to this sector in 2001 and 2006. Private sector investment in constructing and maintaining roads and bridges increased significantly, resulting in a large number of toll roads in the state. ADB provided a road sector loan in 2002. The approval of state policies on the environment, and rehabilitation and resettlement were also positive steps, even if the latter is not deemed robust enough to meet ADB standards.

The MPPRMP was rated “less efficient” because the expectation of increased revenue from tax and the sale of PSU shares and assets to contribute to the GoMP share was overambitious, although the adjustment costs were revised down by $70 million to $530 million to account for bifurcation. The number of employees receiving voluntary retirement payments was only 55% of the estimated amount, and GoMP decided against providing any social safety net assistance. Although policy and management committees were efficient, the lack of a technical secretariat constrained the efficient management of PSU reforms, with TA consultants performing tasks instead of government officials. With two of the three TA projects rated “partly successful,” overall the TA resources were “less efficiently” used.

MPPRMP is rated “less likely sustainable.” The tax administration and treasury systems provide a solid foundation for GoMP to maximize the benefits from the newly introduced value-added tax (VAT), particularly if additional targeted support is provided to the computerized systems. If the one-time entries of the last 3 years, 2003–2005, (which negatively affected the fiscal deficit) can be contained, then there is a positive fiscal outlook with (i) potential increases in VAT revenue, and (ii) benefits from meeting Fiscal Responsibility and Budget Management Act targets. This may well create the opportunity to increase social sector allocations and move closer toward Millennium Development Goals. PSU reforms remain on GoMP’s agenda. If the appropriate support can be provided to complete the reforms initiated under the Program, and with other PSUs, then the reformed PSUs could begin to contribute to the economy rather than be a drain on it. Infrastructure improvements, resulting in a significant increase in the number of toll roads under different management, have raised an opportunity to rationalize toll ways and improving traffic flows across the state. With a recently approved power sector loan, it is likely that constraints in this sector will be addressed, thereby encouraging economic growth.

Based on the above assessment, the MPPRMP is rated “partly successful.”

The socioeconomic, environment, and anticorruption impacts have been varied. Although the expected increase in social sector allocations was not met, a range of the Government’s programs supporting improved education and health care outcomes, along with targeted employment generation poverty alleviation programs, ensured that total social sector expenditure was maintained. Given the high levels of poverty in the state, considerable effort will be required to reduce poverty. The approval of environment and rehabilitation policies was an important step in establishing statewide standards. While not explicitly identified as such, a number of reforms establish a basis for further institutional and administrative actions to limit opportunities for corrupt practices. The TA assessed by the Operations Evaluation Mission (OEM) was rated “partly successful” as the TA did not achieve its outputs and outcome, despite the fact that the consultants produced quality advice and adjusted to the failure to establish the technical secretariat.

ADB's performance is rated "less satisfactory." The delay of over 12 months in approving the loan created significant frustration in GoMP before the program began. When funds from a development partner were not available for a key implementation institution, ADB was not able to find an alternative. The India resident mission provided continuous, high quality, monitoring and policy dialogue support during extended periods between missions from ADB headquarters. The Borrower's (GoMP) performance is rated "satisfactory." GoMP's reform policy bodies provided the necessary oversight and management support, and the Executing Agency administered the program efficiently. Inadequate resources constrained the effectiveness of the nodal PSU agency, and the GoMP's economic policy unit.

A number of issues can be identified from the Program: (i) the initiative to support the GoMP to formulate environment and rehabilitation policies is extremely positive; (ii) the scope and sequencing of TA for complex reforms, which are often subject to delay in implementation, raises challenges for ADB; (iii) the method of setting nominal fiscal targets needs to be carefully reviewed, along with mechanisms to respond to the impact of exogenous factors, e.g., to ensure that changes in government policy are not at variance with loan conditions; (iv) a balance is required between revenue and expenditure reforms, and where PSU reforms include closure of PSUs, sufficient time and resources should be provided to at least achieve financial closure; and (v) the importance of ADB's resident mission to maintain continuous support to complex reforms can not be overstated.

Lessons include the following: (i) although the 3-year design time frame was a positive lesson from GPSRMP, a challenge remains for ADB to sustain involvement given the long-term, iterative nature of reform. The experience since MPPRMP of using cluster loans and project loans for institutional and capacity development needs to be assessed; (ii) increased effort is required in design to assess political economy exogenous factors, and agree on mechanisms to ensure that reform targets can be realigned with government policies should the need arise; (iii) balancing the scope of reforms, including explicitly targeting reforms that will further the government's anticorruption efforts, will have significant flow-on effects; (iv) ADB needs to formalize management arrangements to ensure continuous policy dialogue from within the country in complex reform programs that are not delegated to resident missions; and (v) the Board needs to review how it monitors its concerns are addressed by Management during program implementation.

In formulating the India country partnership strategy, the OEM recommends that ADB's state level support strategy, as revised in the 2003–2006 country strategy and program, should be reviewed—including assessing (i) the opportunities to support priority aspects of ongoing state level public resource management reforms, and (ii) the most appropriate funding modalities to achieve jointly agreed outcomes.

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I. INTRODUCTION

1. In 1996, the India country operational strategy study[1] (COSS) of the Asian Development Bank (ADB) was revised to include an agreement with the Government of India to direct a portion of financing to states. The strategy was to support fiscal reforms in preparation for sector-specific loans. This strategic shift in ADB operations in India began with the approval by ADB's Board of Directors of a $250 million loan for the Gujarat Public Sector Resource Management Program[2] (GPSRMP) in December 1996, which was the first program loan provided by a multilateral development bank to a subnational government in India.[3] In late 1997, ADB began discussions with the government of Madhya Pradesh (GoMP) for a similar loan; 2 years later, the Board approved the second state level program loan, also for $250 million from ordinary capital resources (OCR), for the Madhya Pradesh Public Resource Management Program (MPPRMP).[4]

A. Evaluation Purpose and Process

2. The Operations Evaluation Mission (OEM) is being conducted 3 years after closure of the MPPRMP to assess the achievement of outcomes and impact as defined in the Report and Recommendation of the President to the Board of Directors (RRP). The counterfactual position—the effect on fiscal stability in the absence of the Program—is explored, and the performance of the technical assistance (TA) supporting public sector undertaking (PSU) reform is assessed and rated.[5] The OEM uses the United Nations Development Programme (UNDP) human development report expenditure ratios to assess changes in public expenditure on social development.[6] The program completion report (PCR), which rated the program "successful," notes the constraints from exogenous factors such as the bifurcation of Madhya Pradesh, natural disasters, central government policy changes, and market factors, on achieving fiscal and public sector undertaking[7] (PSU) reform targets. The design referred to risks, including generic exogenous factors, and incorporated some mitigating measures. An OEM to India was conducted in October–November 2006 with consultants experienced in public finance and fiscal analysis, and corporate governance and PSU reform in India.

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1 ADB. 1996. *Country Operational Strategy, India*. Manila. 17 April.
2 ADB. 1996. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to India for the Gujarat Public Sector Resource Management Program*. Manila (Loan 1506-IND, for $250 million, approved on 18 December).
3 The World Bank was to follow with public sector resource management program loans to Uttar Pradesh (2000), Karnataka (2001), and Andhra Pradesh (2002).
4 ADB. 1999. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to India for the Madhya Pradesh Public Resource Management Program*. Manila (Loan 1717-IND, for $250 million, approved on 14 December).
5 ADB. 1999. *Technical Assistance to India for Capacity Building for Public Enterprise Reform and Social Safety Net in Madhya Pradesh.* Manila (TA 3338, for $600,000, approved on 14 December).
6 The (i) public expenditure ratio – the percentage of state income going into public expenditure; (ii) social allocation ratio – percentage of total expenditure allocated to social services; (iii) social priority ratio – percentage of social expenditure devoted to human priority concerns (education, health, water, and sanitation); and (iv) human expenditure ratio – percentage of state income devoted to human priority concerns (the product of the above three ratios). These ratios are not used in any of the three Madhya Pradesh human development reports (1995, 1998, and 2002).
7 Public enterprises are referred to as PSUs in Madhya Pradesh. In Gujarat, they are state-owned enterprises (SOEs); in Kerala, state level public enterprises; and in Assam, public sector enterprises.

B. Expected Results

3. The MPPRMP impact (goal) was improved social development and sustainable economic growth through improved public resource management and increased public expenditure in the social sector for the benefit of the people of the state.[8] Key impact indicators include (i) medium-term sustainability of public finances; (ii) increased revenue; (iii) social sector expenditure increased; (iv) improved financial performance of PSUs; (v) private sector investment in key sectors, particularly power and roads; and (vi) improved environmental sustainability. The MPPRMP was designed to achieve four outcomes (objectives): (i) a well-managed, sustainable, medium-term public finance framework enabling enhanced resource allocation to social sectors; (ii) PSUs restructured to contribute to the economy by efficiently and effectively using state resources; and (iii) private sector investment developing key sectors of the state economy.

4. The fiscal consolidation outcome would be achieved with four outputs: (i) financial management institutions strengthened, (ii) medium-term fiscal framework for FY1999–2003 implemented, (iii) improved revenue generation, and (iv) improved expenditure efficiency and effectiveness. The PSU outcome would be achieved with five outputs: (i) institutional mechanisms in place to implement the PSU restructuring policy and program, (ii) selected PSUs privatized, (iii) selected PSUs restructured, (iv) selected PSUs closed, and (v) cooperative sector reform initiated. Two outputs would achieve the outcome of increased private sector participation: (i) an enabling policy and regulatory framework in place; and (ii) key power, road, and housing sector reforms initiated.

II. DESIGN AND IMPLEMENTATION

A. Formulation

5. Following the shift to state level lending and the approval of the GPSRMP, ADB fielded a state selection mission in early 1997, which visited six states.[9] The Mission conducted intensive dialogue with agencies including the World Bank, which was also pursuing a state level strategy and had provided $400 million, mainly to water management and social development projects in the state. The following factors influenced the Mission to recommend Madhya Pradesh as the second focal state: (i) the commitment of GoMP to implementing fiscal reforms, (ii) poorly developed infrastructure, (iii) its position as the most populous state in India with relatively high poverty levels, and (iv) strong political commitment to social development.[10] The state level strategy of supporting fiscal reform prior to sector-specific loans was pursued. It was agreed that, given the broad-based policy reforms with adjustment costs over a relatively short time frame, a program loan would be the appropriate instrument with an explicit focus on social dimensions (health and education) as opposed to Gujarat.

6. GoMP had not undertaken an extensive study of its fiscal position, so ADB was not able to draw on an in-depth analysis as it did in Gujarat where the program was designed by ADB

[8] The OEM has reconstructed the impact, outcomes, and outputs from the RRP, design and monitoring framework, and policy matrix (Appendix 1, Table 1.3) for the purposes of this program performance evaluation report (PPER).

[9] The mission visited Andhra Pradesh, Karnataka, Kerala, Madhya Pradesh, Rajasthan, and Tamil Nadu. The selection criteria were the same as those used by ADB's 1994 mission that selected Gujarat and included the following: (i) demonstrated commitment to reform; (ii) level of need in terms of population and infrastructure; (iii) satisfactory record of project and policy implementation; and (iv) financial capacity, ability, and willingness to take OCR terms and manage foreign exchange risks.

[10] Madhya Pradesh was the first state in India to prepare a state human development report, with UNDP assistance in 1995, followed by updates in 1998 and 2002.

staff and counterparts without the support of TA. In Madhya Pradesh, with loan approval originally planned for the third quarter of 1998, two 12-month TA were proposed in mid-1997 as part of the loan preparation and implementation strategy. A fact-finding mission in October 1997 confirmed the objectives and scope of two TA projects—one focusing on public finance, the other on strengthening local government—which were approved by the President in December 1997.[11] These advisory TA projects (ADTA projects) were dual-purpose, providing information and building capacity in key institutions in preparation for loan implementation, while assisting GoMP to begin the reform process. While the scope of the public finance TA was reflected in the scope of the fiscal reform measures supported by the subsequent loan, the loan contained only one covenant to further local government fiscal reform.

7. As planned, the MPPRMP was substantially designed by mid-1998, although not approved until December 1999. Consequently, experience from GPSRMP—the only other similar subnational program in India—was limited. However, the design recognized that (i) reform programs should focus on strong policy measures from the outset, creating a broad base to build on and reflecting the Government's commitment; (ii) capacity development and institutional strengthening are critical to maintaining reform momentum and require targeted TA; (iii) the link between public finance and power sector reform (in particular tariff revision) and ensuring at an early stage of comprehensive reforms that an appropriate regulatory and pricing framework is in place for the power sector; (iv) regular monitoring and close interaction between the GoMP and ADB is important to assess progress on compliance; (v) the high poverty levels in Madhya Pradesh emphasis the need for the Program to address social sector policy issues, provide an effective social safety net (SSN), and reform cooperative institutions; and (vi) provide adequate time to achieve reforms by designing a 3-year program. Although there was a significant body of literature on PSU reform by the mid-1990s, there is no direct reference in the RRP to this experience. Yet, the PSU reform measures mainly address these key lessons.

8. Loan processing was to fall victim of a combination of geopolitical considerations—international sanctions imposed on the Government in response to conducting nuclear tests in May 1998, and state government elections—and concerns that the Program may be used in campaigning for state elections scheduled for November 1998. A draft RRP was prepared by May 1998, and the June management review meeting recommended that the July appraisal mission assess (i) the implications of proposed national level policy changes, and (ii) the institutional capacity of the state to implement and pursue the proposed reforms, while deferring the GoMP and central government request to increase the loan amount to $300 million to a later date. In the meantime, the Board representatives of the Group of 7 (G7) countries voiced their concerns to the President that, as international sanctions were in place, all loans to India must meet basic human needs criteria as defined in a memorandum of the deputy secretary of the US Treasury.[12]

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[11] ADB. 1997. *Technical Assistance to India for Support for the Government of Madhya Pradesh Public Finance Reform and Institutional Strengthening*. Manila (TA 2943-IND, for $780,000, approved on 15 December). ADB. 1997. *Technical Assistance to India for Strengthening Local Government in Madhya Pradesh.* Manila (TA 2944-IND, for $700,000, approved on 15 December).

[12] Morrow, D. and M. Carriere. 1999. The Economic Impacts of the 1998 Sanctions on India and Pakistan. *The Nonproliferation Review.* (Fall): 10. Available: http://www.cns.miis.edu/pubs/npr/vol06/64/morrow64.pdf. Morrow and Carriere argued that the overall economic effects of sanctions "had a marginal—but not negligible—effect on the nation's economy [and] would have had a greater effect if they had remained in place for several years and thereby affected significantly not just the commitments but also the disbursements of official creditors such as the World Bank." The GPSRMP incentive tranche to the second tranche release was approved by the Board during the sanction period, with some Board representatives of G7 countries arguing that the sanctions should apply as the Program did not fit the basic human needs criteria, and a tranche release should be treated as a new loan. Others

9. In preparation for the loan and technical assistance coordination committee (LTACC) meeting,[13] staff consulted with G7 country executive directors to confirm that the proposed loan met these criteria.[14] Although there was general agreement that the proposed loan met the basic human needs criteria, the proposed stand-alone TA to support PSU reform did not,[15] and the program loan approach was problematic for some. These executive directors needed to revert to their capitals prior to the Board meeting, which would take some weeks when the processing time was limited by the state government election timetable.[16] In order to meet commitments to GoMP that the loan would be negotiated by September 1998, staff proposed that the loan should be processed up to completion of loan negotiations so that it could be submitted to the Board by early October, or failing that, when sanctions were lifted. Staff argued that GoMP had demonstrated its strong commitment by already implementing some politically sensitive reforms involving considerable adjustment costs. Further, the policy reform agenda had been finalized with GoMP, and deferring loan negotiations could be interpreted as a weakening of ADB's commitment to supporting reforms. It was also noted that the World Bank had recently approved an economic restructuring program similar to the MPPRMP with Andhra Pradesh government.[17]

10. While the above discussions were going on, in mid-August 1998, the findings of the Appraisal Mission that all first tranche conditions were expected to be achieved by the end of the month (a precondition for loan negotiations) were presented to the staff review committee (SRC). It was reported that both the Government and GoMP were very keen for loan negotiations to take place before the end of August 1998 to avoid problems with electoral rules. The SRC agreed to defer a decision on the loan amount and timing to the LTACC meeting, after which loan negotiations were envisaged for late August or early September, followed by a proposed Board meeting in early October. This schedule was not maintained. First, as GoMP was later informed, the LTACC meeting could not be arranged in late August as the President, as chair, was on mission. Second, in early September, the President expressed his concern that the risk of the loan being used for political purposes in the upcoming elections was too great, and the option of proceeding to loan negotiations was put on hold.

11. The state elections were held and the ruling Congress Party was reelected.[18] However, ADB's decision to delay processing the loan led to considerable frustration in GoMP, which expressed its dismay in a strongly worded letter to the Government's finance secretary requesting assistance in getting the approval process on track. The fallout included a senior GoMP official involved in loan formulation being reassigned and the technical secretariat, which had been established and staffed by August 1998, being disbanded never to be reestablished.[19] The credibility of the ADB team was seriously undermined and considerable time was spent rebuilding relationships with counterparts who were somewhat wary through 1999. In February

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argued that the loan was approved prior to sanctions, the tranche was not a new loan, and therefore sanctions did not apply.

[13] The LTACC meeting, then chaired by the President, was the final Management meeting to discuss a loan prior to it being submitted to the Board for consideration.

[14] Two loans were being prepared at the time. The Rajasthan Urban Infrastructure Development Project (1647-IND, for $250 million) was also discussed with G7 directors, met the criteria, and was approved on 5 December 1998.

[15] There was a view by some that the criteria did not apply to TA.

[16] Electoral commission rules prohibit major policy announcements during a period of 60 days prior to an election.

[17] The Andhra Pradesh Economic Restructuring Project, approved in June 1998 for $543.2 million, aimed to provide resources to meet priority needs in human development (primary health, nutrition, and primary education); and in the maintenance of economic assets affecting the rural poor (irrigation, rural roads, and core access roads).

[18] Madhya Pradesh was the only state where the incumbent party maintained its majority.

[19] The director resigned in November 1998.

1999, on advice from ADB, GoMP published a white paper outlining specific policy measures in its reform agenda, including reform of sales tax, reduction of subsidies through improved cost recovery and increased electricity tariffs, and restructuring PSUs. One week later, GoMP revised electricity tariffs, including a substantial increase in agricultural tariffs. By March 1999, ADB staff reported to the LTACC[20] that all prior actions and first tranche conditions had been fully complied with, and loan negotiations were held in April. However, 8 months passed before the Board approved the loan in December 1999.

12. Two issues dominated the Board discussion of the proposed loan: (i) whether the sanctions imposed in response to India's nuclear tests restricting funding to projects addressing basic human needs applied, and (ii) if the Program was consistent with ADB's program loan lending policy. Directors representing five countries abstained, three on the grounds that the Program was not addressing basic human needs, and two that the volume of program loans in 1999 already significantly exceed the current Board-approved target for the year. An alternative position—that the Program met the basic human needs criteria with over half of the counterpart funds being explicitly earmarked for incremental expenditure in basic health, primary education, and rural sanitation, and the remainder being used to mitigate the social impact of public enterprise reform—was noted. Directors agreed with the 3-year, three-tranche approach, but the institutional capacity to implement complex reforms and sufficiency of TA support were raised. They called for close monitoring involving the resident mission, including the social impact, gender inequities, and the provision of measures to promote the access of vulnerable groups to social services.[21] They were concerned about the debt-carrying capacity of this very poor state to ensure that the client is not placed in a riskier financial position than it would be without the loan. Directors noted that the large number of government entities involved would pose a serious risk to project success and sustainability, questioning the effectiveness of a coordination committee to drive the reforms.

B. Rationale

13. In 1998, Madhya Pradesh was India's largest state, covering over 13.5% of India's landmass with 77 million people of whom over 30% were scheduled tribes and castes—the most economically disadvantaged. However, with per capita income of Rs7,500 ($176), Madhya Pradesh was one of India's poorest states, with an agriculture-based economy, the third highest level of poverty in 1999 at around 38%, and wide gender gaps in access to resources and social services. Even after bifurcation of the state in 2000, Madhya Pradesh was India's second largest state by population and area.[22] The state's fiscal problems date back to the early 1980s, but they rapidly deteriorated in the second half of the 1980s when a major upward revision of public employees' salaries took place through the awards of the fourth pay commission. In the second half of the 1990s, the fifth pay commission awards stimulated another round of public employee salary revisions, again straining state public finances which were still struggling to recover from the effects of the earlier round.[23]

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[20] As reported in the mission leader's statement to the LTACC, 12 April 1999.

[21] For example, the preparation of a project administration memorandum introduced to the Project Administration Instructions (PAI 1.05) on 1 July 1996, aimed at assist the Client and ADB to monitor implementation accurately.

[22] The state was bifurcated in 2000 with the new state of Chhattisgarh being formed from 16 eastern districts of the former Madhya Pradesh (some 30% land area) with over 25% of the former state's population, including a large proportion of scheduled tribes and castes. As a result, Madhya Pradesh became India's second largest state with a population in 2006 of over 60 million.

[23] Sen. T. 2000. *Reforming state finances and intergovernmental fiscal relations in India*. National Institute of Public Finance and Policy. New Delhi. Sen argues that, although these were important proximate causes, there were other reasons.

14. The finances of states in India in general and relatively poor states like Madhya Pradesh in particular, are heavily dependent on fiscal transfers from the Government. These transfers come through three channels: (i) the finance commission (sharing tax revenues), (ii) the planning commission (loans and grants for economic and social development expenditure), and (iii) discretionary transfers from central government ministries (vertical programs) which seldom pass through state budgets. The Eleventh Finance Commission (EFC) was in the process of making its recommendations when MPPRMP was approved. Its report, submitted in 2000 for an award period from FY2001 to FY2005, substantially increased the amounts received as the state's share in central government taxes. It recommended sharing all central taxes instead of only two—personal income tax and union excise duty—as had previously been the norm. This recommendation was implemented through a constitutional amendment. However, grants dropped from FY1999 levels after a small increase in FY2000 and subsequent years, from all three sources noted above. The net increase in current transfers from the Government was thus modest.

15. Rising fiscal deficits at the state level through the 1990s drove India's aggregate fiscal deficit to a high level (9.46% of GDP in FY2000 and 9.21% in FY2001). The Government was concerned about the macroeconomic implications of the rising fiscal deficit, particularly the drag on aggregate savings and investment, with its adverse implications for growth. However, the fiscal deficit level of the central Government was higher than all states combined. Further, the state level deficits ensured low capital expenditures on infrastructure, increasing infrastructural bottlenecks and dampening private investment. To stimulate economic growth, it was increasingly necessary to undertake careful fiscal reform that would efficiently boost the state's receipts and reduce unproductive expenditure. There was broad agreement among the Government, independent researchers, and the multi- and bilateral development agencies on this issue. The World Bank and ADB were already supporting state level reform, and the Government was attempting to encourage state level fiscal reforms through a system of memoranda of understanding (MOU) with individual states; this produced mixed results.[24] The fiscal condition of Madhya Pradesh was typical of most states, with the added problem of low levels of social development badly in need of state government attention.[25] GoMP was acutely aware of this situation, which provided the main impetus for fiscal reform in the state.

C. Cost, Financing, and Executing Arrangements

16. The reform adjustment costs were estimated at about $600 million for 1999–2002. PSU reforms accounted for about 70%, of which non-personnel outlays accounted for 50%, and voluntary retirement and social safety net costs another 20%. Revenue losses from tax reform measures were estimated at $185 million, around 30%. The state government request to increase the loan from $250 million to $300 million, in line with the department's projections, was presented to the various ADB internal management committee meetings. However, the President decided that the loan limit would be unchanged at $250 million.[26]

17. The MPPRMP was a three-tranche $250 million loan to the Government. The rupee counterpart funds generated from the loan proceeds were transferred to GoMP by the Government to government of Gujarat on a 70:30 loan-grant ratio with the loan carrying 11.8%

[24] See Sen. 2000 (footnote 23) and Rao, G. M. 2002. State Finances in India: Issues and Challenges. *Economic and Political Weekly* XXXVII (31): 3261–3271.

[25] In India, social services are primarily in the domain of the state government, not the central Government. However, in practice, the central Government is the main player with respect to poverty alleviation through vertical programs, but not other social services.

[26] This issue was presented at the Management Review Meeting, SRC, LTACC meetings.

interest and 15 years maturity. The exchange rate risk was assumed by the Government. The transfer was treated as additional to the annual center-state fiscal transfers. It was estimated that the effect of bifurcation reduced adjustment costs by $70 million to around $530 million. The tax revenue loss was estimated to decline from $185 million to $150 million, and the PSU adjustment costs to decline by $35 million or higher depending on the ultimate restructuring plan for selected PSUs. Accordingly, the loan size was justified on the basis of the revised adjustment costs for the truncated Madhya Pradesh state.

18. The Government requested that the portion of the loan under the initial Loan Agreement that had not been disbursed as of 26 February 2002, be subjected to the terms and conditions of ADB's London interbank offered rate (LIBOR) based lending facility. ADB and the Government agreed that, as of 26 February 2002 (the transformation date), the loan would comprise (i) a pool-based loan of $100 million, and (ii) a LIBOR-based loan in the amount of $150 million. Therefore, the initial Loan Agreement was amended and restated to provide for the application of different terms and conditions to (i) the portion of the loan disbursed as of the transformation date, and (ii) the portion of the loan that remained undisbursed as of the transformation date.

19. The GoMP finance department was the Executing Agency (EA). A policy level public resource management committee (PRMC), chaired by the chief minister, was established to advise and oversee implementation of the reforms. Two empowered committees—on public finance reform and PSU restructuring, both headed by the chief secretary with secretaries of relevant departments as members (finance, commercial taxes, and public enterprises department)—managed reform implementation reporting to the PRMC. A technical secretariat was to be established to provide guidance on technical aspects of the PSU reform. However, this was never established during the life of the Program. A special purpose project steering committee was not established; rather, the PRMC assumed this role.

D. Scheduling and Design Changes

20. The program period was originally envisaged to be approved in 1998. This was revised in early 1999 to April/May 1999. The loan was finally approved in December 1999 for a 3-year period, which meant it should have been completed in December 2002. However, ADB's project performance management system (PPMS) program performance report, following the dates in the RRP, recorded the Program as commencing in March 1999, completed in March 2002, and therefore closed 6 months later in September 2002. The Loan Agreement dated 14 December 1999 refers to the final date for withdrawals from the loan account as 30 September 2002, 33 months from effectiveness.

21. The program loan was to be disbursed in three tranches, with the first tranche of $100 million released on 16 December 1999 when the MPPRMP was declared effective. The second tranche of $75 million was disbursed in February 2002 and the third tranche of $75 million was disbursed in March 2003, upon compliance with the corresponding tranche conditions. Both releases were behind the planned schedule primarily because of the effect of bifurcation. It took some time for ADB, the Government, and GoMP to be assured that the legal status of GoMP as defined in the original Loan and Program Agreements was unchanged. This led to a delay of 5 months in releasing the second tranche.[27] Bifurcation continued to impact PSU restructuring

[27] An ADB mission in February 2002 sought clarification from GoMP as to whether GoMP alone was obliged to fulfill the contractual obligations stipulated in the Program Agreement after 1 November 2000, and whether GoMP consequently was alone entitled to draw on and had to repay the second and third tranches of the ADB loan provided to India under the Loan Agreement. Although the mission recommended that the Program agreement be

through the remainder of the Program, resulting in a 9-month delay in the release of the final tranche on 17 March 2003, with program completion and loan closure some 39 months after approval.

22. No design changes were affected during implementation. Although a concern was raised after bifurcation that the Loan Agreement may need to be revised, this was not necessary. In response to a clarification from GoMP on the interpretation of "closure" with regard to some PSU loan conditions and covenants, ADB confirmed that "closure" according to the second tranche condition may be interpreted as operational closure rather than full legal closure in terms of the Industrial Disputes Act, 1947, settlement of workers' dues, or settlement of creditors dues through closure under the Companies Act, 1956.[28]

E. Results

23. The OEM redefined the Program's impact, outcome, and output statements for the purposes of this PPER to reconcile the inconsistencies and ambiguities between the descriptions in the RRP text, design and monitoring framework (DMF), and policy matrix (paras 3–4). The Program's DMF is provided in Appendix 1 Table A1.1, followed by a comparison of the Program's structure in the text, DMF, policy matrix, and Loan Agreement (Tables A1.2 and A1.3); and OEM's reconstruction of the key DMF statements (Table A1.4). Appendix 2 summarizes the status of compliance by condition and covenant at the time of tranche release, PCR, and OEM.

1. A Well-Managed Sustainable Medium-Term Public Finance Framework Enabling Enhanced Resource Allocation to Social Sectors

24. **Financial Management Institutions Strengthened.** To establish the institutional arrangements underpinning GoMP's fiscal reforms, three covenants were agreed. As part of loan effectiveness, GoMP established a policy level PRMC chaired by the chief minister to advise and oversee the implementation of state reforms including the establishment of an enabling environment and the respective policy, institutional, and regulatory issues. The PRMC acted as a steering committee for the MPPRMP and provided guidance to two technical empowered committees—on public finance reform and PSU—headed by the chief secretary reform. All three committees met as required during the life of the Program. In June 1999, a second covenant was met when the State Budget and Fiscal Analysis Unit (SBFAU) was established in the finance department to provide improved budget planning, monitoring, and economic policy analysis—including implementation of the medium-term fiscal framework and advice to the empowered committees.[29] However, the unit was inadequately staffed to perform these functions, with an economic advisor (consultant) and one mid-level official. Rather than provide the kind of economic policy advice that was envisaged, it was limited to providing the state finance commission with financial information. At the time of the OEM, only the official remained. The final covenant to computerize and network the finance department's treasury operations—to improve the effectiveness of payment and audit systems and expenditure control through an upgraded management information system—was successfully implemented,

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re-executed with GoMP, and the Loan agreement with the Government be restated and amended, this was not deemed necessary and the second tranche was released on 27 February 2002.

[28] Manes, Eric. 2001. *Back-to-Office Report of Review Mission for Madhya Pradesh Public Resource Management Program*. Manila (Loan 1717-IND, 13 February).

[29] The State Budget and Fiscal Analysis Unit (SBFAU) was established on 7 June 1999 with the support of Technical Assistance to India for Support to the Government of Madhya Pradesh Public Finance Reform and Institutional Strengthening, approved 15 December 1997 for $780,000.

significantly improving expenditure management beyond the life of the Program. Although it was not explicitly referred to as such, this action has significant anticorruption implications.

25. **Medium-Term Fiscal Framework for FY1999–2003 Implemented.** The MPPRMP projected nominal fiscal deficit levels to be achieved as tranche release conditions. For loan effectiveness, the primary deficit was to be below 3.4% of state domestic product (SDP) and capital expenditure to be at least 1.6% of SDP in the FY1999 budget. By the first tranche, the primary deficit was to be below 1% of SDP and capital expenditure at least 2% of SDP in the FY2001 budget. By the final tranche, progress in fiscal consolidation would be evidenced by the primary deficit being below 0.7% of SDP, and capital expenditure at least 2.3% of SDP in the FY2002 budget.

26. The effect of three exogenous factors during the program period on the state's fiscal condition undermined these projections. First, the net increase in transfers from the Government as a result of the EFC was less than expected. Second, the state was bifurcated in November 2000, carving out the new state of Chhattisgarh from the previous Madhya Pradesh—affecting revenue, power availability, and expenditure responsibilities. Revenue decreased mainly because much of the high value mineral bearing areas of the state were in Chhattisgarh, thus negatively affecting the tax and non-tax (royalties) receipts of the truncated Madhya Pradesh. Similarly, a larger share of the power plants went to Chhattisgarh on the basis of location, leaving the truncated Madhya Pradesh with a serious power shortage. The issuance of Ahluwalia bonds[30] for power sector debt also affected the state's revenue base. In terms of expenditure responsibilities, there were mixed effects. The smaller Madhya Pradesh had a larger share of the population in comparison to its area, which implied larger public expenditure. Moreover, a large majority of government employees—given the choice of Chhattisgarh or truncated Madhya Pradesh—chose the latter, causing a disproportionately high salary burden on Madhya Pradesh. Conversely, most of the comparatively underdeveloped districts of the state, generally with a higher than average scheduled tribe population, went to Chhattisgarh, thus reducing the development expenditure in these areas (Appendix 3 analyzes the impact of bifurcation). The final factor was widespread floods in August 2000, which raised expenditure needs while adversely affecting revenue.

27. A summary of the fiscal situation in Madhya Pradesh for the decade FY1995–2004 (Appendix 4, Table A4.4) shows that, with the exception of the last 2 years of the series, the deficit figures peaked in FY1998 at 3.3% SDP, followed by a fiscal correction of 1.5–1.9% until FY2002, coinciding with the MPPRMP. Although neither the fiscal deficit nor capital expenditure figures projected for the respective tranche releases were met, there was an improvement in the fiscal condition during the life of the MPPRMP, despite the effect of exogenous factors. However, the fiscal deficit deteriorated after the MPPRMP closure—mainly because of a series of one-time entries. For example, in FY2003, almost the entire increase in the deficit can be traced to a jump in the non-plan revenue, roughly the same as current expenditures on economic services. Again in FY2004, the sharp drop in revenue deficit, changing to a surplus, is mainly attributable to a large (probably one-time) receipt in the power sector. Similarly, the 6.3% fiscal deficit—

[30] In 2000, the Government formed an expert committee chaired by Montek Ahluwalia to settle outstanding state electricity board dues to central power sector PSUs. The Ahluwalia committee recommended issuing bonds (referred to as "Ahluwalia bonds") to restore the financial viability of state electricity boards. The bonds were for a 15-year period with a 5-year moratorium on payment of the principal, and issued through the Reserve Bank of India at a tax-free interest rate of 8.5% with lock-in restrictions and with 10% being released into the secondary market per annum. To improve their financial standing, the state electricity boards would accept reform-based performance milestones such as establishing a state power regulator, metering distribution feeders, and improving revenue realization.

despite a revenue surplus—was due to a large increase in capital expenditure on economic services. In 2005, GoMP enacted the Fiscal Responsibility and Budget Management Act (FRBMA), agreeing with the Government to reduce the fiscal deficit to 3% SDP by FY2008. With the fiscal deficit reduced to 4.08% in FY2005 and expected to be 3.69% in FY2006, GoMP is on track to receive incentives, including a loan waiver from the Government for complying with the Fiscal Responsibility and Budget Management Act conditions.

28. **Improved Revenue Generation.** This output was to be achieved by rationalizing the sales tax system, reforming stamp duty in line with recommendations of the 1996 and 1997 state finance minister's committee on stamp duty, and improving cost recovery of water and utilities charges. Revenue generation did not improve during the life of the Program, but positive changes occurred after program closure in 2004; with the adoption of value-added tax (VAT) in 2006, significant additional revenue is expected.

29. Rationalizing the sales tax system was to be achieved through five covenants, leading to a second tranche condition to introduce VAT. Prior to effectiveness, GoMP had widened the tax base by reducing the number of goods exempted from tax (under Schedule I of the Madhya Pradesh Commercial Tax Act, 1994) from 93 to 39 items, and reduced the number of sales tax rates from six to four (2%, 4%, 8%, 12%). Some amount of computerization and training of tax commissioners and tax officers on commercial taxes and taxation policy took place, but several facets of sales tax and VAT administration are yet to be computerized. Although the Madhya Pradesh assembly passed the VAT legislation on 7 August 2002, making it one of the first states to prepare legally for VAT, it was not introduced until April 2006 because of restrictions from the Government. Therefore, it is appropriate to review the entire administrative structure and computerized system for VAT.

30. **Reform Stamp Duty.** Three covenants were agreed with reform of the stamp duty system in line with recommendations of the state finance minister's committee on stamp duty (1996), including reducing the maximum rate on conveyances and rationalizing stamp duty on capital market instruments achieved prior to effectiveness. Although the valuation system for stamp duty was reorganized with central and regional valuation cells, and a new methodology to assess properties for levy of property tax introduced, the valuation systems for property tax and for stamp duty continue to be different. The covenant to implement property tax reform for local government, including preparation of ready reckoners for tax assessment does not appear to have had a significant impact on local bodies' finances despite substantial independence granted to them. The own resources of even urban local bodies continue to be totally inadequate to meet their expenditure responsibilities, resulting in poor operation and maintenance (O&M) of assets.

31. **Improve Cost Recovery.** An effectiveness covenant to adjust water charges to cover at least 50% of O&M expenditure was met, and by the beginning of FY2002 it was reported that about 70% of O&M expenditure was covered by water charges. A cabinet order, passed on 31 July 2002, raised O&M charges by a further 5% for FY2002 and stipulated additional increases of 5% annually for the subsequent 5 years, meeting the second tranche condition of covering at least 75% of O&M expenditure. However, at the time of the OEM, irrigation water charges are reported to have fallen below the prescribed level. No recent figures are available for charges levied for water supply by urban local bodies, but they are reported to be well below the prescribed level. As the utilities commission was not established, a time-bound action plan and coordinated system of managing utility user charges for enhanced sustainability was not achieved. Utility rate revisions have been undertaken in the power and water sectors by the respective regulatory authorities on an ad hoc basis.

32. **Improved Expenditure Efficiency and Effectiveness.** This would be achieved by a number of sequenced conditions and covenants to rationalize and prioritize expenditure, reallocate expenditure to social services, and shift priority from current to capital expenditure. The rationalization and prioritization of expenditure would be achieved through strengthening expenditure management by preparing and monitoring the implementation of a core investment plan (CIP); and approving policy, legislation, and administrative orders to control the numbers of state government employees. Prior to loan effectiveness, GoMP had rationalized the industrial incentive scheme by increasing the negative list, and prepared a policy and draft legislation to prohibit absorption of employees of PSUs into the civil service. The legislation was passed in December 2000 (a second tranche condition) introducing competitive, merit-based appointments to government positions. The third tranche condition to adopt a flexible wage policy by enabling local governments to have service conditions and salary scales for their employees, separate from the state government, was met through an administrative order. However, this has resulted in large numbers of teachers and primary health workers being engaged under unattractive contractual conditions. It is reported that the standard of education and health delivery has significantly lowered as few contracted teachers or health workers have been adequately trained or are qualified, other than being residents of the village in which the school or health center is located.[31]

33. A CIP was prepared for 2000–2004 but it was not sustained as GoMP adopted the Fiscal Responsibility and Budget Management Act, 2005, which requires the state to prepare a 3-year rolling medium-term fiscal framework (MTFF) with accompanying rules that specify the path to a zero revenue deficit, and a maximum of 3% fiscal deficit as a ratio of SDP by FY2008. In FY2005, the state prepared an outcome budget that, despite its title, contained few meaningful performance measures—perhaps because this was the first such budget to have been prepared. A gender budget was also reported to be under consideration.

34. **Reallocate Expenditure to Social Services and Shift Priority from Current to Capital Expenditure.** Prior to effectiveness, with TA support, GoMP undertook a study on the policy and regulatory frameworks of health and education sectors—including the level of user fees in social service facilities; and cost of services to identify potential for further resource reallocation toward primary and preventive health care, and elementary education. Attempts to clear the backlog of capital expenditure and shortfall of non-personnel expenditure in health centers through increased annual budget allocations were not successful during the program period. Although a plan was prepared to ensure that the present levels of social sector outlays are protected from budgetary cuts, the social allocation ratio[32] shows a reduction from FY1999 levels in subsequent years (23.7% in FY2004 compared with 34.2% in FY1999), but the social priority ratio is fairly steady (Appendix 4, Table A4.4). However, some social sector expenditure—including the central share of the national primary education scheme (SSA) and of some of the health schemes such as Reproductive and Child Health II—was moved off budget. Meeting national norms still appears to be a long-term goal, but the gap between national averages and state indicators is closing very slowly. The third tranche condition—to include

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[31] A primary and upper primary school dropout rate of over 20% reflects, among other things, quality of teaching, learning, and confidence of parents in keeping their children in school. Surveys of primary health care stations in rural areas show that 90% did not have a female medical officer, 40% of doctor posts were vacant in 2002–2003, and 20% did not have a doctor in 2005. Sen, T. *Financing Human Development in Madhya Pradesh*. Draft paper National Institute of Public Finance and Policy. New Dehli.

[32] Calculated in accordance with UNDP human development report standards. The social allocation ration measures social sector expenditures as a ratio of total expenditures. The social priority ratio measures the percentage of social expenditure devoted to human priority concerns (education, health, water, and sanitation).

appropriate additional budgetary allocation equivalent to the Government's share to ensure the sustainability of the district primary education program after termination of assistance from the Government—was overtaken by the introduction of the Government's SSA scheme, which covers the entire state. Consequently, the total expenditure on education (the Government plus GoMP share) is substantially higher than before its introduction. However, only the GoMP's own expenditure and its 25% share of SSA expenditure is shown in the budget figures. The two covenants to address health issues, through support to the activities of the mission on control of diarrheal diseases, were achieved. The mission was extended beyond the 40,000 target to 51,000 villages. As 20,000 villages became part of the new Chhattisgarh state, the third tranche covenant was not appropriate. The mission ended after achieving its target.

35. The second tranche condition—that state government employment, other than technical positions in essential social services and police, be reduced through natural attrition, and such posts abolished with resources saved through natural attrition to be reallocated to poverty-reducing social services—remains under judicial review, with some of the daily wage workers having to be reinstated from 2004. Some 60,000 posts were identified and the policy of natural attrition continues. New schoolteachers are no longer employees of the state government. However, expenditure contractions generally do not appear to have been large enough to either control deficits or increase social sector expenditures. In general, although deficits have been controlled and GoMP social sector expenditures have been maintained, the overall level of social sector expenditures increased through the program period.

2. Public Sector Undertakings Restructured to Contribute to the Economy by Efficiently and Effectively Using State Resources

36. Fourteen of the state's 31 PSUs—ranging in size, purpose, and viability—were selected for reform. A combination of a policy-level committee, an advisory technical secretariat, and an enhanced line department would ensure transparency and accountability. Appendix 5 analyzes the reform, including a detailed update of the status of the targeted PSUs.

37. **Institutional Mechanisms in Place to Implement the PSU Restructuring Policy and Program.** An empowered committee on public enterprises restructuring, headed by the chief secretary with principal secretaries of key GoMP departments, was established prior to loan effectiveness. Its mandate was to review and approve: (i) the extent of shareholding to be divested in those enterprises identified for privatization or divestment, (ii) acceptance of the bid of successful bidder in case of privatization, (iii) price at which shares will be offered to public in case of divestment, (iv) restructuring plans to be adopted for enterprises being restructured, and (v) enterprises to be closed. A technical secretariat was established in August 1998 to act as an advisory body to the empowered committee, with responsibility to (i) undertake preparatory and technical analysis of PSUs; (ii) conduct valuation of PSUs; and (iii) provide TA on reform options, including restructuring and divestment. However, one of the impacts of ADB's decision to delay processing the loan until a year later was the disbanding of the technical secretariat and its staff. When the loan was approved in late 1999, the technical secretariat had not been reestablished and was never established during the life of the Program. In the absence of the technical secretariat, the departments of finance and public enterprises prepared a note on PSU reform experience to meet the second tranche condition to this effect.

38. The United Kingdom Department for International Development (DFID) was very interested in supporting reforms in the state, and it proposed a substantial grant project[33] to complement the MPPRMP. A portion of this project was to finance the costs of the technical secretariat—consultants and operational costs. DFID did not proceed with the project, influenced in large part by the Government's decision in 2000 not to allow bilateral donors to provide grant funds directly to state governments for policy-based reforms. Given the protracted nature of the negotiations and the apparent importance of the technical secretariat to this component of the MPPRMP, it is difficult to understand why ADB did not make available the necessary grant resources to fund the technical secretariat.

39. The state renewal fund (SRF) committee was established in 1998 to manage the financial resources for the voluntary retirement scheme (VRS) to be provided to retrenched employees to mitigate the adverse social impact of PSU restructuring. It was reconstituted as the cabinet subcommittee, and the VRS extended until FY2002 when GoMP decided to discontinue it on the grounds that the VRS was setting a precedent for government to continue to underwrite the costs of restructuring rather than the PSU. A cabinet subcommittee on the VRS was established in 2001 to oversee VRS implementation. GoMP met a second tranche condition by allocating Rs1.5 billion for the SRF in the FY2000 budget. The SRF was activated in September 2000. Rs200 million was disbursed in FY2000 for VRS. Rs1.5 billion was allocated in the FY2001 budget and Rs1.6 billion was disbursed. In FY2002, another Rs.1.5 billion was budgeted and Rs938 million was disbursed. Although budget allocations were made for the SRF in FY2003 and FY2004, no disbursements took place. The average payout on VRS was Rs180,000–Rs370,000 ($4,090–8,409) per employee. Madhya Pradesh State Financial Corporation (MPSFC) funded a VRS for its employees. A total of 9,000 employees, including 5,000 from Madhya Pradesh State Road Transport Corporation (MPSRTC), were retrenched and received VRS payments. This is just over half the design estimate of 16,500.

40. An SSN committee was established in January 2000 and a SSN scheme was finalized in 2001, including the retraining of displaced employees using existing industrial training institutes, training centers, and other institutions. The SSN also identified a counseling service to help former PSU employees use the cash compensation received from the VRS payment for investment and entrepreneurship. The scheme included monitoring of displaced employees and provision of placement services, and it was expected that the technical secretariat to be established under the MPPRMP would implement the SSN. In the absence of the technical secretariat, the VRS committee took responsibility for preparing the SSN. However, in 2002, GoMP decided not to implement the SSN on the grounds that it would set an example for all public and private bodies wishing to downsize, and would have cascading cost implications. Although a small survey was conducted by a TA that identified workers' concerns and perceived needs with respect to the SSN, no systematic socioeconomic surveys were undertaken of retrenched employees during the life of the Program or beyond.

41. The Department of Public Enterprises (DPE) was designated the nodal state government agency responsible for coordinating PSU reforms, including (i) ensuring specific corporate governance measures were being implemented, and (ii) preparing annual reports on the progress of reforms. However, only one annual report for FY2003 was published, in September 2005. The DPE reported to the OEM that it is constrained by lack of timely information from respective PSUs. Despite plans to strengthened DPE by appointing qualified

[33] There was reference in the program files to a £70 million project, of which about £1 million was to be allocated to the technical secretariat. GoMP reported to the OEM that it was currently in discussions with DFID to revive the technical secretariat. DFID confirmed that discussions were ongoing but did not say when they may be concluded.

professionals, it remains a small department with limited human and financial resources, and without the power to enforce compliance by respective PSU administrative departments with their responsibilities.

42. The corporate governance measures proposed included: (i) appointing professional PSU managers on a competitive, merit basis; and establishing procedures to make managers accountable for PSU performance; (ii) increase PSUs' operational autonomy by introducing financial criteria on return on investment for dividend payment and an investment limit for which PSUs do not need approval from GoMP; and (iii) authorizing enterprise-specific salary scales, including differentiation in remuneration linked to productivity and the financial performance of individual PSUs. The last two measures were approved by GoMP prior to loan effectiveness, but the professionalization and accountability of PSU management was only achieved on paper. A committee was established to screen candidates, and recommends appointments for higher-level positions. PSU performance-based MOUs, with activity-specific targets laid down along with the percentile rankings of each activity serving as a scorecard of the performance of PSUs and their managing directors, were signed annually between the PSUs and GoMP. A performance review committee, chaired by the finance department with powers to recommend action against managing directors in case of noncompliance with targets, reportedly undertook regular quarterly reviews. However, there is still no accountability of managers of PSUs that continue to lose money, as there is no substantive implementation of the MOU.

43. **Selected PSUs Privatized.** Although GoMP planned to partially divest its shareholding in five PSUs, it did not succeed in divesting its stake in any of the enterprises. Further, over the period FY2001–2003, the performance of these PSUs has been disappointing, without exception. Mainly because of the provisioning for nonperforming assets, Madhya Pradesh State Industrial Development Corporation's operating performance has shown a significant deterioration, with a net loss of Rs2.78 billion recorded in FY2003 compared with a net loss of Rs460 million in FY2001. Madhya Pradesh State Agro Industries Development Corporation's performance has also deteriorated, with a net loss of Rs7.7 million recorded in FY2004 compared with a net profit of Rs3.1 million in FY2000. This resulted from operating losses, as revenues have been more or less static. Madhya Pradesh Financial Corporation recorded a net loss of Rs280 million in FY2003 compared with a net profit of Rs20 million in FY2001 because of reduction in revenues and relatively fixed interest costs. The net losses of MPSRTC increased from Rs650 million in FY2001 to Rs1 billion in FY2003, primarily because of a decline in revenues coupled with rising fuel costs and relatively fixed employee costs. This resulted in a decision to close it rather than divest. Four of the five PSUs continue to be a drain on scarce state budget resources.

44. **Selected PSUs Restructured.** The proposal to lease or sell Madhya Pradesh State Tourism Development Corporation Limited (MPSTDC) was shelved. Of the 70 tenders initially received for sale of individual properties, 22 were found to be eligible but no offers were received from hospitality sector companies so the offers were rejected. Following significant investments by the Government in MPSTDC properties over the past 4 years, the upkeep of the properties improved and the road infrastructure at major tourist locations was upgraded, resulting in the increased arrival of tourists. As a result, the operating performance of the company improved, with net profit of Rs270,000 recorded in FY2003.

45. **Selected PSUs Closed.** Eight enterprises were identified for closure. The program design did not specify what closure entailed, and there are at least three interpretations: (i) closing down operations of the PSU and retrenching all but a core team of staff necessary to achieve financial closure; (ii) closing finances of the PSU, including receipt of the funds from the

sale of assets and meeting all creditor's obligations, and may include a court-appointed liquidator being involved; and (iii) the legal closure of the PSU in accordance with the relevant law. This led to GoMP requesting clarification from ADB on the interpretation of "closure" with regard to meeting tranche conditions and non-tranche covenants. It was mutually agreed that "closure" would mean the operational closure of the respective PSUs. While GoMP has succeeded in effecting the operational closure of the selected PSUs, the final liquidation of the enterprises and the recovery of proceeds from sale of assets has not been completed. In the case of Madhya Pradesh Police Housing Corporation, after achieving operational closure, GoMP decided to revive it again to manage a police modernization program funded by the Government to construct police housing in the state.

46. **Initiate Reform of Cooperatives Sector.** A report on the financial performance of cooperatives sector was prepared with the assistance of TA consultants in July 2001. GoMP enacted enabling provisions for cooperative societies based on the model multipurpose Government of India National Cooperative Development Corporation Act, 1962 and relevant acts in other states. Under this act, all previous GoMP control and restrictions have been removed. Cooperatives have been given full operational freedom in their business. New cooperatives, not receiving loan or share capital from GoMP or government guarantees, can register under this act and existing cooperatives can apply for conversion to this act. A number of respondents reported to the OEM that cooperatives continue to be open to political manipulation and capture by local elites. To implement the recommendations of the Government of India's Vaidhyanathan Committee on cooperatives,[34] GoMP signed an MOU with the central Government and the National Bank for Agriculture and Rural Development to revive cooperatives in the state.

3. Private Sector Investment Developing Key Sectors of the State Economy

47. The intent of this outcome was to create a legislative, regulatory, and policy environment that would attract private investors, and follow up ADB sector loans in key infrastructure sectors. With a mix of conditions and covenants, the MPPRMP focused on three sectors—power, roads, and housing. Support was also provided to prepare environment and resettlement policies. The focus in the power sector was to establish an adequately resourced electricity regulatory authority as mandated by law, and to formulate a power sector master plan. Road sector interventions focused on approval of a roads policy and establishing a utilities pricing commission for road tariffs—with various covenants encouraging investment plans, establishing a private sector cell within the Public Works Department (PWD), and analyzing distance-based toll rate options and experiences with build-own-transfer (BOT) arrangements. Housing sector interventions were aimed at amending the State Accomodation Control Act, 1961 and establishing a state rent tribunal. The power and road interventions were far more successful than housing. GoMP approved both an environment and a resettlement policy.

48. **Power Sector.** Two conditions—focusing on establishing an adequately financed state electricity regulatory commission and a covenant to prepare a power sector CIP on the basis of a power sector master plan—were agreed and met. In 1998, the Government passed the Electricity Regulatory Commissions Act providing for the establishment of autonomous central and state energy regulatory commissions to regulate power utilities and set tariffs. The Government envisaged that the regulatory commissions would be accountable for transparent

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[34] The committee was formed under the chairmanship of Prof A. Vaidhyanathan as per the announcement made by the Finance Minster. This task force was appointed by the Government to look into matters relating to co-operative banks.

and economically sound regulation, which would contribute to improving the financial status of state electricity boards and utilities operating as PSUs with poor corporate governance and financial management records.

49. Madhya Pradesh Electricity Regulatory Commission (MPERC) was established in June 2000 as a statutory authority mandated to regulate power generation, transmission, and distribution systems; rationalize tariffs; set standards; and issue and regulate licenses—to promote private sector participation and improve the efficiency of the power sector. The Madhya Pradesh Electricity Act, approved by the Madhya Pradesh legislative assembly in November 2000 and made effective in July 2001, was at the time the most progressive power sector reform act in India. In addition to subsuming and expanding the powers of MPERC, it included provision for: (i) restructuring Madhya Pradesh State Electricity Board, (ii) metering all consumers, (iii) rationalization of tariffs so that all classes of consumers would pay at least 75% of the cost of supply over 5 years, (iv) budget provision for MPERC for 5 years, and (v) arbitration with the Central Electricity Regulatory Commission. This provided a sound legal and institutional basis for ADB to approve a $200 million sector loan in 2001[35] to support further reform in the power sector, including implementation of a power sector investment plan, followed by another in 2006.[36]

50. **Roads Sector.** The enabling environment was defined by a second tranche condition to announce a state roads policy and three associated covenants: (i) to prepare a road sector CIP, (ii) establish a private sector cell in the PWD, and (iii) prepare a plan to establish a utilities pricing commission for road and transport tariff setting. These were to be followed by a third tranche condition to establish the utilities pricing commission; and a covenant to prepare a report on PWD experience with public-private partnership (PPP) arrangements including policy, regulatory, and institutional recommendations.

51. By August 2001, the Government had formulated a road development policy to improve the road network and maintenance, and encourage private participation through three preferred schemes: (i) BOT; (ii) maintain, operate and transfer; and (iii) PPP. The policy noted that 17 bridges and 4 bypasses had already been constructed under BOT, with 2 maintain, operate and transfer concessions also under implementation. The policy referred to enabling legislation, including an amendment to the Indian Tolls (Madhya Pradesh) Act, 1932, enabling the levying of tolls on new construction and upgraded roads and bridges. The road development policy addresses toll rates. Although it does not outline how tolls will be determined, it does note that toll rates would be increased by 25% from the beginning of FY2000, and mandates a 25% increase every 3 years thereafter. The policy was updated in 2004, with toll rates established for different forms of transport on a per kilometer (km) basis with a 7% annual increase. The Madhya Pradesh Highway Bill, 2001, established the road development corporation as a statutory highways authority responsible for implementing roads projects and other matters associated with the construction and maintenance of state roads. The private sector cell set-up under the MPPRMP was transferred from PWD, which is essentially an administrative department, to the roads development corporation, which has operational responsibility.

52. The road policy was followed by a master plan (2001–2010) totaling some $1 billion, including $570 million for road rehabilitation and reconstruction, and $430 million for road

[35] ADB. 2001. *Report and Recommendation of the President to the Board of Directors on the Proposed Loan to India for the Madhya Pradesh Power Sector Development Program*. Manila (Loan 1869-IND, for $200 million, approved on 6 December).

[36] ADB. 2006. *Report and Recommendations to the President to the Board of Directors on the Proposed Multitranche Financing Facility India: Madhya Pradesh Power Sector Investment Program*. Manila.

maintenance. This was included in the roads component of the state's 10th Five Year Plan (2002–2007) with a total budget of $655 million, including the $570 million to rehabilitate 4,770 km of state highways and district roads, and $85 million for maintenance. In line with the covenant, an annual roads sector CIP was prepared in 2000 for inclusion in the FY2001 budget. However, the CIP was not institutionalized as a budget planning tool, as it was discontinued after the program closed.

53. The MPPRMP was instrumental in establishing a policy, and focused institutional capacity for private sector participation. The state has aggressively pursued PPP in the road sector to the point where it was suggested to the OEM that it is saturated by toll roads and there is a need to rationalize the management of tolls. The follow-on ADB-financed road sector project[37] makes no reference to the role of the MPPRMP, although it refers to the policy and institutional frameworks in place.

54. **Housing Sector.** The housing sector was identified to address problems in urban areas resulting from unauthorized housing construction, growth of slums, and inadequate legislation, particularly the State Rent Control Act. The aim was to improve the regulatory framework for private sector investment, and enable the state to access housing finance through the Government's institutions and programs.[38] This would be addressed through three covenants. It was expected that, prior to the second tranche release, the draft amendments to the State Accomodation Control Act prepared prior to loan signing would be promulgated—including provisions to exempt a portion of the rental housing market from provision of the act, permit rent revisions based on market trends, expedite the judicial process for dispute resolution and establish a rent tribunal. This was to be followed by another covenant to establish a rent tribunal prior to the third tranche release. The rent tribunal would also have undertaken a review of the initial impact of the amended act on the level of rents and investment in the housing sector. However, the act was not amended nor was the tribunal established.

55. Although the amendments were drafted and the recommendations of a select committee of the legislature were incorporated in a revised draft, they were not debated by the legislature. As the enactment of the amendment is a precondition for the tribunal, and the amendment did not reach the legislature, the "substantial" rating should be at best partial to acknowledge the considerable work done to prepare a draft for legislative approval. As the tribunal could not be established it is difficult to see how even a partial rating could be given. In summary, although the Program made little headway in establishing an enabling environment in the housing sector, Madhya Pradesh Housing Board was able to access about 9% of the loan funds available for state governments from the Housing Finance Project.[39]

56. **Environment Policy and Action Plan.** Environment interventions focused on two conditions, leading to the approval of a state environment policy and action plan; and two covenants to improve the monitoring capacity of the state Pollution Control Board (PCB). The policy and time-bound action plan were to be announced as a second tranche condition, followed by implementation of the action plan for the third tranche release. The environment policy was prepared by the Housing and Environment Department after a 2-year consultation

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[37] ADB. 2002. *Report and Recommendation of the President to the Board of Directors on the Proposed Loan to India for the Madhya Pradesh State Roads Sector Development Program*. Manila (Loan 1958/1959-IND, for $180 million, approved on 5 December).

[38] One such program was funded by ADB. 1997. *Report and Recommendation of the President to the Board of Directors on the Proposed Loan to India for the Housing Finance Project*. Manila (Loans 1549/1550/1551-IND, for $300 million, approved on 25 September).

[39] ADB. 2003. *Project Completion Report on the Housing Finance Project in India*. Manila.

process with nongovernment organizations, concerned government departments, specialists, and people's representatives. It was approved in 1999, meeting the second tranche condition. This was followed by an action plan outlining key actions that concerned government departments would take to address identified issues.

57. The initiative to prepare a state environment policy was an extremely positive contribution to ensuring the state government had a policy outlining principles and standards to guide development, in light of the projected increase in public and private sector investment over the coming decades. The MPPRMP was designed well before either the Rome or Paris declarations (2003 and 2005) and, perhaps not surprisingly, there is no reference in the RRP that the rationale for this initiative was to develop country systems that would preclude the need to apply ADB standards.[40] ADB provided sector loans to power in 2001 and 2006 (footnotes 35 and 36), and roads in 2002 (footnote 37). None of these refer to the GoMP environment policy, although their respective summary initial environmental examinations refer to relevant legislation and regulations of the Government (in particular, the environmental impact assessment notification). Appendix 6 analyzes the use of the state's environment and rehabilitation policies.

58. **Environmental Monitoring.** To complement policy formulation, the Program aimed to strengthen the state's PCB environmental monitoring capacity through two covenants. The first, undertaken prior to September 2000, included implementing measures to strengthen the monitoring capacities of PCB and its regional offices. This was to be followed by an integrated training program for PCB staff and industrial associations on environmental monitoring and environmental management by June 2001. Both covenants were fully complied with through implementation of a national environmental capacity building project for state PCBs, by the Government of India's Ministry of Environment and Forest, and the central PCB. This project included environmental monitoring training for PCB technical staff who established an e-governance program through the PCB website.[41] Citizens' complaints of polluting units are received, investigations are conducted, and polluting units are put on a list and monitored. The website continues to be regularly updated, including the status of court cases.

59. **Rehabilitation Policy.** Although there is scant reference in the RRP to the rationale for including the formulation of a policy on resettlement and rehabilitation, GoMP's development policy letter explicitly mentions the need for this, along with an environment policy. As with the environment policy, two conditions were agreed. A draft policy on rehabilitation to address the social impacts of economic development was to be completed by March 2000 for the second tranche, followed by finalizing the policy by March 2001 for the third tranche. The Department of Rehabilitation prepared a model rehabilitation policy in 2002 for people displaced by projects. The policy provided a framework for rehabilitation measures, replacing the previous ad hoc system of special orders and resolutions. Although the draft policy was submitted to ADB for comment in October 2000, there is no record in ADB's files of any comments provided to GoMP on the draft policy.

[40] Through ADB. 2005. *Strengthening Country Safeguards Systems*. Manila (RETA 6285, for $800,000, approved on 12 December), ADB is developing a corporate approach for the application of country safeguard systems. This involves an analysis of equivalence between country safeguard systems and ADB safeguard policies and requirements; and the country's capacity to implement country safeguard systems in terms of implementation practices; track record; and the capacity of relevant national, subnational, and sector institutions. India is a case study country.

[41] Available: http://www.mppcb.nic.in.

60. The GoMP cabinet discussed the draft policy in July 2001 and requested provision of more compensation to resettled persons. The policy was revised and approved in September 2002. A copy was provided to ADB, which accepted that the condition had been fully complied with. It is not until the policy had been approved that ADB's files record comments. An assessment of the policy by ADB's Regional Sustainable Development Department in August 2002, in the context of the third tranche progress report, stated that the policy includes "provision for sufficient compensation and other assistance to project-affected-persons to restore their livelihood, progress in the spheres of community participation in project planning and implementation."[42] In February 2003, there is reference to the new policy being an improvement on the previous use of project-specific special orders, noting it is based on 14 principles, including that displaced persons acquire the previous level of their life and that they should improve their status within a reasonable time; special attention should be paid to scheduled tribes and scheduled castes; compensation should be paid to land owners and leaseholders within a specified period, allotment of land if available; sufficient civic amenities should be provided in new settlements; and displaced persons should access employment in project-related activities. However, it is noted that the standard of restoring livelihoods may be lower than the entitlements under the 1979 Narmada water disputes tribunal ruling. The OEM notes that a recent review of the application of rehabilitation measures for families affected by the Sardar Sarovar Project (Namada Dam) is very critical of (i) the application of the measures, and (ii) the findings of an oversight group commissioned by the Government and endorsed by the Supreme Court to survey damage-affected villages and report to the court and prime minister.[43]

61. Neither the first power sector nor road sector projects required any resettlement. However, the power sector loan approved in December 2006 (footnote 36) did require resettlement. In this case, the RRP summary resettlement plan contains a comparative analysis of the Madhya Pradesh rehabilitation policy, the Government's national policy on resettlement and rehabilitation for project-affected persons, and ADB's *Involuntary Resettlement Policy* (1995) against 18 policy principles. The Madhya Pradesh policy matches ADB's in 13 principles. Of the five where a difference is identified, only the principle related to entitlements under the GoMP policy is judged not to fulfill ADB specifications. Comments on the other four principles do not appear to be significant. There is no commentary on the findings of the comparative assessment, other than a statement that the resettlement framework will be revised if there are major changes to relevant policies and laws during project implementation. This implies that the Madhya Pradesh policy is not acceptable. The framework assumes that ADB's policy will be implemented.

F. Consultants

62. Consultants were engaged in accordance with the Guidelines on the Use of Consultants by Asian Development Bank and Its Borrowers (2006, as amended from time to time) in the two stand-alone and the TA attached to the Program.[44]

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[42] File correspondence 22 August 2002.

[43] Levien. M. 2006. Narmada and the Myth of Rehabilitation. *Economic and Political Weekly*. XLI (33): 3581–3585. Levien argues that the scale of the project, displacing over 35,000 families (500,000 people), meant that providing the legally required rehabilitation of 2 hectares of cultivatable, irrigable land, and community resettlement sites with civic amenities was simply impossible to meet given the land shortage in India, let alone restoring people's livelihoods. The issue, then, is not necessarily the rehabilitation measures per se, but their implications for large-scale development projects affecting such large numbers of people.

[44] ADB. 1999. *Technical Assistance for Capacity Building for Public Enterprise Reform and Social Safety Net in Madhya Pradesh.* Manila (TA-3338, for $600,000, approved on 14 December).

G. Loan Covenant

63. GoMP fully complied with 12 of 15 second-tranche conditions and substantially complied with the remaining three. Of the 22 non-tranche release covenants to be completed prior to the second tranche release, 19 were fully complied with, two substantially complied with, and one partially complied with. GoMP fully complied with nine of 13 third-tranche conditions, substantially complied with three, and partially complied with one. GoMP also fulfilled 18 of 22 non-tranche covenants, substantially complied with three, and partially complied with one. A waiver of full compliance for the condition to establish a utilities pricing commission for roads and transport tariff setting, and operationalize the commission, was approved by the Board (Appendix 2 updates the status of compliance of covenants).

64. The Loan Agreement also contained three covenants under the title of environment: (i) the Borrower (the Government) shall cause the state to ensure that the technical secretariat carries out an environmental assessment of the public enterprise reforms in accordance with all applicable laws of the state; (ii) the Borrower shall ensure that, in formulating infrastructure policy and regulatory reforms, the state shall make adequate provisions for enforcement of environmental mitigation measures consistent with the applicable state laws and monitoring of environmental impact in key infrastructure sectors; and (iii) the Borrower shall cause the state to support the environmental sustainability of economic growth by adoption of a state environment policy which will stipulate a time-bound action plan for implementation of market-based instruments for environmental management. The technical secretariat was never formed, so this covenant was not met. The state adopted an environment policy with an action plan; and the road, draft water, and draft science and technology policies are incorporated in environmental considerations.

H. Policy Framework

65. Within 11 months of the MPPRMP being effective, the Government decided to bifurcate Madhya Pradesh, transferring a number of districts to create the new state of Chhattisgarh.[45] Appendix 3 outlines the impact of bifurcation. Following the recommendation of the EFC, the Ministry of Finance designed a medium-term fiscal reforms program requiring the states to reduce the ratio of revenue deficits to their total revenues by 5% every year to gain eligibility for receiving a portion of grants. There were problems in the design of this performance-linked grants program,[46] and the Twelfth Finance Commission (TFC) recommended replacing it with an incentive-based debt-restructuring program. To be eligible to qualify, the states are required to pass a FRBMA entitling them to restructure and consolidate market loans and loans from the Government at a substantially reduced interest rate. A state could also avail of the benefits of waiver of loan repayment due for the next 5 years beginning FY2005, directly linked to the reduction in its revenue deficit. GoMP has enacted a FRBMA.

[45] Two other new states were formed at this time through the same bifurcation process. Jharkhand was created out of the southern districts of Bihar, and Uttarakhand from northwestern districts of Uttar Pradesh.

[46] Rao, G. M. 2004. Linking Central Transfers to Fiscal Performance of States. *Economic and Political Weekly* May 1: 1820–1825. Rao argues that the size of incentive-linked transfers is too small to influence state fiscal performance, multiple schemes segment the incentive, and the scheme design is faulty, failing to address the causes of deteriorating state fiscal performance.

III. PERFORMANCE ASSESSMENT

A. Overall Assessment

66. The OEM rates the MPPRMP overall “partly successful.”[47] GoMP’s political commitment to reform has not been fully translated into action, despite the influence of exogenous factors on achieving key fiscal consolidation outcomes. GoMP’s fiscal deficit decreased from a high of 6.3% in FY2004 to 3% of SDP in FY2008, as charted in the FRBMA, 2005. However, this is the same level as the starting point in the MPPRMP (from 3.7% SDP in FY1999 to 0.7% in FY2002). There are positive signs in revenue generation, with the introduction of the VAT, but there has been no significant change in GoMP’s resource allocation to social sectors and PSU reforms are stalled. Private investors have responded positively, particularly in the road sector. However, while the approval of a state environment and rehabilitation policy is positive, with the exception of the recently approved energy sector loan (footnote 36), ADB has not referred to either policy when it has been relevant to follow up on projects. With two of the three TA projects rated “partly successful,” and the other “successful,” the overall use of these resources was neither effective nor efficient. The performance of the Borrower was rated “satisfactory,” and ADB’s rated “partly satisfactory.” The OEM differs from the PCR’s overall rating of “successful.”

B. Relevance

67. The MPPRMP is rated “relevant” (footnote 47). It was consistent with the Government’s overall economic reform agenda with the states, with the Ninth Five Year Plan (1995–2000), and other national level policies—in particular, the emphasis on social services and a decentralized mode of delivery. ADB’s 1998 COSS reinforced the state level focus, with Madhya Pradesh selected to follow Gujarat. The Program was consistent with ADB’s institutional development objectives of supporting economic growth and the focus in India on alleviating infrastructure constraints by supporting the development of an effective policy, regulatory, and institutional environment and improving infrastructure availability and quality of service; promoting upgrading and protection of the environment; and targeting social sector interventions. The Madhya Pradesh chief minister fully supported the fiscal reform agenda, recognizing that the state’s difficult financial position required exogenous support to undertake the required reform measures. The MPPRMP was consistent with the GoMP white paper of February 1999, documenting the severity of the financial crisis and a reform strategy. ADB provided leverage to push through reforms in an environment where the status quo was valued. Whether there was consensus or not, there was no strong opposition at the time the Program started. However, bureaucratic support appeared to be negatively affected by the delays to program approval in 1998. A change of government resulted in some parts of the reform program being delayed (e.g., the judicial reversal of the GoMP order on retrenchment of casual workers, and introducing VAT) in response to the strong opposition of traders. This was successfully overcome through a taxpayer awareness program, suggesting that overall there was cross-party commitment to the necessity of reforms.

68. The overall program logic was sound with respect to the three outcomes—fiscal reform, PSU reform, and creating an enabling environment—but not with respect to the minimal support to local body fiscal reform, and the extremely limited social service interventions. A reasonable

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[47] Overall performance is based on four criteria: relevance, effectiveness, efficiency, and sustainability. Each criterion was scored on a four-point scale, from 0 to 3, for example: “irrelevant” (0), “less relevant” (1), “relevant” (2), and “highly relevant” (3). The weighted scores are then computed for the overall assessment with “highly successful” ≥ 2.7, “successful” 1.6 ≤ S < 2.7, “partly successful” 0.8 ≤ PS < 1.6, and “unsuccessful” < 0.8. ADB. 2006. *Guidelines for Preparing Program Performance Evaluation Reports for Public Sector Operations*. Manila.

assessment of risks was made, although the possibility of bifurcation of the state was not explicitly referred to. Feasible mitigation measures were proposed, although not all were implemented, particularly the institutional arrangements for PSU reform. The latter failure made managing a complex PSU reform more difficult. A 3-year time frame is the minimum required to embed the key foundations for fiscal reforms, including PSU reform. However, the 12-month time frame of TA projects was too short. There is little documentary evidence of consideration of alternative fiscal policy options, particularly on the expenditure side (e.g., state pension liabilities, or instituting expenditure performance measurement and reporting systems). As the MPPRMP was essentially designed by mid-1998, although not approved until December 1999, the limited experience from ADB's only other similar subnational program in India (GPSRMP) and the World Bank's state level power sector and economic restructuring project in Andhra Pradesh, was drawn on in the design. Although there was no direct reference to the considerable international experience of PSU reform,[48] a range of PSU reform options were assessed and implemented, consistent with some of the key lessons from that experience.

69. Institutional limitations were recognized, and assistance was proposed to build capacity. TA to support revenue reforms such as sales tax and VAT reform was relevant, triggering computerization of budget and treasury functions, while also preparing the tax department for the eventual introduction of VAT. TA support for PSU reform was "relevant" but insufficient. The TA for local government information systems was not complemented by policy reforms in the loan, did not target the most pressing local government fiscal constraints, and was not sustained. The VRS and SSN had sufficient funds on paper, but the technical secretariat designed to implement PSU reforms was not established, and GoMP did not provide the PSU nodal line department with adequate resources and powers to manage this aspect of the reforms.

C. Effectiveness

70. The Program is rated "less effective,"[49] as two of the three outcomes were not met. Although the fiscal deficit targets agreed in tranche conditions were not attained, they were substantially met after adjustment to account for exogenous factors. A study of the counterfactual position conducted an econometric analysis of structural adjustment loans on individual states (Appendix 4).[50] After controlling for exogenous factors, the study finds that, in the short term, the loan has not led to any significant improvement in the overall fiscal situation in any of the states. The response to fiscal stress is influenced by the structure of incentives faced by states, and political economy factors. The analysis of revenue and fiscal deficits showed significant interstate variations, with the fiscal deficit deteriorating when off-budget deficits caused by power sector losses are correctly included. However, the study did not find a significant relationship between the level of development expenditure and the size of revenue or fiscal deficits in states. In Madhya Pradesh, the attempted expenditure compression was not significant. The tax performance does not show any significant improvement, nor did the loan result in enhancing non-tax revenues from user charges and returns from state enterprises. As

[48] For example, the 1989 issue of *World Development*, Volume 17 (5) was entitled "Privatization" and included eight articles on PSU reform, focusing primarily on issues relating to privatization in the developing world. Although the experiences being discussed were at national level, many of the lessons were equally applicable to state level PSUs.

[49] Based on a four-point scale, from 0 to 3, as follows: "ineffective" (0), "less effective" (1), "effective" (2), and "highly effective" (3).

[50] The states of Gujarat, Madhya Pradesh, and Kerala (ADB); and Uttar Pradesh, Karnataka, and Andhra Pradesh (World Bank) were compared with the balance of the 15 major states in India, none of which had received state level multilateral loan support.

the period of analysis was limited, the study noted that the results could change over the medium term when the reform measures impact fully on the state's revenues and expenditures.

71. The simplification of taxes and computerization of tax administration and treasury accounts was a very positive reform. Given limits on increasing revenues, expenditure growth had to be contained, mainly at the cost of investments and O&M costs of physical infrastructure, rather than cutting expenditure on social services. Despite some constraints on human development expenditures (vacant posts of teachers and doctors accumulated for a long time), the relevant ratios show that social sector expenditures generally were not adversely impacted by the fiscal reform, but social sector expenditures did not increase over the period as proposed. Without the implementation of significant central government vertical programs in health, education, and poverty alleviation—complementing the state's allocation—social development indicators would have worsened. As it was, they improved marginally from an acknowledged low base over the program period.

72. Once GoMP clarified that, for the purposes of tranche conditions "closure" meant operational closure, it succeeded in closing all eight PSUs selected. However, this level of closure made it relatively easy to revive a PSU, if considered politically expedient to do so, as was the case with the police housing corporation. Efforts to improve corporate governance and restructure PSUs were less than satisfactory. The lack of a technical secretariat, and an under-resourced nodal line agency constrained the effectiveness of PSU reforms—particularly the monitoring and accountability for corporate governance changes, which were effected on paper, but not in practice. There were considerable difficulties in agreeing on the apportionment of assets and liabilities of key PSUs after bifurcation, leading to protracted negotiations that could only be resolved at the highest levels of government. Even if the technical secretariat had been established, it would have had little bearing on this process. GoMP was unable to restructure or divest any of the five selected PSUs, and over 2001–2003 their performance has, without exception, been disappointing.

73. A small number of critical legal, policy, and institutional reforms created an enabling environment for private sector participation in the power and road sectors. The electricity regulatory authority was established and a power sector master plan was formulated. A roads policy was approved and a private sector cell within PWD was established, later transferred to the Road Development Corporation. Housing sector interventions were less successful. The approval of state environment and resettlement policies was a positive step in promoting the environmental sustainability of economic development, although the latter is not deemed sufficiently robust to be applied in ADB sector loans.

74. In common with many ADB policy-based loans, the description of the Program in the RRP text, DMF, and policy matrix is inconsistent. It appears that the policy matrix was essentially the design tool, and the DMF was completed last to meet a template requirement. Although the design contains a detailed analysis of the education and health sectors, it did not adequately identify and address these potential influences. Generic assumptions and risks were identified but mitigation measures were not well developed to address risks.

D. Efficiency

75. The Program is rated "less efficient."[51] The loan was provided to assist GoMP to finance the adjustment costs, including lost tax revenue and PSU reform liabilities estimated to be $600 million, later revised down to $530 million after bifurcation. To expect that GoMP would be able to cover the balance by increased receipts and sale of PSU shares and assets was overly ambitious. Tax revenues have increased substantially only since FY2004 (VAT was not implemented until 2006) and realizations from sale of assets of PSUs was delayed by the slow pace of liquidation. In all, almost 9,000 employees received VRS, compared with a design estimate of 16,500 employees with an estimated cost of $57 million. The OEM was informed that the VRS is estimated to have provided for around 65% of the remuneration that was being earned by employees prior to retrenchment. Although this was said to be sufficient to enable them to take up alternative employment, an independent survey was not conducted to confirm this. Contrary to MPPRMP design, the SSN did not proceed—further reducing adjustment costs. With two TA rated "partly successful" and one "successful," these resources were less efficiently used. In terms of process efficiency, the respective policy and management committees provided appropriate levels of oversight, but the failure to establish a technical secretariat constrained the efficient management of PSU reforms and resulted in TA consultants performing tasks that should have been conducted by government officials.

E. Sustainability

76. The Program is rated "less likely sustainable."[52] The MPPRMP provided the impetus for substantial reform, in particular providing a better appreciation of the direction needed and encouraging GoMP to articulate its reform program through a white paper. The macroeconomic scenario of India was not favorable to reform during the first 2 years of the Program, but started improving thereafter, coinciding with the last phase of the MPPRMP. Appendix 4, Table A4.4 provides a summary of the fiscal situation in Madhya Pradesh over a decade from the mid-1990s. Barring the last 2 years of the series, the highest deficit figures are for FY1998, followed by a fiscal correction until FY2002, coinciding with the MPPRMP. Exogenous factors, such as the widespread floods in August 2000 followed by bifurcation of the state in November 2000, affected the state's fiscal condition. The post-MPPRMP years show some deterioration, but the deficit figures may be the result of one-time entries. For example, in 2003–2004, almost the entire increase in the deficit can be traced to a jump in the non-plan revenue (roughly the same as current) expenditures on economic services. In 2004–2005, the sharp drop in revenue deficit is mainly attributable to a large (probably one-time) receipt in the power sector. Similarly, the fiscal deficit of 6.01% of SDP, despite a revenue surplus, is the result of a large increase in capital expenditure on economic services.

77. The Government of India, on its part, allowed reduction of interest liabilities through debt swapping, and more recently the substitution of plan loans by cheaper market loans. In addition, some centrally sponsored schemes were substantially revised to fall more in line with the states' interests, and expanded in scope (notably the schemes relating to elementary education, health, and power). The growth of the Indian economy has been strong in recent years. Higher incomes have helped generate healthy tax revenues, while the significant drop in market interest rates compared with the 1990s has helped contain interest obligations at a much lower level than before. The state has exhibited fairly high levels of fiscal deficit in the last 2 years despite these

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[51] Based on a four-point scale, from 0 to 3, as follows: "inefficient" (0), "less efficient" (1), "efficient" (2), and "highly efficient" (3).

[52] Based on a four-point scale, from 0 to 3, as follows: "unlikely sustainable" (0), "less likely sustainable" (1), "sustainable" (2), and "most likely sustainable" (3).

favorable factors. This is due to a decision to clean up the books with respect to Madhya Pradesh State Electricity Board, make substantial capital expenditures in various areas, and retire a substantive amount of outstanding debt. None of these are likely to continue beyond 1 or 2 years, but the positives are more long term.

78. The exogenous factors that contributed to the continuation of the reforms include incentives provided by the EFC and TFC, various central government schemes, and a favorable macroeconomic situation creating space for reform. By allowing for normative levels of expenditures on salaries and imputing normative rates of return on investments in public enterprises in the assessment of expenditures and receipts for the computation of deficit grants, both the finance commissions provided incentives for the reform agenda supported by the MPPRMP. In particular, they provided further incentives in the form of loan write-offs and rescheduling, on the basis of reforms undertaken with adoption of the FRBMA, 2005,[53] and linking a part of the grants to fiscal reform in accordance with the EFC. Further, following the Government's lead, the state has produced an outcome budget for FY2005, but this not a performance measurement tool. A gender budget is reportedly under consideration. The GoMP's proposal to introduce a detailed medium-term expenditure framework, beginning with a few selected departments, is a positive but limited development from the MPPRMP budget planning support, and needs to be adopted by all departments to be effective.

79. Two major reforms have been sustained despite initial setbacks. VAT has finally been introduced despite missing the target during the MPPRMP because of constraints from the Government, and stamp duty reforms have stood the test of time.[54] However, computerization of the treasury has been the most successful reform, and is likely to be highly sustainable. The computerization process, started in 1989, was given a significant push by the MPPRMP, further supported by the EFC and GoMP's own funds. Computerization has been an ongoing process; the presently functional unified system became operational in 2004, and new features were added to the system to make it more comprehensive and useful. To a substantial extent, the MPPRMP can be credited with providing the thrust to completely overhaul the old system, and introducing an optimized new system.

80. In the case of local governance and finances, the intended reforms have not come about, even in the medium term. Although the ADB program envisaged building a linked local government finances database, as of now, even receipts and expenditures of urban local bodies at an aggregate level are not readily available. As a result, the state finance commission has to collect this information itself, every time it is set up, causing considerable delay in producing its report. The major reforms in the property tax system—shifting to the unit area-based system[55] to assess the annual ratable value in 1997 and a system of self-assessment by taxpayers in Madhya Pradesh—predated the MPPRMP. Overall, own revenues are completely inadequate for discharging the responsibilities of urban local bodies resulting in only those services that are specifically funded by higher-level governments being attended to properly. For example, while the municipal bodies are responsible for urban water supply, user charges levied are

[53] Adoption of a Financial Responsibility and Budget Management Act specifies a path to the committed levels of zero revenue deficit and a maximum of 3% fiscal deficit as a ratio of SDP by the final year, FY2008. This has been mainly the result of incentives attached to the adoption of such an Act in terms of debt rescheduling/write-off, as mandated by the twelfth finance commission.

[54] The rate rationalization is yet to be fully carried out; the rate on conveyance is still above the 6% recommended by the chief ministers' committee.

[55] This system consists of dividing the city into various zones based on market prices for property, and valuing property at different basic rates for each zone, supplemented by specific property characteristics such as size and type of construction.

inadequate to meet O&M costs. The problem is exacerbated by the fact that connections are not metered, and there are no funds to install meters.

81. GoMP's commitment to improve physical infrastructure—including roads, power, and irrigation—while seeking greater coverage and better quality of social services (such as education and health) remains. The strong commitment to contain wages and salaries has been reviewed, particularly in education where the construction of almost 20,000 new primary and middle schools required the engagement of over 50,000 new teachers. The commitment to more widespread and qualitatively improved educational services resulted in the state passing an Education Guarantee Act, 2002, that required a major recruitment drive for schoolteachers, which is ongoing. Key technical support institutions were not sustained, although GoMP is negotiating with DFID for support to reestablish a form of the technical secretariat to further PSU reforms. Without this support, it is unlikely that PSU reforms will progress significantly, and the location of the technical secretariat will influence its overall sustainability.

IV. OTHER ASSESSMENTS

A. Impact

82. **Socioeconomic Impact.** Despite GoMP's long commitment to social priorities, Madhya Pradesh is below Indian averages in most social indicators. Madhya Pradesh is predominantly rural, with scheduled castes and scheduled tribes making up over 35% of the population. With about 38% of the over 60 million people in the state below the poverty line, Madhya Pradesh has the third highest level of poverty in India despite consistent improvements against the human development index over the past two decades. The overall literacy rate of 63.7% is almost equal to the national average, but female literacy at 50.3% is 25.8% less than male literacy, which is one of the highest gaps in India. Madhya Pradesh is 11th by per capita income among India's 15 larger states. The Program was expected to impact on poverty reduction, with the reform efforts expecting to foster social development and in particular increase resource allocations to social sectors to support human development. As the fiscal deficit projections were not met during the program period, or to date, the expected fiscal space to increase allocations did not come about. On the positive side, expenditure in social services was not sacrificed to meet deficit shortfalls (Appendix 4, Table A4.4). The Government's vertical poverty alleviation programs for education, health, and employment has taken some expenditure pressure off the GoMP budget.

83. Madhya Pradesh has reasonably steady, if slightly declining, social expenditure ratios over a 10-year period from FY1995–2004 despite (i) the impact of bifurcation in FY2000 and FY2001, which had an effect across the board; and (ii) the tightening of public expenditures as a part of fiscal reforms. The public expenditure ratio, measuring the percentage of state income that goes into public expenditure, was marginally higher in FY2004 than 10 years earlier. It showed a decline in FY2001 during the program period, but hovered about 4% lower than the UNDP norm of 25%. The social sector ratio, measuring the percentage of total expenditure allocated to social services, has shown a 10% decline over the decade after reaching a high point of 34% in 1998 and 1999. However, it dropped to 23% in FY2004, well below the UNDP norm of 40%. The social priority ratio, which measures the percentage of social expenditure devoted to human priority concerns (education, health, water and sanitation), has been consistently in the mid- to high 50% range, above the UNDP norm of 50%, peaking during the Program in FY2001. The human development ratio, the product of the above three ratios, measuring the percentage of state income devoted to human priority concerns, follows the same trend. It had a marginal overall decline but a small rise in the year prior to the Program;

this was held for the first 2 years and then declined.

84. The VRS and SSN, including retraining and counseling, were designed to mitigate the negative socioeconomic impact of PSU reforms. Severance pay was provided to retrenched employees, but GoMP did not proceed with the SSN so employees were given no further support to deal with retrenchment and finding alternative employment. The planned study to assess the socioeconomic impact of PSU reforms on employees or on others affected by PSU closure, was not conducted so there is no independent assessment of the impact.

85. GoMP approved a rehabilitation policy under the Program in September 2002 to address the social impacts of economic projects, protecting the rights and entitlements of people forced to resettle.

86. A poverty impact assessment (PIA) is conducted during preparation of policy-based program loans to assess the direct short- and long-term impact of policy measures on the poor in terms of demand for labor; net public transfers; and prices of, and access to, goods and services. The PIA identifies a series of assumptions and associated mitigation measures in defining potential impact. The 1995 PIA format was revised prior to preparation of the MPPRMP to include impact on the nonpoor. Although the PIA appendix is referred to in the RRP (para. 97), the PIA analysis is not reflected in the DMF or drawn on in any depth in the RRP. The PIA was completed as a template requirement in the formulation process, rather than as a design tool linked directly to the DMF. Consequently, analysis of the value of the PIA has limited applicability and the GoMP allocation to social services was not increased during the life of the Program (para. 83 and Appendix 4).

87. **Impact on Environment.** The Program was categorized as environmental category C. Environmental implications of the proposed policy and institutional reforms were reviewed during program design. The Madhya Pradesh state environment policy (1999) was approved before implementation. Although the Program included provision of training on environmental monitoring for PCB staff, the training was provided under a central government program supported by ADB.[56]

88. **Impact on Anticorruption.** In the late 1990s, the profile of the impact of corruption on the public sector was rising, as evidenced by the reaction in the development community to formulate policy positions and provide assistance to developing member countries directly supporting anticorruption initiatives. ADB's governance policy,[57] approved in 1995, recognized that corruption needed to be addressed through a governance framework. In 1998, ADB approved an *Anticorruption Policy* (1998, as amended to date). ADB's RRP template had not been revised to include anticorruption aspects when the MPPRMP was being designed, and the RRP did not specifically identify how policy actions might support GoMP's anticorruption endeavors. However, in retrospect, the MPPRMP included a number of measures that would contribute to reducing the incidence of corrupt practice by government officials—particularly improvements, including computerization, of the tax administration system. The intent behind the MOU approach to improving the corporate governance of PSUs, by establishing performance benchmarks for enterprises as well as managers, was to improve accountability. Efforts to control the number of government employees were initial steps in civil service reform,

[56] ADB. 2000. *Technical Assistance to India for Environmental Management at the State Level*. Manila (TA 3423-IND, for $3,620,000, approved on 22 March).
[57] ADB. 1995. *Governance: Sound Development Management*. Manila.

with the potential to identify ghost employees[58]. Establishing central and regional valuation cells and introducing a methodology to assess properties for levy of property tax and stamp duty was designed to improve revenue generation in a transparent manner. The intent of establishing a system for monitoring implementation of the CIP, with periodic review of project performance, was to put in place an expenditure performance review process. However, this did not occur.

B. Asian Development Bank Performance

89. The performance of ADB is rated "less than satisfactory."[59] After the reconnaissance mission in November–December 1997, it was 2 years before the loan was approved by the Board and made effective. ADB's decision to delay processing in late 1998 as originally agreed with GoMP, for fear of the loan being used in a forthcoming state election campaign, had a deleterious effect on the relationship and required considerable staff time to rectify. The provision of multipurpose advisory TA had some merit if the original approval schedule had been maintained. However, with the delays, the TA was insufficient to support program implementation. Further, the TA supporting local government reform was not focused on the most pressing constraints. It was neither complemented by the loan-supported reform agenda, nor was the specific intervention sustained. ADB's decision to await approval of a large DFID funded project, of which a small proportion was to finance the technical secretariat, rather than provide the necessary TA resources was unfortunate, as the secretariat was never to be established.

90. Monitoring of program performance by headquarters staff was on an irregular basis. However, the role of the ADB India resident mission staff in supporting program monitoring was extremely important, even though the loan was not delegated. Resident mission staff provided the kind of "daily" support such reform programs require particularly when, in 2002, headquarters missions were often short and none were fielded from October 2002 to March 2003, prior to preparation of the third tranche progress report. While project officers handling the program changed twice during implementation, staff members specializing in public resource management were assigned to the MPPRMP each time.

C. Borrower Performance

91. The Borrower's performance is rated "satisfactory" (footnote 59). GoMP officials and executive leadership demonstrated ownership of reforms, taking difficult decisions to fulfill the conditions of the first tranche by August 1998 as agreed, although ADB's delay in approval took its toll. Similarly, second and third tranche conditions were met, with delays caused by the difficulties in settling issues associated with bifurcation. At appraisal, GoMP's limited experience and institutional capacity to implement comprehensive financial reforms were identified as risks that could limit the development impact of the Program. TA was provided to strengthen institutional capacity. However, consultants cannot replace government officials, and the fact that the technical secretariat was not established, and the SBFAU and DPE were inadequately resourced, was problematic. The EA administered the Program efficiently.

[58] Employees who are recorded as bona fide, such as staff who have died but remain on the records or people whose names are put on the records but do not attend the place of work yet receive salaries and other benefits.
[59] Based on a four-point scale of "unsatisfactory," "less than satisfactory," "satisfactory," or "highly satisfactory."

D. Technical Assistance

92. A total of $2.08 million was provided through three TA projects to complement reform and capacity-building initiatives supported by the MPPRMP. Two were approved in December 1997, 2 years prior to the eventual approval of the Loan Agreement. These focused on strengthening local government information systems, and assisting GoMP to establish fiscal reform and institutional strengthening initiatives. The third, focusing on PSU reform, was attached to the Loan Agreement.

93. **Strengthening Local Government.**[60] The 73rd amendment to the Indian Constitution introduced local government at the *panchayat* (village) level, including significant roles in implementing government projects. Madhya Pradesh was the first state to directly elect village level *gram panchayats* (local government)*.* These have become reasonably strong, although it is reported that they have been captured by local elites.[61] To improve governance of district level local government bodies (LGBs) in Madhya Pradesh, a TA was approved to (i) develop the resource-raising capabilities of LGBs through policy support and training; (ii) improve information gathering at the district level, to enhance rational decision making at local and state levels; and (iii) strengthen training facilities of LGBs, facilitating dissemination of best practices throughout LGB administration. The TA provided equipment and capacity building on data collection and processing to various government agencies, with 33 person-months of consulting services provided from June 1998 to December 2000. The consultant team designed and installed a statistical package for more efficient fiscal data management in 31 district level directorate of economics and statistics offices, and trained over 100 officers. Although the TA completion report (TCR) rated the TA "successful,"[62] the key constraint to LGB capacity was, and remains today, the LGB's ability to manage funds—including maintaining accounts. With one part-time locally engaged administration officer in a *gram panchayat*, given little training support but having to deal with many vertical programs, it is not surprising that LGB fiscal reform has not been successful. Although the TA aimed to build a database on local finances, at the time of the OEM even receipts and expenditures of urban local bodies at an aggregate level are not readily available. As a result, the state finance commission has to collect this information on its own, every time it is set up, causing considerable delay in producing the report. In summary, the TA has not proved sustainable. As the MPPRMP did not complement the TA with policy conditions supporting improved local government governance, it is unclear how the TA was to contribute to the MPPRMP's reform outcomes. The OEM did not conduct an in-depth assessment, but considers that the TA was at best "partly successful."

94. **Fiscal Reform and Institutional Strengthening.**[63] The TA to support fiscal reform focused on (i) strengthening the sales tax administration, including staff member training to facilitate transformation of the sales tax system to VAT; (ii) strengthening the stamp duty and registration directorate, establishing a state level central valuation cell and district valuation cells for valuation of assets, and training staff members on the new valuation system; (iii) assessing the institutional, policy, and regulatory frameworks for improvement of social services, particularly health and education services; (iv) establishing an SBFAU and training staff

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[60] ADB. 1997. *Technical Assistance to India for Strengthening Local Government in Madhya Pradesh.* Manila (TA 2944-IND, for $700,000, approved on 15 December).

[61] Manor. J. 2001. Madhya Pradesh Experiments with Direct Democracy. *Economic and Political Weekly*. March 3:715–716.

[62] ADB. 2001. *Technical Assistance Completion Report on Strengthening Local Government in Madhya Pradesh*. Manila.

[63] ADB. 1997. *Technical Assistance to India for Support for the Government of Madhya Pradesh Public Finance Reform and Institutional Strengthening*. Manila (TA 2943-IND, for $780,000, approved on 15 December).

members to strengthen the analytical capability for budget planning and monitoring as well as revenue and expenditure analysis and projections; and (v) training staff members from the finance department and key infrastructure departments on expenditure prioritization and CIP. GoMP established an economic reform committee to oversee the TA, with the support of two empowered committees on public finance reform and PSU restructuring. An international consulting firm provided international (9 person-months) and national (35 person-months) consultants whose performance was rated "satisfactory," even though the consultant team members changed and the interaction between the consultants and the EA was reportedly weak. The consultants' report provided a comprehensive analysis and review of GoMP's public finances. Savings from the original budget enabled the engagement of an international consultant to assist GoMP to design the proposed VAT system. The TA was rated "successful" by the TCR [64] and an Operations Evaluation Department (OED) Technical Assistance Performance Audit Report,[65] which found the most successful interventions were in tax, SBFAU, and computerization of treasury functions. The outcomes of interventions in key expenditure departments—such as in health, education, public works, and water resources—were relatively less visible. The OEM agrees with the rating of the above two assessments.

95. **PSU Reform.** [66] This TA, attached to the MPPRMP, aimed to support GoMP's efforts to develop and implement a comprehensive and socially sustainable program of public enterprise reform. It had three objectives: (i) to establish effective institutional mechanisms for restructuring and divestment of PSUs, including assistance in designing and implementing the SSN; (ii) capacity building for undertaking PSU reform; and (iii) improving corporate governance, including strengthening accounting and information systems of PSUs. This TA was subject to an in-depth review conducted by the OEM (Appendix 7). The TA was rated "relevant," as it was consistent with the GoMP reform agenda and ADB's India strategy. The TA produced quality reports and advice but it was rated "less effective" as the institution it was planned to support was not created, and GoMP chose not to operationalize an SSN. Its planned 12-month time frame was insufficient to support the complex public sector undertaking reform agenda in support of a 3-year program loan. It was rated "less efficient" and "less likely sustainable" as, without further exogenous resources to provide the necessary technical advice to further PSU reforms, GoMP's reform effort would be limited and the materials prepared under the TA would be of little practical value. The OEM overall rating of "partly successful" matches that of the TCR.

V. ISSUES, LESSONS, AND FOLLOW-UP ACTIONS

A. Issues

96. **Environment and Rehabilitation Policies.** The inclusion of support for GoMP to formulate environment and rehabilitation policies was a very positive initiative, particularly given its intent to harness private sector investment in key infrastructure sectors. However, it appears from the files that ADB provided no substantive comment on drafts of the rehabilitation policy. In the most recent power sector loan where an analysis of the rehabilitation policy was conducted, it found the level of compliance inadequate in one key principle compared with ADB's *Involuntary Resettlement Policy* (1995), and this was sufficient to undermine its use. In the context of Paris Declaration alignment commitments, there is an opportunity for ADB to be more

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[64] ADB. 2002. *Technical Assistance Completion Report on Support for the Government of Madhya Pradesh Public Finance Reform and Institutional Strengthening*. Manila.

[65] ADB. 2004. *Technical Assistance Performance Audit Report on Selected Technical Assistance for Fiscal Management and Tax Administration in India*. Manila.

[66] ADB. 1999. *Technical Assistance to India for Capacity Building for Public Enterprise Reform and Social Safety Net in Madhya Pradesh.* Manila (TA 3338-IND, for $600,000, approved on 14 December).

proactive in working with the Government to address apparent gaps in policies that ADB supported being formulated.

97. **TA Scope and Sequencing.** Two ADTA projects were approved in 1997, when the Program was expected to be approved by the third quarter 1998. These TA were multipurpose, providing experience for design while building institutional capacity in fiscal and local government reform through program implementation. The TA attached to the loan was largely constrained by the failure to establish a technical secretariat, which was a key institution in terms of the broader PSU reforms. Given that ADB's TA resources were limited, more strategic use of TA resources would likely have achieved better results. For example, the choice not to provide TA support for the technical secretariat from the outset is unfortunate, given its apparent importance in the program design. The inclusion of a TA to address one aspect of local government fiscal reform, but not following up in the Program, is difficult to reconcile as the TA itself had little lasting impact—partly as it was not focused on the key constraint in this area.

98. **Nominal Fiscal Targets.** Setting nominal fiscal targets by judgment, rather than through applying a rigorous modeling technique, was repeated in the MPPRMP with similar results to the GPSRMP. ADB staff recognized that this was problematic in their presentation of the final GPSRMP progress report to the Board, after the MPPRMP had been approved. Setting targets can be important to focus reforms. However, where they become part of tranche release conditions, mechanisms need to be agreed in the design to address the positive or negative impact of exogenous factors.

99. **Balancing Revenue and Expenditure Reforms.** Was the balance of revenue and expenditure reforms sufficient to achieve an outcome of enhanced resource allocation to social sectors? It is difficult to increase social sector expenditures (overwhelmingly on education and health) and simultaneously require a contraction in GoMP's wage bill, when wages dominate the sector budget and resources for capital expenditure are limited. Preparing a strategic investment plan to prioritize expenditure was a positive planning initiative. However, lack of a performance-based budgeting system with an accountability link of expenditure to the budget, diluted its operational effectiveness and missed an opportunity to contribute to anticorruption efforts.

100. **Exogenous Factors.** Although these were identified as risks, with specific reference to changes in the Government's policy, mitigation measures were not adequately identified. Although bifurcation of the state had been in the background for over a decade, it came very rapidly in response to political considerations, and had a significant impact on the pace of reforms. However, the impact of the fifth pay commission's awards, and the fact that the EFC was about to deliver its recommendations, was known before the Program was approved. In addition, experience from the GPSRMP should have alerted the program designers to the likelihood that, for example, (i) nominal fiscal targets could be problematic; and (ii) mitigation measures, in the form of an institutional mechanism to ensure that the relevant conditions could be flexibility addressed, could have been identified.

101. **Conditions at Variance with Policy.** When a nominal fiscal deficit target is fixed in a condition that later is at variance with the target set by the Government in its fiscal restructuring plan for the states, resolution is required. When the program conditions were designed, the Government had no set targets for states. However, based on the recommendation of the EFC, the Government initiated incentive-linked grants in which each of the major states was required to reduce its ratio of revenue deficit to total revenues by 5% every year for 5 years beginning FY1999.

102. **Design.** The logic of three outcomes—fiscal consolidation, PSU reform, and creating an enabling environment for private sector participation—to contribute to the impact was sound. However, as with the GPSRMP, the description of the Program in the RRP text, DMF, and policy matrix was inconsistent.[67] The RRP text describes a Program with three outcomes in Section B, and four in Section C. The DMF describes four outcome statements, one of which is in neither of the text descriptions. The structure of both the policy matrix and the Loan Agreement are consistent with the three outcomes in Section B of the text. As may be expected with a policy-based loan, the policy matrix appears to be the key design tool, with the DMF completed as a documentation requirement. However, a policy matrix is not constructed using the DMF logic that each level (from activities to outcomes) must contain sufficient "conditions" to achieve the next higher level. Rather, the policy matrix defines a set of necessary, but not always sufficient, policy actions to produce a desired reform within a policy area.[68] The policy actions, many of which become tranche conditions or covenants, were a mix measurable outcomes, outputs, and processes. The DMF's monitoring indicators are a mix of appropriate indicators and activities, with some being outside the control of the state government—creating difficulties in adjusting them to factors within and beyond its control. Generic assumptions and risks are identified, but are not clearly distinguished to enable mitigation measures to be developed to address risks.

103. **PSU Closure.** The lack of clarity over the meaning of PSU closure was resolved during program implementation, with ADB agreeing that operational closure was sufficient. However, without actual liquidation, the value of the assets of the disinvested entity could not be realized and appropriated by GoMP—thereby contributing to the adjustment costs as envisaged. Without the technical capacity including the relevant staff from a PSU's finance department, to ensure that all the requirements for financial closure were being undertaken in a timely fashion, this process will be drawn out and may require specialist forensic accounting expertise. Further, as illustrated by the police housing corporation, it is relatively easy for government to revive an operationally closed PSU, but more difficult if it is financially closed or under a court-appointed liquidator. Of course, once legally closed, creating a new PSU is the only option. It is recognized that legal closure is a lengthy process in India. To agree that operational closure is sufficient, is one step too short in a PSU reform program.

104. **Monitoring.** ADB's role in implementation is broadly to monitor and provide technical advice through policy dialogue. While the former can be achieved through missions, the latter requires a more hands-on approach, one that was well performed by staff in the India resident mission, between headquarter missions, despite the Program not being delegated. In complex reforms, it is often difficult to keep track of the details. For example, in the case of the fairly successful reform of stamp duties, one important part of the reform was to lower the rates in accordance with the recommendations of the committee of chief ministers. This was not done, yet assessments note that measures relating to stamp duty were fully implemented. This reinforces the need for vigilance in monitoring, as well as the essential role that resident missions play in ADB partnership with clients.

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[67] Unfortunately, based on OED evaluation findings and review of draft RRPs for proposed programs, this issue remains today. For example, the ADB. *2005 Panel Report to Management on the Quality-at-Entry of ADB Projects and Country Strategies Approved 2004–2005, Manila,* recently completed by OED, finds "the criterion of development objectives, evaluability [sic] and sustainability [in projects] was one of the weaker areas with only two-thirds of the projects assessed rated as satisfactory or better" (p.14).

[68] For example, policy actions to achieve a reform outcome may need to be sequenced over a period longer than a loan's agreed duration. The policy actions to prioritize and rationalize expenditure were not sufficient to achieve this output.

105. **ADB Board.** As with the GPSRMP, there is a correlation between the lessons reported in the PCR and this OEM, and some of the issues raised by the Board in approving the MPPRMP. This raises questions as to how Management responds to ensuring that Board member's concerns are addressed during implementation, and how the Board monitors that its concerns are being addressed when progress reports are discussed.

B. Lessons

106. **Responding to the Iterative Nature of Reforms.** The lesson from the GPSRMP that a 2-year time frame is insufficient was reflected in the 3-year design of the MPPRMP—with the Program being completed within 39 months, including the delays resulting from bifurcation. However, the fact that a number of reforms are still incomplete in 2006 reinforces the long-term, iterative nature of fiscal reforms. This provides a challenge for ADB in terms of its ability to sustain involvement over a long period, its financing modalities, and its relevance to the client. Providing sufficient TA for the duration of the Program is also a challenge, particularly when delays in implementation have resource implications for TA. The availability of the cluster loan modality provides the flexibility to accommodate a longer-term commitment, and respond to changing political and reform imperatives. In addition, the use of the project loan modality for institutional strengthening and capacity development may provide similar opportunities, even under OCR conditions.

107. **Align Reform Targets.** According to the Indian Constitution state level lending program by multilateral institutions must involve the Government of India, which is the Borrower, onlending to the states. Mechanisms need to be in place to align reform targets between ADB, the state government, and central Government. This also requires flexibility within ADB for Management to make adjustments required to achieve outcomes.

108. **Anticorruption.** As public resource management programs address fundamental aspects of government financial management, the opportunity to explicitly target revenue and expenditure reforms that support government's anticorruption agenda has the potential to have significant flow-on effects.

109. **Exogenous Factors.** This includes the political economy (e.g., policy change by the Government) or natural disasters, and these will probably occur over the medium term. Mitigation measures, particularly related to political economy factors, need to be designed in the Program, with policy actions, conditions, and covenants individually assessed by clearly specifying a mechanism to change conditions in response to such factors.

110. **Monitoring and Policy Dialogue.** Complex reform programs require continuous monitoring and policy dialogue through the combined and well-coordinated resources of both headquarters and the resident mission. Where Management is unwilling to delegate such programs to resident missions, monitoring and policy dialogue arrangements need to specify clearly the different roles and responsibilities of headquarters and resident mission staff to maximize the use of staff resources.

C. Follow-up Actions

111. By the fourth quarter of 2007, in formulating the India 2007–2010 country partnership strategy, the OEM recommends that ADB's state level support strategy, as revised in the 2003–2006 country strategy and program,[69] should be reviewed to assess the opportunities to support

[69] ADB. 2003. *Country Strategy and Program (2003–2006): India.* Manila.

priority aspects of ongoing state level public resource management reforms, and the most appropriate funding modalities to achieve jointly agreed outcomes.

ANALYSIS OF MADHYA PRADESH PUBLIC RESOURCE MANAGEMENT PROGRAM DESIGN

Table A1.1: Madhya Pradesh Public Resource Management Program Design and Monitoring Framework

Design Summary	Targets/Measurable Indicators	Monitoring Mechanism	Assumptions/Risks
A. Goal Assist GoMP reform efforts to foster social development and sustainable economic growth through improving public resource management and enhancing public expenditure to social sector	Medium-term sustainability of public finances Capacity building for prudent management of public expenditure and debt and strengthening resource mobilization, including through improved tax administration Expenditure reallocation to social sector, and protection of these outlays from budgetary cuts Preparation of plan indicating how national norms on health and education could be met as state's financial constraint eases Alleviation of social impact of development Strengthened corporate governance; and improved financial performance of PSUs Policy, regulatory, and institutional frameworks of key sectors (power, roads and transport, and housing) Improved environmental sustainability of the reform process	Finance department, supported by SBFAU, to prepare periodic reports on fiscal trends, expenditure allocation to social and economic services, and tax and expenditure policy measures Plan on how national norms in health and education could be achieved Committee to be established to prepare SSN design and submit report to the ADB Technical secretariat to report on progress of PSU restructuring, and the DPE to publish annual report on public enterprise sector performance GoMP to report on sector core investment program and experience with private sector involvement in social and political infrastructure Sector policies; action plan for strengthening environmental management and monitoring	Political acceptability of and commitment to fiscal consolidation and tax reforms and acceptance by PSU management of greater transparency and accountability Capacity building on expenditure management and control to prevent expenditure overrun and avoid unproductive expenditure crowding out social sector allocations Program success is contingent on stable political and exogenous environment; exogenous shocks, including policy decisions by the central Government, could adversely affect economic development, private sector environment, and SRF implementation
B. Program Objectives Enhanced resource allocation to social sector, within a medium-term framework of sustainable public finances and strengthened fiscal management, to foster social development and satisfy basic human needs while mitigating social impact of development	Expenditure allocation for enhanced capital outlays and non-personnel expenditure on health, and adequate budgetary provision for sustainability of DPEP within framework of fiscal consolidation, reflected in reduction in state's primary deficit from budgeted 3.4% of SDP to about 0.7% of SDP Committee to prepare SSN design; preparation of policy on rehabilitation	Finance department to provide budget documents; SBFAU to undertake regular monitoring, and report to be provided to ADB on compliance with the agreed policy measures; plan to ensure protection of social sector outlays from budgetary cuts Report on SSN design; ADB review of rehabilitation policy prior to finalization	Difficulty in achieving targeted improvement in public finances because of adverse (exogenous) conditions, and inability to mobilize resources to fund increase in social sector spending Government support and commitment to SSN

Design Summary	Targets/Measurable Indicators	Monitoring Mechanism	Assumptions/Risks
Improving corporate governance and increased efficiency of resource use through restructuring public sector undertakings	Enhanced efficiency, improved financial performance, and reduced fiscal burden of PSUs on the GoMP budget; reduced role of the Government in commercial activities and enhanced accountability and transparency of PSU management	Technical secretariat to be established with ADB TA, to oversee and advise on implementation of PSU reform; DPE to publish annual report on PSU performance, including reform progress	Absence of political and labor resistance to PSU reform and timely development of capacities of concerned agencies to implement restructuring; conducive capital market conditions and active private sector participation to ensure success of PSU divestment
Evolving enabling environment for private sector participation in key sectors	Private sector participation and sustainable sector development in the power, roads and transport, and housing sectors	More transparent process of investment, production, distribution of profits, and personnel decisions; reduction of subsidies and other direct financial support for PSUs Sector policies in roads and transport and housing to be implemented; utilities pricing commission and State Electricity Regulatory Commission to be established	Consensus between bureaucracy and private sector, to avoid delay in the preparation and implementation of policy action plan for promoting private sector involvement
Promoting environmental sustainability of economic development	Guidelines for market-based instruments; strengthened technical capacity of Pollution Control Board	State environment policy to be implemented; time-bound action plan for implementation of market-based instruments	Acceptance by industry of market-based instruments and enhanced environmental monitoring
C. Program Components 1. Foster social development, support institutional strengthening, and improve public finances; the Program will include	Key parameters of fiscal performance (i.e., fiscal deficit, expenditure allocation) to be set as benchmarks Capacity building and institutional and procedural strengthening	Finance department to provide finance bill with details on new revenue measures and expenditure reports; ready reckoners for property assessment Provision of training; preparation of studies, implementation of recommendations, and reporting of impact including feedback on required changes	Adequate strengthening of fiscal management and implementation capacity of finance department; increased fiscal pressure caused by lower than programmed revenue growth; pressure on unproductive expenditure
a. institutional strengthening	Establishment of the PRMC, headed by chief minister, and the Empowered Committee on Public Finance Reform, headed by chief secretary; management information system for finance department; committee for design and implementation of SSN	Establish SBFAU in the finance department; draft SSN design to be submitted to ADB; computerization and networking of finance department's treasury operations for improved expenditure management and control	Timely establishment of SBFAU; availability of adequately experienced staff; adequate capacity to design and implement SSN and proper monitoring
b. adoption and implementation of medium-term fiscal framework for FY1999–FY2003	The primary deficit to be reduced from 3.4% of SDP in the FY1999 budget to 1.0% in the FY2001 budget and to 0.7% in the FY2002 budget; capital expenditure to be at least 1.6% of SDP in FY1999, 2.0% of SDP in FY2001, and 2.3% in FY2002	Finance department to provide finance bill with details on new tax measures and expenditure reports	Exogenous factors, such as natural calamities, and slippages in expenditure control may adversely affect fiscal consolidation

Design Summary	Targets/Measurable Indicators	Monitoring Mechanism	Assumptions/Risks
c. improved efficiency and effectiveness of resource use, through	Increased wage flexibility by evolving policy to unlink wage setting; decline in budgetary subsidies; reallocation of expenditure to social services, particularly health and education; increased effectiveness and efficiency of the payment and audit system through computerization of finance department	TA report on policy and regulatory framework of health and education sectors; TA report on computerization and/or networking of finance department; wage policy	Resistance to reducing the size of government employment; line departments to resist reallocation of resources to social sectors; pressure on increase in unproductive expenditure
(i) rationalized and prioritized expenditure	Prepared and implemented CIP; reviewed and implemented recommendations of the study on industrial incentives scheme; prohibited regularization of casual and/or temporary (after 1988) workers into state government and PSUs and of PSU employees into state government	Develop a system for monitoring implementation of CIP; evolve policy and introduce legislation on prohibition to absorb PSU employees into state government service	Adequate capacity of relevant departments to develop and implement CIP; resisting pressure for regularizing casual and/or temporary workers
(ii) reallocated expenditure to social services	Adequate provision in the FY1999 budget and annually thereafter to clear backlog of capital expenditure and shortfall of non-personnel expenditure in existing rural health facilities; reduced state government employment other than technical positions in essential services and police through attrition, abolished posts, and reallocation of resources saved through attrition to poverty-reducing social services; appropriate budgetary allocation equivalent to the central Government share of 85%, to ensure sustainability of DPEP; prepared and implemented action plan, with ADB TA support, to ensure that social sector outlays are protected and national norms could be met in due course	ADB TA report; action plan on protection of social sector outlays; budget documents	Resistance of bureaucracy to adopting social sector-friendly policy in view of strong pressure on the overall budget Improved budget management and control to enable adequate provision for sustainability of DPEP and allow increased allocation for health and education expenditure
(iii) shifted priority from current to capital expenditure	Capital expenditure raised from 1.6% in the FY1999 budget to at least 2.3% in the FY2002 budget	Finance bill; expenditure reports; CIP	Revenue shortfall, exogenous factors such as natural calamities, or inadequate compression of unproductive expenditure may tighten resource availability for increase in capital expenditure

Design Summary	Targets/Measurable Indicators	Monitoring Mechanism	Assumptions/Risks
d. mitigated social impact of economic development	GoMP to issue notification of the operationalization of SRF and allocate appropriate resources in the FY1999 and subsequent budgets	Notification of setting up of SRF; report to be submitted to public resource management committee and ADB	Acceptance by bureaucracy of allocation of adequate budgetary resources to SRF
	Design and implement SSN	Establish a committee with responsibility for preparing and implementing SSN; review SSN, including socioeconomic survey of affected groups	Full cooperation between ADB consultant team, state government, and PSU management required Weak management capacity of SSN committee in preparing guidelines for SSN
e. strengthened resource mobilization through			
(i) rationalization of sales tax system	Tax base to be widened by reducing the number of goods exempted from 93 to 39 items; and reducing the number of sales tax slabs from 6 to the 4 main rates of 2%, 4%, 8%, and 12%	Finance department to provide new tax rate schedule; systems plan for full computerization of sales tax administration	Acceptability by the business community of the reform proposals, under which industrial concessions and tax exemptions would be reduced or eliminated
(ii) phasing-in of VAT system	Implementation, through appropriate legislation, of the first stage of VAT by lowering tax on manufacturing inputs; subsequently, by June 2001, full introduction of VAT	Legislative bill; review of the impact of VAT	Higher than programmed revenue losses from tax reduction/input tax relief might delay improvement in fiscal position
(iii) reform of stamp duty system in line with recommendations of the 1996 and 1997 state finance ministers committee on stamp duty	Reduced maximum rate on conveyances; and rationalized stamp duty on capital market instruments	New tax rate schedules to be provided; annual finance bill; establishment of central and regional valuation cells	Acceptability of new valuation of property; timely establishment of valuation cells; adequate capacity in applying new valuation methodology
(iv) improved cost recovery	Water charges to cover at least 50% of O&M cost by June 1998 and 75% by March 2001; prepared time-bound action plan and implement system of user charges on utilities	Finance department to report on revised water tariff and progress on implementation of the action plan	Acceptability of increased utilities prices

Design Summary	Targets/Measurable Indicators	Monitoring Mechanism	Assumptions/Risks
2. To undertake public enterprise reform and improve corporate governance, the Program will	Operational and institutional strengthening, including approval of policy guidelines on public sector reform; setting up empowered committee and technical secretariat; establishing procedures for enhanced accountability of PSU management Restructuring 14 PSUs, including closure and/or merger of nine PSUs, sale and/or lease of assets of one PSU, full or partial divestment of four PSUs VRS, and retraining of employees affected by PSU restructuring	Transfer nodal responsibility for reform of all state PSUs from line departments to DPE; technical secretariat to report on progress of implementation of PSU reform; financial criteria requiring minimum rate of return on public investment to be introduced	Appropriate technical capacity of DPE and timeliness in staff assignment and recruitment to strengthen DPE; resistance to closure of PSUs and labor retrenchment among PSU employees and society as a whole
a. develop policy and institutional mechanism for PSU reform	GoMP to (i) approve policy guidelines on public sector restructuring and reform; (ii) set up ECPR, headed by chief secretary; and (iii) establish technical secretariat to assist in PSU reform	Technical secretariat to submit a report on restructuring and divestment of PSUs and the strengthening of PSUs' accounting systems	Setting up technical secretariat with appropriate technical capacity to undertake PSU reform; adequate monitoring and guidance from ECPR
b. improve corporate governance and support institutional strengthening	DPE to assume nodal responsibility for reform of state PSUs; DPE to review candidates for appointment of all functional directors on professional basis, with due regard to PSUs' service rules	DPE to establish procedures for enhanced accountability of managing director for PSU performance and introduce appropriate monitoring mechanism	Staffing DPE with employees with appropriate qualification; decisiveness in implementation of accountability procedures and adequacy of monitoring for compliance
c. increase operational freedom of PSUs	GoMP to introduce financial criteria regarding return of investment for dividend payment and establish investment limit for which PSUs do not need approval from government; provision of performance incentives by differentiation in remuneration linked to productivity and PSUs' financial performance	DPE to issue and publish annual report on performance of PSUs	Adequate capacity of GoMP to enforce the new operational framework for PSUs
d. restructure and/or divest PSUs	49% divestment of MPSIDC 49% divestment of corporate units of MPSRTC 74% divestment of MPSAIDC 25% divestment of MPSFC under SFC 1951 (GoMP shareholding further reduced to not more than 26%, contingent upon amendment to the SFC) Sale and/or lease of the properties of MPSTDC	Technical secretariat to provide regular reports on progress made	

Design Summary	Targets/Measurable Indicators	Monitoring Mechanism	Assumptions/Risks
e. close and/or merge PSUs	Closure of MPSLDC, MPSExC, MPSFishDC, MPSLandDC, MPSIC and MPSTC	Government orders for closure of PSUs; approvals from Board for Individual and Financial Reconstruction and its appellate authority for closure of managed mills of MPSTC; GoMP to report to ADB on settlement of workers' and creditor's dues	Acceptability by labor unions and employees of closure of PSU; timely conclusion of legal process of PSU closure; adequacy of resource availability for voluntary retirement scheme
	Incorporate MPHB; subsequent divestment of 49% of GoMP's share in MPHB; closure of MPSCB and MPPHC	GoMP to approve restructuring and merger proposal	Synergies from merger do not materialize; adequacy in settlement of workers' dues
f. initiate reform of cooperatives sector	Review and assessment of constraints in cooperatives sector and recommendations to enhance their operational freedom and efficiency	Report on the financial performance of cooperatives sector (with ADB TA support)	Full cooperation from cooperatives sector
3. To promote enabling policy environment for private participation in key sectors, the Program will support	GoMP to introduce legal and regulatory frameworks for key sectors; setting up of independent electricity regulatory authority, utilities pricing committee, and rent tribunal	GoMP to prepare power system master plan and sector CIPs; adjustment in tariffs in the power and roads and transport sectors; report on impact of amendment to Rent Control Act	Development of outstanding issues at the central government level on sector policies regarding private sector participation: political and public acceptability of increasing power tariff, toll charges, and rents
	Rationalization of routes; guidelines and procedure for private sector participation	State roads policy; state transport policy; report on experience with private sector projects	Adequate capacity for developing effective framework for private sector participation
	Institutional strengthening of PWD	A private sector cell to be established and operationalized, which will provide report to ADB	Availability of required expertise and experience by PWD staff
	Improve policy framework for private sector investment in housing sector by amending the State Rent Control Act	Amendment to State Rent Control Act to be enacted	Timely approval of the amendment
a. power sector reform	GoMP to (i) establish an independent MPERC; (ii) make MPERC fully operational by March 2000; and (iii) have MPERC announce its first revision of electricity tariffs no later than 120 days after becoming operational	GoMP to include in the finance minister's 1998/99 budget speech detailed explanation indicating full amount of subsidy on account of electricity consumption to agriculture sector; notification for establishment of MPERC; written directions to MPERC on minimum level of tariffs for agriculture	Timely operationalization of MPERC; acceptance by agricultural and domestic consumers of increase in electricity tariffs

Design Summary	Targets/Measurable Indicators	Monitoring Mechanism	Assumptions/Risks
b. roads and transport sector reform	(i) creating policy for private sector participation; (ii) rationalizing routes; (iii) strengthening PWD's capacity to process private sector projects; and (iv) developing tariff setting mechanism and reviewing existing toll rates for roads and bridges	State transport policy and state roads policy to be announced A private sector cell to be established and operationalized within PWD GoMP to prepare a plan for establishing a utilities pricing commission	Appropriate implementation of the denationalization of routes; adequate strengthening of PWD; consensus between PWD and private sponsors on the contractual arrangements for private sector projects
c. housing sector reform	Providing for market-based rental increases and exempting newer properties from provisions of State Rent Control Act; setting up of rent tribunal	Enact amendment to State Rent Control Act; report on impact of the amendment on the level of rents and on sector investment	Timely approval of the amendment; resistance to rent increases
4. To promote sustainable development, the Program will support			
a. strengthened environmental management	Developed market-based instruments; strengthened technical capacities of the PCB and its regional offices; training program to PCB staff and industrial associations on environmental monitoring and management	A state environment policy to be prepared and announced; time-bound action plan for implementation of appropriate policies, including market-based instruments for environmental management to be prepared	Adequate capacity of state agencies to formulate and implement the action plan, and effectiveness in environmental monitoring and management
b. mitigation of social impact of economic development	Preparation of policy on rehabilitation to address social impacts of economic development and ensure policy framework for project intervention on socially sustainable basis	Submit draft rehabilitation policy to ADB for review	Timely preparation of rehabilitation policy; adequacy of guidelines for resettlement issues associated with project implementation

ADB = Asian Development Bank, CIP = core investment program, DPE = Department of Public Enterprises, DPEP = District Primary Education Program, ECPR = Empowered Committee on PSU Reform, GoMP = government of Madhya Pradesh, MPERC = Madhya Pradesh Electricity Regulatory Commission, MPHB = Madhya Pradesh Housing Board, MPSLandDC = Madhya Pradesh State Land Development Corporation, MPPHC = Madhya Pradesh Police Housing Corporation, MPSAIDC = Madhya Pradesh State Agro Industries Development Corporation, MPSCB = Madhya Pradesh Slum Clearance Board, MPSExC = Madhya Pradesh State Export Corporation, MPSFC = Madhya Pradesh State Financial Corporation, MPSFishDC = Madhya Pradesh State Fisheries Development Corporation, MPSIC = Madhya Pradesh State Industries Corporation, MPSIDC = Madhya Pradesh State Industrial Development Corporation, MPSRTC = Madhya Pradesh State Road Transport Corporation, MPSTC = Madya Pradesh State Textile Corporation, MPSTDC = Madhya Pradesh State Tourism Development Corporation, O&M = operation and maintenance, PCB = Pollution Control Board, PRMC = Public Resource Management Committee, PSU = public sector undertaking, PWD = Public Works Department, SBFAU = state budgeting and fiscal analysis unit, SDP = state domestic product, SFC = State Financial Corporations Act, SRF = state renewal fund, SSN = social safety net, TA = technical assistance, VAT = value-added tax, VRS = voluntary retirement scheme.
Source: Operations Evaluation Mission.

Table A1.2: Comparison of MPPRMP Program Structure as Outlined in the Policy Framework, Design and Monitoring Framework, Policy Matrix, and Loan Agreement

Objectives and Scope (RRP Section B)	**Policy Framework** (RRP Section C)	**Design and Monitoring Framework** (RRP Appendix 1)		**Policy Matrix** (Appendix 3)	**Loan Agreement** (Schedule 5)
		Impact/Outcomes	**Components**		
The objective is to support GoMP's reform efforts to foster social development and sustainable economic growth by addressing prevailing resource and implementation constraints in Madhya Pradesh, focusing on:		The impact was to support GoMP's reform efforts to foster social development and sustainable economic growth through improving public resource management and enhancing public expenditure to social sector through three objectives:			
1. Enhancing resource allocation to social sectors to support human development	1. Capacity building and institutional strengthening for improved fiscal management and sustainable public finances 2. Reallocation of expenditures to social services	1. Enhanced resource allocation to social sector, within a medium-term framework of sustainable public finances and strengthened fiscal management, to foster social development and satisfying basic human needs while mitigating social impact of development	1. Foster social development, support institutional strengthening, and improve the public finances	A. Social development, institutional strengthening, and public finance	A. Social development, institutional strengthening, and public finance
2. Improving public finances and fiscal capabilities and management, and fostering efficient allocation through reform of public enterprises, including corporate governance reform	3. Public enterprise reform	2. Improving corporate governance and increased efficiency of resource use through restructuring public sector undertakings	2. To undertake public enterprise reform and improve corporate governance	B. Public enterprise reform and corporate governance	B. Public enterprise reform and corporate governance
3. Strengthening the policy, regulatory, and institutional frameworks for private sector participation in key sectors	4. Evolving enabling framework	3. Evolving enabling environment for private sector participation in key sectors 4. Promoting environmental sustainability of economic development	3. To promote enabling policy environment for private participation in key sectors 4. To promote sustainable development	C. Enabling environment for private sector involvement	C. Enabling environment for private sector involvement

GoMP = Government of Madhya Pradesh, RRP = Report and recommendation of the President to the Board of Directors.
Source: ADB. 1999. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to India for the Madhya Pradesh Public Resource Management Program*. Manila (Loan 1717-IND, for $250 million, approved on 14 December).

Table A1.3: Comparison of the Design and Monitoring Framework and Policy Matrix

Design and Monitoring Framework (RRP Appendix 1)		**Policy Matrix** (RRP Appendix 3)	
Components	**Outputs**	**Objectives**	**Policy Areas**
1. Foster social development, support, institutional strengthening, and improve the public finances	i) institutional strengthening ii) adoption and implementation of medium-term fiscal framework for FY1999–2003 iii) improved efficiency and effectiveness of resource use, through: a) rationalized and prioritized expenditure b) reallocated expenditure to social services c) shifted priority from current to capital expenditure iv) mitigated social impact of economic development v) strengthened resource mobilization through: a) rationalization of sales tax system b) phasing-in of VAT system c) reform of stamp duty system in line with recommendations of the 1996 and 1997 state finance minister's committee on stamp duty d) improved cost recovery	A. Social development, institutional strengthening, and public finance	A. 1. Institutional strengthening A. 2. Medium-term fiscal framework A.7. Rationalization and prioritization of expenditure and strengthening of expenditure management A. 8. Reallocation of expenditure to social services and strengthening of institutional and legal frameworks for enhanced cost recovery A. 9. Mitigate social impact of economic development, including social safety net mechanism for PSU reform A. 3. Reform of sales tax system A. 4. Phasing-in of VAT system and strengthening of tax administration A. 5. Reform of stamp duty system and strengthening valuation system for assessment of stamp duty and property tax A. 6. Improved cost recovery
2. To undertake public enterprise reform and improve corporate governance	i) develop policy and institutional mechanism for PSU reform ii) improve corporate governance and support institutional strengthening iii) increase operational freedom of PSUs iv) restructure/divest PSUs v) close/merge PSUs vi) initiate reform of cooperatives sector	B. Public enterprise reform and corporate governance	B. 1. Develop policy and Institutional mechanism for PSU reform B. 2. Improve corporate governance and strengthen institutions B. 3. Restructure and divest/privatize PSUs B. 4. Merge and close PSUs; and sell/lease of properties B. 5. Initiate reform of cooperatives sector
3. To promote enabling policy environment for private participation in key sectors	i) power sector reform ii) roads and transport sector reform iii) housing sector reform	C. Enabling environment for private sector involvement	C.1. Initiate power sector reform C. 2. Develop policy and regulatory framework for promoting private sector participation in transport and roads sectors Strengthen capabilities of PWD to process private sector projects Develop tariff setting mechanism C. 3. Improve framework for private investment in housing sector
4. To promote sustainable development	i) Strengthened environmental management ii) mitigation of social impact of economic development		C. 4. Improve environmental sustainability of economic development Strengthen environmental management C. 5. Social impact of economic development

FY = fiscal year, PSU = public sector undertaking, PWD = Public Works Department, RRP = Report and recommendation of the President to the Board of Directors, VAT = value added tax.
Source: Operations Evaluation Mission.

Table A1.4: Reconstruction of Madhya Pradesh Public Resource Management Program Design and Monitoring Framework Impact, Outcomes, and Outputs

Impact / Outcomes	Outputs
Impact. Improved social development and sustainable economic growth through improved public resource management and increased public expenditure to social sector	
Outcome 1. A well-managed sustainable medium-term public finance framework enabling enhanced resource allocation to social sectors	1.1 Financial management institutions strengthened 1.2 Medium-term fiscal framework for FY1999–2003 implemented 1.3 Improved revenue generation 1.4 Improved expenditure efficiency and effectiveness
Outcome 2. Public sector undertakings restructured to contribute to the economy by efficiently and effectively using state resources	2.1 Institutional mechanisms in place to implement the public sector undertaking restructuring policy and program 2.2 Selected PSUs privatized 2.3 Selected PSUs restructured 2.4 Selected PSUs closed 2.5 Cooperatives sector reform initiated
Outcome 3. Private sector investment developing key sectors of the state economy	3.1 An enabling policy and regulatory framework in place 3.2 Key power, road, and housing sector reforms initiated

FY = fiscal year, MPPRMP = Madhya Pradesh Public Resource Management Program, PSU = public sector undertakings.
Source: Operations Evaluation Mission.

STATUS OF PROGRAM COMPLIANCE

Table A2.1: Tranche Release Conditions

Condition	Status at Tranche Release	PCR Status	PPER Status
I. Second Tranche			
A. Social Development, Institutional Strengthening, and Public Finance Reform			
(A.1) The primary deficit to be below 1.0%[a] of SDP in the FY2001 budget, and capital expenditure is to be at least 2% of SDP by September 2000.	Substantially complied with. The revised budget estimates for FY2001 indicated a primary deficit of 1.6% of NSDP and capital expenditures of 1.5% of NSDP. As the state was bifurcated on 1 November 2000, this revised estimate refers to 7 months of the pre-bifurcated state and 5 months of the post-bifurcated state. The bifurcation, which was not envisioned at the time of program preparation, incurred significant fiscal costs not included in the original fiscal framework. GoMP and ADB estimated that the fiscal costs of bifurcation were 0.82% of FY2001 NSDP. This cost includes a revenue loss of 0.67% of NSDP based predominately on a loss in electricity duties (0.43% of NSDP), caused by higher-than-proportional high-priced consumer capacity in Chhattisgarh, and a loss in own non-tax revenue (0.19%), because of higher than proportional mineral and forestry resources in Chhattisgarh. This revenue loss can be considered a permanent loss. On the expenditure side, GoMP incurred 0.15% of NSDP higher expenditures, which have permanent and transitory components. The permanent component is based on a higher-than-proportional government salary bill (0.07% of NSDP) for class III and IV staff members who were not moved to Chhattisgarh. The transitory component (0.08%) was due to expenditures to set up the capital at Raipur, salary advances, and travel grants for those staff members required to move and higher-than-proportional expenditures on un-bifurcated organizations. Therefore, the fiscal costs of bifurcation account for three quarters of the 1.10% of NSDP shortfall between program targets and FY2001 revised estimates. Without bifurcation, GoMP could have achieved the primary deficit of 1.0% of NSDP and capital expenditure of 1.72% of NSDP, falling short of the targets by only 0.28% of NSDP. Other factors, not associated with bifurcation, have led to a higher fiscal deficit in FY2001 than originally envisioned under the	In July 2004, GoMP submitted an MOU to the Government under the SFRF. The MOU is currently being deliberated by the Government for signing. The monitoring indicator used in the MOU is the ratio of revenue balance to revenue receipt.	The final audited figures show primary deficit to be 1.53% and capital expenditures to be 1.51% of SDP in 2001–2002. Both kept rising in subsequent years as a proportion of SDP, with primary deficit dropping substantially in 2004–2005.

Condition	Status at Tranche Release	PCR Status	PPER Status
	Program. The general power tariff award increase, which was originally envisioned to be made within 90 days of the establishment of the MPERC, did not materialize until recently. There has also been slower-than-expected improvement in systems for tax and non-tax revenue enhancement.		
(A.2) Introduce the legislation on prohibition to absorb state PSU employees into state government service.	Fully complied with. Legislation passed by Parliament on 12 December 2000 prevents the wholesale absorption of state PSU employees into government service. The legislation requires that any candidate for a government service post must be recruited on a competitive basis, with due consideration for experience, qualifications, and merit.	Condition satisfied.	No further developments
(A.3) Review technical assistance recommendations, prepare and implement a plan to ensure that the present levels of social sector outlays are protected from budgetary cuts, integrate such plan in the overall CIP, and indicate how the national norms on health and education could be met as the state's financial position eases over time and as additional exogenous assistance becomes available.	Fully complied with. The plan to protect the level of social sector outlays was implemented through the first 3 years of the Program. Since the time of program appraisal in July 1998 (FY1998) through the FY2001 budget, total social expenditures increased by 11.4% in real terms, broken into total education expenditures, which increased by 6.2%, and total health expenditures, which increased by 28%. Taking into account the bifurcation of the state, the protection of social expenditures is also sustained as a share of NSDP. Between FY1998 and FY2001, total social expenditures as a share of NSDP increased from 3.75% to 4.01%, total education expenditures increased from 2.88% to 2.94%, and total health expenditures from 0.87% to 1.07%. To account for yearly fluctuation and the bifurcation of the state, 3-year average expenditures for FY1998–FY2000, normalized for the impact of bifurcation, are compared with FY2001 expenditures. This comparison reveals that yearly social expenditures increased by 3.6% between FY1998–FY2000 and FY2001. Education expenditures remained constant in real terms, while health expenditures increased by 19%. The investment component of the action plan is being protected for FY2001–FY2004 by incorporation into the statewide CIP, formalized under the Program. The state CIP will be included in the November 2001 supplementary budget documentation and will be an official component of the FY2003 budget.	Condition satisfied.	Social allocation ratio (social sector expenditures as a ratio of total expenditures) actually shows reduction from 1999–2000 levels in subsequent years (23.71% in 2004–2005 as compared to 34.24% in 1999–2000), but social priority ratio is fairly steady. It should be noted that some of the social sector expenditure (central share of SSA and central share of some of the health schemes such as reproductive and child health II) have moved out of the budget to parastatals. Meeting national norms appears to be still a long-term goal, as the gap between national averages and the state indicators are closing only slowly.

Condition	Status at Tranche Release	PCR Status	PPER Status
	The plan to meet national norms in health and education has been an input-based indicator in use for the past few decades. Under the Program, the plan to meet national norms has been formalized, and the first few years of the plan have been integrated into the CIP, emphasizing the need to allocate more resources as the state's financial position eases over time and as additional resources become available. For example, under current financial conditions, the national norms will likely take about 10 years to meet, but could be met earlier with additional resources.		
(A.4) (not in RRP) Provide sufficient provision in the FY2001 state budget to reduce the backlog of capital expenditures and shortfall of non-personnel expenditures in existing rural health facilities.	Fully complied with. Outlays are being made to meet this objective. The Appraisal Mission estimated that a total of Rs2.5 billion over 5 years was needed to eliminate the backlog. Based on bifurcation of the state, in FY2001 the number of rural health centers under the control of GoMP was three quarters of the original. Therefore, the amount to be allocated was Rs1.875 billion in FY2001, for an average of Rs375 million per year. In FY2001, the amount of additional capital expenditure allocated to rural health was Rs323 million, falling slightly below the average expected. GoMP committed to recoup this Rs52 million by increasing the average outlay to Rs388 million for the next 4 years and formalizing this commitment in the state CIP.	Condition satisfied.	Capital expenditures have been rising steadily and substantially in the first half of the current decade; total capital outlay increased from 1.51% of SDP in FY2000 to 4.59% in FY2004. In general, the infrastructural requirements of the education and health sector are likely to be fully met in another 2–3 years. However, it should be noted that personnel problems in these sectors, particularly in remote rural areas, are still acute.
(A.5) During the Program period, state government employment other than technical positions in essential social services and police to be reduced through natural attrition, and such posts abolished. Resources saved through natural attrition to be reallocated to poverty-reducing social services.	Fully complied with. A government order was issued on 8 January 2000 to reduce government employment by 30% as a medium-term goal. As a result, no increase in staff has occurred since the start of the Program, and posts in pre-bifurcated Madhya Pradesh were identified (accounting for 12% of government employment) which could be abolished over the 5-year period FY2000–FY2004. A total 19,448 vacant posts were abolished immediately. The remaining 37,000 posts were identified as superfluous and have been ordered to be abolished on the date the incumbent retires. All departments were asked to retrench daily wage employees appointed after 31 December 1998. As a result, various departments have retrenched approximately 22,000 daily workers. In addition, the Government introduced contracts for the education department in place of permanent government staff to allow for flexibility and increase incentives. During FY2002, total government salaries for the state have decreased for the first time (comparing bifurcated Madhya Pradesh in FY2002 with hypothetically bifurcated Madhya	Condition satisfied.	Under judicial review, some of the daily wage workers had to be reinstated from 2004. The policy of natural attrition continues, and new schoolteachers are no more employees of the state government. Expenditure contractions, in general, do not appear to have been large enough to (a) control deficits and (b) increase social sector expenditures. In general, deficits have been controlled, but overall social sector expenditures could not be increased, although the more important of those seem to have received due priority.

Condition	Status at Tranche Release	PCR Status	PPER Status
	Pradesh in FY2001).		
(A.6) Use SRF funds for restructuring and/or closure of PSUs; replenish SRF through required further allocation in the FY2001 budget.	Fully complied with. GoMP made an Rs1.5 billion provision for the SRF in the FY2001 budget, and the SRF was activated in September 2000. A total of Rs20 million was disbursed in FY2001 for VRSs. Some Rs1.5 billion was allocated in the FY2002 budget and Rs570 million was disbursed. An addition Rs1 billion will be allocated to the SRF in a supplemental budget to enable disbursement of a VRS for MPSRTC (estimated at Rs1.9 billion). The SRF committee was reconstituted as the cabinet subcommittee, and schemes and/or guidelines were extended for the next 3 years.	Condition satisfied.	GoMP had made available required funds to MPSRTC for VRS to its employees from its own funds in FY2006 and FY2007. Similarly, GoMP had settled most of the old liabilities pertaining to the banks and financial institutions for the PSUs identified for closure under this Program.
(A.7) Establish a committee to design and prepare the SSN and submit the draft SSN design to ADB.	Fully complied with. The committee was established in January 2000. The draft SSN was submitted to ADB in January 2001. The Mission provided comments, and a redraft of the SSN has been prepared. The draft report proposed retraining of displaced employees using existing industrial training institutes, training centers, and other institutions. The SSN also identified a counseling service to help former PSU employees use the cash compensation received from the VRS payment for investment and entrepreneurship. Monitoring of displaced employees, and placement services are also envisioned in the plan. Implementation of the SSN will occur through the technical secretariat being established under the Program.	Condition satisfied.	No further action after program completion as SRF discontinued. GoMP decided in FY2002 not to undertake SSN on the grounds that the scheme could create a precedent for all public and private bodies desiring to undertake downsizing, leading to cascading cost implications
B. Public Enterprise Reform and Corporate Governance			
(B.1) DPE must assume nodal responsibility for reform of all state PSUs.	Fully complied with. A government order designating the DPE as the responsible department for PSU reform was issued on 1 March 2000. DPE has led the current effort to close and restructure nonviable PSUs covered by the Program, and has been responsible for introducing governance and performance-based enhancements to the management of PSUs remaining under state ownership. In particular, DPE is charged with formulating and monitoring, on a quarterly basis, MOUs with 34 large PSUs and 16 smaller PSUs and cooperatives. DPE is also a member of the committee to vet and select functional directors for PSUs, establishing financially based criteria for dividends and instructing PSU to link pay scales with profitability.	Condition satisfied.	DPE maintains nodal responsibility but has a small staff with limited capacity to meet envisaged mandate.

Condition	Status at Tranche Release	PCR Status	PPER Status
(B.2) Implement restructuring of MPSRTC, including through formation of four corporate units with operational autonomy, and introduce efficiency enhancing measures.	Substantially complied with. GoMP decided on 18 April 2001 to restructure MPSRTC by dissolving the corporation and forming four geographically based corporate units under the Companies Act, 1956. By transforming the company from a state transport corporation to four companies, the units will each be more manageable, will achieve greater autonomy to make further efficiency enhancements, and will be easier to divest. GoMP issued the order to form the four companies on 26 August 2001. Assets and liabilities are being divided among the new units pending the bifurcation of the company, necessary to split the balance sheet between Madhya Pradesh and the new state of Chhattisgarh according to Section 58 (3) of the MPSRA 2000. In the meantime, GoMP has taken actions in advance of bifurcation to introduce efficiency measures by (i) allowing the company to adjust tariffs up to 7.5% per year; (ii) introducing commercial principles, including the elimination of new guarantees, government appointments, and bus tickets for special groups; and (iii) offering a VRS to 5,800 workers. Disbursement of the VRS for the 5,800 workers is awaiting the following: (i) Rs1 billion additional allocation to the SRF was requested for a supplemental budget; (ii) a council of ministers decision on restructuring the transport sector; and (iii) bifurcation of the company, to ensure that the VRS is not disbursed for workers who will ultimately work in Chhattisgarh. Based on the TA consultant's technical review of the company, which engendered doubt regarding its future viability, GoMP is considering a more significant restructuring of the state transport sector that could involve a much more significant downsizing of the company.	Currently, the ratio of buses to employees in MPSRTC is 1:12; most of the fleet is in need of repair or replacement. By cabinet order, 4,453 workers have opted for VRS. An additional 4,500 can be given VRS as well, at a total cost of Rs2.1 billion. However, MPSRTC does not have the resources to fund the scheme and the labor unions oppose VRS to maintain their political power. Since 1999, while the price of petrol has doubled, the fares have not been adjusted accordingly. On average, MPSRTC is not able to pay more than 70% of basic wages of its employees. High overhead costs and inefficient management of the organization persist.	GoMP will liquidate MPSRTC, when the bifurcation of assets and liabilities of MPSRTC between Madhya Pradesh and Chhattisgarh is complete. Out of the 10,600 employees of the corporation, 8,900 have been offered VRS, with disbursement to 8,300 employees having been completed and the VRS compensation for 600 employees scheduled to be disbursed shortly. Of the balance 1,700 employees, 500 who opted for VRS have been retained because of certain legal cases and the need for adequate human resources to carry out the winding-up process. Another VRS for the balance 1,200 employees has been announced. The last date for submission of applications is 28 October 2006, with 50–60% of these employees expected to signify their acceptance. Around 510 routes have been leased to private companies, with lease rentals of approximately Rs27.5 million per month being received and applied toward meeting administrative expenses, financing court cases and payment of old arrears. GoMP has attached assets of the company against the amount of around Rs8 billion outstanding from MPSRTC toward road tax. While creditors guaranteed by GoMP have been repaid, NBFCs that extended lease finance have been approached with a one-time settlement scheme. The process of auctioning the bus fleet has already commenced, while assets such as machinery are being disposed of through open auction. The entire liquidation process is expected to be completed by 2008, with approvals from various government agencies having been obtained.

Condition	Status at Tranche Release	PCR Status	PPER Status
(B.3) Undertake financial and organizational restructuring of MPSFC including classifying nonperforming assets and fully provision as per applicable norms on basis of March 1999 accounts, discharging overdue obligations, and re-capitalizing MPSFC to ensure compliance with capital adequacy requirements.	Substantially complied with. The classification of assets has been completed according to Reserve Bank of India norms, provisions have been applied accordingly, and the accounts are subject to annual audit. The company has paid its major overdue obligations as of 31 March 1999, but has negative equity of Rs1 billion on the reclassification. Given that the classification has revealed that more than 30% of its assets are nonperforming and its core clientele represents a risky sector of the borrowing community, MPSFC finds its viability in question. Under these conditions, GoMP has prudently ruled out recapitalization through injection of new budgetary funds. Due to the high level of contingent liabilities in the balance sheet of MPSFC, immediate liquidation has also been ruled out. Instead, GoMP has instructed the corporation to downsize and cut costs to reduce losses and limit GoMP's exposure. The company prepared a performance-based action plan in August 2001 for operational restructuring. The restructuring plan strategy has at its core (i) performance indicators that will be monitored and verified by a third party, (ii) branch closure and early retirement to reduce noninterest operational costs, (iii) refinancing of its funding sources to reduce interest costs, and (iv) a cap of guaranteed funding at current levels to prevent additional GoMP exposure to the company. Bifurcation of the company is necessary prior to implementation of the downsizing plan, as the result of the MPSRA 2000. The bifurcation scheme was prepared by the board of MPSFC, was approved by its general body, and is awaiting orders to be issued by the Government, according to the MPSRA.	Currently, the NPAs of MPSFC are 45%. It has been trying to clean its portfolio by restructuring its own debt and providing one-time settlement schemes to its customers that defaulted on their loans earlier. The retirement age has been reduced from 60 to 58, and financially unviable branch offices (4 of 13) have been closed, which reduced MPSFC's administrative expenses by 23%. They are ready to offer VRS to a number of their employees, but have no resources to finance the scheme. Their organizational restructuring efforts are ongoing.	Post-bifurcation of assets and liabilities of MPSFC and the division of employees between Madhya Pradesh and Chhattisgarh, a VRS scheme was offered and accepted by 15 employees, with the disbursement having been effected out of MPSFC's own funds. Two loss-making branches have been closed down as part of organizational restructuring measures. An MOU was executed with SIDBI in 2003 facilitating reduction of interest on loans by 2% and the provision of refinancing at concessional rates. Financial restructuring involving settlement of high cost bonds worth Rs680 million placed with SBI and Bank of Baroda was completed. Moreover, while SLR Bonds amounting to around Rs770 million have been prepaid/ redeemed, negotiations for restructuring/ reduction of SLR bond liability of around Rs700 million, owing to various public sector banks, are in progress. GoMP has also provided share capital support of Rs40 million besides a short-term loan of Rs600 million in FY2006 to finance the cash deficit. While disbursements increased to Rs1.15 billion in FY2006 (Rs420 million in FY2004), recovery has marginally improved to Rs920 million from Rs830 million in FY2004. The capital adequacy ratio continues to be negative owing to accumulated losses of the SOE, which aggregated to Rs2.27 billion on 31 March 2006 (Rs2.16 billion on 31 March 2004). NPAs declined to 25% of MPSFC's total loan portfolio on 31 March 2006 from 47% on 31 March 2004.

Condition	Status at Tranche Release	PCR Status	PPER Status
(B.4) Close the four corporations and the wholly owned units of MPSIC; report on settlement of workers' and creditors' dues.	Fully complied with. Operational closure is based on (i) the order for closure; (ii) operations having been ceased; and (iii) a VRS offered to all but core employees needed for windup. All companies have been closed by order, and a VRS has been offered to all employees of the five companies and one additional company (slated for third tranche release). Disbursement of the VRS took place for 82% of the scheduled 3,200 employees from the five companies. In addition, as a proactive measure, GoMP advanced closure for MPSTC (scheduled for third tranche), disbursed VRS for 68% of the staff (the balance is delayed by individual court disputes over VRS amount), closed the managed and owned mills, and retrenched almost 5,000 workers under the Industrial Disputes Act . **MPSFishDC.** The closure order was issued on 17 March 1998, and the corporation was subsequently merged with the Fisheries Federation (an apex body of the Fisheries Cooperative Union) on 31 August 1999. As the operations of the PSU are no longer under the jurisdiction of GoMP, wages for 500 employees are no longer a state obligation. **MPSLandDC.** The closure order was issued on 7 June 2001, and operations ceased on 30 June 2001. The issue of "interim relief" for workers, which prevented earlier disbursement of VRS payments, was resolved. The VRS scheme for 567 people was offered, and 552 workers accepted it. The SRF approved the VRS payment, and disbursement of Rs174 million took place on 10 September 2001. **MPSLDC.** The closure order was issued on 4 June 1998 and operations ceased in August 2000. The VRS and statutory dues amounting to Rs113 million were disbursed to all 132 employees, apart from a core staff of 13, on 31 October 2000. **MPSExC.** The final order to close was issued on 25 July 2001. Operations, apart from winding up on the order, ceased in May 2001. Following receipt of the chief minister's closure order, the VRS was offered to all remaining 63 employees. The SRF will approve for payment of the VRS is set by the end of November 2001 with disbursement to take place by the end of 2001. **MPSIC**. The company has closed 19 units in four phases. In phase one, four units were ordered closed on 3 July 1999, and disbursement of the VRS for 212 employees (Rs48 million) was made on 2 February 2001. In phase two, two sugar mills were ordered to close on 28 August	Condition satisfied.	**MPLeaDC.** Official liquidator is yet to be appointed in respect of MPLeaDC, with legal advice and secretarial assistance on last mill closure required by the SOE. A total of 97 former employees have filed a joint appeal challenging their retrenchment, with the matter pending before the M.P. High Court. Four tanneries of MPLeaDC have been closed and efforts to dispose of their properties are in progress. While GoMP's decision on assets of Damoh tannery is awaited, efforts to dispose off the assets of Narsingarh tannery are ongoing, while the matter relating to two tanneries in Mandsaur and Barhwani has been referred to the respective district collectors for a decision on alternative use of the facilities. Auction in respect of other usable assets is in progress, while the lease for the Emporium Building in Bhopal has been terminated and possession handed back to the owner. A claim of Rs6.1 million has been preferred with GoMP for settlement of claims of certain creditors and for meeting legal expenses. **MPSExC.** The operations were discontinued with effect from March 2002 with 12 permanent employees retained and 48 employees taking VRS funded through SRF. The entire business of MPSExC was vested in Madhya Pradesh Trade & Investment Facilitation Corporation in June 2004. In the intervening period between March 2002 (when the closure of MPSExC took effect) and June 2004, the business had been transferred to MPSIndDC. **MPSFishDC.** No further action required, as the condition was complied with at the time of tranche release. **MPSLandDC.** Not able to confirm the status of remaining employees or the sale of assets and settlement of outstanding liabilities.

Condition	Status at Tranche Release	PCR Status	PPER Status
	2000 and disbursement for 1,261 employees (Rs163 million) was made on 10 September 2001. In phase three, 11 units were ordered closed on 12 September 2001, and the VRS was offered to the remaining 315 workers on 27 September 2001. Disbursement is scheduled to take place by 31 March 2002. In phase four, two units currently under management contracts with private parties will be closed after the contracts expire in March 2002. **MPSTC**. The corporation was scheduled for closure before the third tranche but has been closed earlier than planned. The company closed two managed mills and one owned mill and 4,780 workers were retrenched under the Industrial Disputes Act. The MPSTC headquarters was ordered closed on 3 July 1998. VRS was disbursed to 369 (Rs140 million) of the 539 headquarters workers on 23 March 2001.		
C. Enabling Environment for Private Sector Involvement			
(C.1) Make MPERC fully operational by (i) establishment and incorporation of the MPERC in accordance with Chapter IV of the ERC Act; and (ii) finalization of the rules of the MPERC in accordance with Sections 57 and 59 of the ERC Act.	Fully complied with. MPERC was established in June 2000 and made fully operational in accordance with Chapter IV of the ERC act. Since then, GoMP has implemented power reform far beyond the stage envisioned by the Program. The Madhya Pradesh Vidyut Sudhar Adhiniyim (Electricity Act), 2000, approved by the Madhya Pradesh legislative assembly in November 2000 and made effective in July 2001, is the most progressive power sector reform act in India to date. In addition to subsuming and expanding the powers of MPERC through the creation of the MPERC, it includes provision for (i) restructuring of the MPSEB, (ii) metering of all consumers, (iii) rationalization of tariffs so that all classes of consumers will pay at least 75% of cost of supply over 5 years, (iv) budget provision for MPERC for the next 5 years, and (v) arbitration with the Central Electricity Regulatory Commission. Rules of the MPERC were developed and notarized under the ERC act. Under the Madhya Pradesh Electricity Act, the MPERC powers have been expanded. Therefore, additional rules for MPERC are needed to reflect the expanded powers. These rules are current being drafted by MPERC with the assistance of TA provided in preparation for the Madhya Pradesh power sector development program.	Condition satisfied.	

Condition	Status at Tranche Release	PCR Status	PPER Status
(C.2) Announce the State Roads Policy.	Fully complied with. PWD has framed various road development programs under national highways, central road funds, bond roads, normal plan roads, and non-plan works. These programs were included in the roads sector CIP and integrated in to the overall state CIP.	Condition satisfied.	The policy on road development in Madhya Pradesh 2001–2010 provided input to the Madhya Pradesh State Roads Act promulgated on 2 July 2005. The act provided statutory authority for the MPRDC as the state's highway authority.
(C.3) Announce the State Environment Policy and a time-bound action plan for implementation of appropriate policies, including MBIs for environmental management.	Fully complied with. The environmental policy was declared and adopted on 16 March 1999. An environmental status report was prepared by the Environmental Planning and Coordination Organization. An implementation action plan was prepared and submitted in June 2001. Implementation of the action plan, including market-based instruments, will take place with the assistance of ADB TA, scheduled to begin in the fourth quarter of 2001.	Condition satisfied.	Environment policy approved
(C.4) Preparation of a draft policy on rehabilitation to address social impacts of economic development.	Fully complied with. The draft policy was submitted to ADB on 15 October 2000. The cabinet discussed the draft policy in July 2001 and requested it to be strengthened to provide more compensation to resettled persons. A review of the reformulated policy took place on 21 August 2001. Following further revision, the policy will be resubmitted to the cabinet for approval. GoMP is well advanced toward finalization of the policy, which is a third tranche condition.	Condition satisfied.	Rehabilitation policy approved
II. Third Tranche			
A. Social Development, Institutional Strengthening, and Public Finance Reform			
(A.1) Make progress in fiscal consolidation, with primary deficit to be below 0.7% of SDP in the FY2002 budget; and capital expenditure to be at least 2.3% of SDP.	Overall: Substantially complied with. (a) Fully complied with for primary deficit target. The policy matrix makes provision for adjusting the fiscal consolidation targets for the primary deficit, expressed as a percentage of NSDP, by any shortfall in the devolution of central taxes to the state relative to the amount assumed in the medium-term fiscal framework. For FY2002, this shortfall has been estimated to be equivalent to approximately 0.6% of NSDP. Accordingly, the adjusted program target for primary deficit in FY2002 becomes 1.3% of NSDP. The actual outturn was 0.97% of NSDP, placing it well below this limit. (b) Substantially complied with for capital expenditure floor. The measured result for capital expenditure was	Overall, the fiscal balances of Madhya Pradesh improved during the program implementation period. Capital expenditure, especially for health and education, was also protected.	Final figures actually show a progressive rise in primary deficit as a ratio of SDP in 2 years after 2000–2001, without any adjustment. The costs of bifurcation and the droughts may explain it, as mentioned in the PCR, but the overall improvement in fiscal balance is really visible only in 2004–2005, and not before.

Condition	Status at Tranche Release	PCR Status	PPER Status
	1.83% of NSDP in FY2002 compared with the program target of 2.3% of NSDP, thus reflecting a shortfall of 0.47% of NSDP. However, the state's bifurcation has caused significant costs of fiscal adjustment that are additional to the shortfall in central tax devolutions from the Government not included in the original fiscal framework. GoMP and ADB estimate that the fiscal costs of bifurcation amounted to 0.82% of FY2001 NSDP and that the fiscal costs remained in excess of 0.6% of NSDP in FY2002. FY2002 has also been a year of drought in Madhya Pradesh, leading to an unforeseen need for substantial drought relief expenditures on the current account. Because capital expenditures are treated as a residual item of discretionary expenditure for Indian states, the unforeseen fiscal cost arising from bifurcation has absorbed financial resources in excess of the shortfall on capital expenditure.		
(A.2) Introduction of VAT.	Fully complied with. Madhya Pradesh assembly passed the VAT legislation on 7 August 2002, making it one of the first states to prepare legally for VAT. GoMP has undertaken a detailed training program for revenue department officers for VAT. Ongoing TA on VAT, funded by ADB, is providing additional assistance to GoMP (as well as other states) on auditing procedures and VAT administration. Based on the decision of the Interstate Empowered Committee for VAT and the Government, VAT will commence in Madhya Pradesh and other major Indian states on 1 April 2003.	Condition satisfied. Considerable effort and resources have been dedicated to ensuring Madhya Pradesh would be ready in technical and capacity terms to introduce the VAT by 2001. They have undertaken the necessary measures, but the Government deferred the introduction of VAT across India indefinitely, citing lack of capacity in most states. There has been no training for the last year and a half since VAT and all related procedures are put on hold by the Government.	After several years of withholding actual implementation of VAT on various pretexts, it was finally introduced in April 2006.

Condition	Status at Tranche Release	PCR Status	PPER Status
(A.3) Adjust water charges to cover at least 75% of O&M expenditure.	Fully complied with. As of the beginning of FY2002, approximately 70% of O&M expenditure was covered by water charges. A cabinet order, passed on 31 July 2002, has raised O&M charges by a further 5% for FY2002 and stipulated additional increases of 5% annually for the subsequent 5 years.	Condition satisfied. Recovery of 100% O&M is targeted by order of GoMP. In addition, a water sector restructuring loan from the World Bank is being developed for $400 million—expected to go to the World Bank Board in July 2004. This loan (i) has similar conditionality for cost recovery; (ii) targets reclaiming capacity created but not used, i.e., 50% of capacity; and (iii) institutional restructuring.	Irrigation water charges reported to have fallen below the prescribed level. No recent figures are available for charges levied for water supply by urban local bodies, but are reported to be well below the prescribed level.
(A.4) Adopt flexible wage policy enabling local governments to have separate service conditions and salary scales for their employees from state government.	Fully complied with. Salaries of local governments were de-linked from general government by Government Order 4-886/98/10-1 dated 11 September 1998. This decision has been implemented, making local government wage structures flexible and reflective of prevailing local labor market conditions. Local recruitment of teachers under the DPEP program and of paramedical workers has permitted substantial expansion of social services at a greatly reduced unit cost relative to staffing under state level pay scales and through centralized administrative procedures.	Condition satisfied. Government orders were issued for government employees that there would be no new hiring and natural attrition would continue. Flexible wage policy has not delivered drastic change.	No change in status quo after the loan program ended.
(A.5) Include appropriate additional budgetary allocation equivalent to the Central Government share to ensure sustainability of the District Primary Education Program after termination of exogenously funded Central Government assistance.	Fully complied with. A new centrally-sponsored scheme supported by the Government and GoMP, known as the national primary education scheme (SSA) will cover all the districts including the original districts covered under DPEP I and II. Programs for increased coverage of primary education facilities to disadvantaged districts will continue after the DPEP's termination on 30 June 2003 under this centrally sponsored scheme. Funding for this scheme is shared in the proportion 75% central and 25% state funding. For the 5-year duration of the new 10th Plan, GoMP has identified funding consisting of a central share of Rs21 billion and an GoMP share of Rs7 billion. The costs of funding 11,000 teachers, now covered under the DPEP, has been integrated into state budget planning.	Condition satisfied. World Bank continued after the European Commission sponsored the DPEP, as well as GoMP. Program rolled out to even more districts. A program exists for hiring teachers on a 2-year contractual basis—trying to alleviate the burden on the budget vis-à-vis their salaries, benefit packages, and ultimate pension payments.	With the introduction of the centrally sponsored SSA scheme, which expands the coverage to the entire state, the condition is rather irrelevant, since the total expenditure on education (central plus states' share) is substantially higher than before its introduction. However, only the state's own expenditure and its (25%) share in SSA spending is shown in the budget figures.
(A.6) Review the SSN	Substantially complied with. GoMP has reviewed the main	GoMP has taken a decision	No change.

Condition	Status at Tranche Release	PCR Status	PPER Status
including socioeconomic survey of affected groups, make recommendations for changes to SSN as required, and submit such SSN review to ADB.	features of the SSN for workers affected by retrenchment, the impact of the program, problems encountered under the implementation of the SSN, and recommendations for improvement. A small survey conducted under TA has identified workers' concerns and perceived needs with respect to the SSN. In the next phase of PSU reform, GoMP, with TA funded by DFID, will study in detail the affected groups and the socioeconomic impacts of PSU reform.	in 2002 not to undertake SSN. They were and/or are of the opinion that this would set an example for all public and private bodies wishing to downsize and would have cascading cost implications.	
B. Public Enterprise Reform and Corporate Governance			
(B.1) The technical secretariat will submit a report on the experience gained from reform of PSUs and the progress in improvement in corporate governance, together with recommendations for changes, if any, to the policy and institutional framework for PSU reform.	Substantially complied with. In the absence of a technical secretariat, yet to be established, GoMP's Department of Finance, in consultation with DPE, has prepared a note on progress in improving corporate governance. The Madhya Pradesh DPE has set up performance management systems for public enterprises, and the backlog of unaudited accounts has been reduced. GoMP has placed a cap on MPSFC guarantees, has limited its financial guarantees on borrowings of PSUs, and has frozen recruitments of PSUs. GoMP intends to establish the technical secretariat and has entered into an agreement with DFID for a grant to be used to staff the secretariat with contract staff.	A technical secretariat was not established. A £1 million TA proposal was submitted to the Government of India in May 2003. However, TA was still not approved. In its absence, a cabinet subcommittee on VRS was established and oversaw PSU reform so far, and approved about Rs1.60 billion for VRS to date. Principal secretaries for finance and industry indicated that scope still exists for a technical secretariat. Discussions with DFID are ongoing to establish a technical secretariat, supported by a DFID grant.	The proposal to establish a technical secretariat has been revived in recent discussions with DFID.
(B.2) Establish procedures for enhanced accountability of managing directors for PSU performance and introduce appropriate monitoring	Fully complied with. PSU performance is being monitored on the basis of MOU signed annually between PSUs and GoMP. A performance review committee, chaired by the Department of Finance, undertakes regular quarterly reviews. Activity-specific targets are laid down along with percentile rankings of each activity and serve as a scorecard of the performance of PSUs and their managing directors. The performance review committee can also recommend action against managing directors in case of noncompliance with targets.	An MOU mechanism exists, such that each PSU signs an MOU with the relevant line ministry. The process is facilitated by DPE. In the MOU, qualitative and quantitative targets are supposed to be identified each year, and the chief secretary is supposed to	No substantive implementation of the MOU for accountability of PSU managers, which continues to be an issue in the effectiveness of PSUs.

Condition	Status at Tranche Release	PCR Status	PPER Status
mechanisms.		review whether these targets have been met at the end of each fiscal year. "Action" is supposed to be taken against managing directors that do not meet their targets. However, a principal-agent problem exists—last year's MOU was just signed when the Mission was in the field.	
(B.3) Incorporate MPHB.	In view of changed circumstances due to bifurcation, the policy condition is proposed to be amended to: “Take a cabinet decision to incorporate MPHB.” The Madhya Pradesh cabinet decided to incorporate MPHB on 27 August 2002. However, implementation of this decision is awaiting the division of assets and/or liabilities between Madhya Pradesh and Chhattisgarh. If the policy condition is amended as proposed, the condition is fully complied with.	MPPHC was given VRS, since MPHB could not absorb the massive human resources of MPPHC.	Changes to corporate structure of MPHB still awaiting decisions on restructuring subject to finalizing asset division with Chhattisgarh.
C. Enabling Environment for Private Sector Involvement			
(C.1) Establish a utilities pricing commission for road and transport tariff setting and making operational the commission.	Partially complied with. GoMP has designated the Madhya Pradesh State Bridge Development Corporation, a subsidiary of PWD, as the nodal agency for design and implementation of BOT and other public-private partnerships for construction and operation of toll roads. GoMP amended the India Tolls (Madhya Pradesh) Act in 1999 to facilitate private sector participation in road projects. GoMP has not established a utilities pricing commission to date. The concession agreements for BOT with toll rates defined for the full contract period have already been announced for the first batch of BOT contracts. Consequently, the state authorities were concerned that potential BOT bidders would be confused by the alternative governance of a utility pricing commission, if such a commission were implemented in 2002. Under the Madhya Pradesh State Road Sector Development Program, TA for institutional strengthening and capacity building for the road sector will be provided, and BOT operations will be evaluated. GoMP has not yet established a utilities pricing commission pending the outcome of the TA for the reorganization of PWD, although it has requested ADB for advice on legal and financial aspects of model concession agreements.	Only MPERC was established—no other utility pricing or commissions exist. However, several GoMP officials noted that after ensuring "one utility" can be priced effectively and without too much political resistance, other utilities could be considered "in the future.”	A utilities commission has not been established. The electricity regulatory authority is functioning, and tolls for BOT roads are set through policy and then included in the contract between the Government and contractor. There was a waiver of full compliance with one tranche release condition based on the achievement of partial compliance.

Condition	Status at Tranche Release	PCR Status	PPER Status
(C.2) Implement the time-bound action plan for improved environmental monitoring and management.	Fully complied with. An environmental policy was adopted and promulgated by GoMP in 1999. Assistance for implementation of environmental policy, including improved environmental monitoring and management, has been provided under ADB TA for environment management. In addition, under a centrally sponsored program, environmental data collection and pollution monitoring capabilities are being upgraded through an exogenously funded multistate government program.	Condition satisfied.	
(C.3) Finalization of policy on rehabilitation.	Fully complied with. The Madhya Pradesh cabinet approved the rehabilitation policy on 17 August 2002.	Condition satisfied.	Rehabilitation policy in place

ADB = Asian Development Bank, BOT = build-operate-transfer, CIP = core investment program, DFID = Department for International Development, DPE = Department of Public Enterprises, DPEP = District Primary Education Program, ERC = electricity regulatory commission, FY = fiscal year, GoMP = government of Madhya Pradesh, MBI = market-based instrument, MOU = memorandum of understanding, MPERC = Madhya Pradesh Electricity Regulatory Commission, MPHB = Madhya Pradesh Housing Board, MPSLandDC = Madhya Pradesh State Land Development Corporation, MPSLDC = Madhya Pradesh State Leather Development Corporation Limited, MPPHC = Madhya Pradesh Police Housing Corporation, MPSEB = Madhya Pradesh State Electricity Board, MPSExC = Madhya Pradesh State Export Corporation, MPSFC = Madhya Pradesh State Financial Corporation, MPSFishDC = Madhya Pradesh State Fisheries Development Corporation, MPSIC = Madhya Pradesh State Industries Corporation, MPSRA = Madhya Pradesh State Reorganization Act, MPSRTC = Madhya Pradesh State Road Transport Corporation, MPSTC = Madya Pradesh State Textile Corporation, NBFC = nonbanking finance company, NPA = nonperforming asset, NSDP = net state domestic product, O&M = operations and maintenance, PCR = program/project completion report, PPER = program/project performance evaluation report, PSU = public sector undertaking, PWD = Public Works Department, RRP = report and recommendation of the President, SBI = State Bank of India, SDP = state domestic product, SFRF = states' fiscal reforms facility, SIDBI = Small Industries Development Bank of India, SLR = statutory liquidity ratio, SOE = state-owned enterprise, SRF = state renewal fund, SSA = Sarva Shiksha Abhiyan (national primary education scheme), SSN = social safety net, TA = technical assistance, VAT = value-added tax, VRS = voluntary retirement scheme.

[a] The target is adjusted for any shortfall in the devolution of central taxes to the state, calculated as the difference between the amount of central tax transfer assumed in the medium-term fiscal framework (Appendix 4, Table A4.2) and the actual amount of tax devolution from the central Government. The target is also adjusted for outlays in natural calamities in excess of the programmed outlays of 0.1% of SDP, if applicable.

Source: Operations Evaluation Mission.

Table A2.2: Post-Loan Approval Non-Tranche Release Covenants

Condition	Status at Tranche Release	PCR Status	PPER Status
A. Covenants to be Achieved by the Release of the Second Tranche			
(A.1) Set up by March 2000 a state budgeting and fiscal analysis unit in the Finance Department to strengthen the analytical and technical capacity for development and analysis of economic policy options and strengthen the debt management capability.	Fully complied with. The unit was established on 7 June 1999 in the Finance Department under the economic adviser. The duties of SBFAU are to prepare various reports on state finances for the Government, prepare the background paper for MOU with Government, and undertake analytical and technical work to assist in budget preparation.	SBFAU currently has only one staff member. The Economic Policy Analysis Unit, under the Institutional Finance Department, currently handles most of SBFAU's tasks.	The Economic Policy Analysis Unit is functioning, but is nowhere near the envisaged SBFAU. It is understaffed, has no experts at the moment, and is essentially working as a finance commission cell within the Finance Department.
(A.2) Computerize sales tax administration, including monitoring and accounting systems, and a system for registration of traders and cross-checking taxpayer information on the basis of the systems plan being prepared with ADB technical assistance.	Fully complied with. The Commercial Tax Department has initiated a three-pronged approach to computerizing the sales tax and/or VAT administration, auditing, and trader registration: (i) systems study and software development contract for software application was awarded to Computer Maintenance Corporation Ltd.; the software is being modified to incorporate the VAT design adopted in August 2001; (ii) the networking architecture was approved and procurement of hardware and networking equipment for 73 circle offices of the sales tax administration is at an advanced stage. Following hardware procurement, acceptance testing will begin in January 2002; and (iii) training of staff is ongoing with Computer Maintenance Corporation Ltd. support.	Covenant fulfilled.	Some amount of computerization has taken place, but several facets of sales tax/VAT administration yet to be computerized. It is probably necessary to have a fresh look at the entire administrative structure and a new computerized system for VAT.
(A.3) Complete training for all tax commissioners and tax officers on commercial taxes and taxation policy to strengthen tax assessment and enforcement capacity.	Fully complied with.	Covenant fulfilled.	No new developments after program completion.

Condition	Status at Tranche Release	PCR Status	PPER Status
(A.4) Review and assess the fiscal impact of the first stage of VAT introduction and make recommendation, if any, for further strengthening of tax administration.	Fully complied with. GoMP was one of the first states to develop an action plan to transform its antiquated tax system into a VAT, and preparation for the VAT is well advanced, but implementation must await preparation by other states and Government of India harmonization. The following actions have been taken: (i) reduced rates; (ii) not offering new incentives and withdrew new incentives effective 1 January 2000 while grandfathering old incentives; (iii) reduced the list of tax-free goods; (iv) created a state level VAT cell and five working groups; (v) prepared draft VAT legislation which is publicly available; (vi) drafted rules and procedures; (vii) publicized the VAT through workshops; (viii) training of VAT officers; and (ix) begun computerization work. GoMP has carried out some calculations under alternative scenarios assuming the VAT would be in place by 1 April 2002. Estimates of the fiscal impact were made, revealing the first phase of VAT—reducing rates from 4% to 2%, the revenue loss would have been around Rs1.65 billion per annum.	Covenant fulfilled.	Since VAT has been introduced recently, the time for an assessment is not yet ripe.
(A.5) Establish central and regional valuation cells and introduce methodology to assess properties for levy of property tax and stamp duty, taking into consideration technical assistance recommendations.	Fully complied with. Order to set up the valuation cells was issued in April 2001. The state set formal guidelines intended to bring recorded values into greater conformity with market values. As of 1 April 2000, three tiers of a valuation cell were operating, and associated oversight functions were operational at the three levels of administration responsible for overseeing the recording of property titles and transfer transactions. The function of the valuation cells is to prepare procedural guidelines for valuation and statistical information, collecting information on market valuation by use and geographic zone, notification of rates after public hearings to deal with objections, and periodic revisions of benchmarked property rates.	Covenant fulfilled.	The condition has been complied with regarding the reorganization of the valuation system for stamp duty. However, the valuation systems for property tax and for stamp duty continue to be different.
(A.6) Prepare time-bound action plan and implement system of user charges on utilities for enhanced sustainability taking into consideration technical assistance recommendations.	Fully complied with. User charges have been raised for most services. Irrigation charges were raised threefold (on a weighted average basis) in 1999–2000. Urban local bodies have been given full freedom to fix water charges and are raising water fees to cover a rising proportion of operation and maintenance. Road used charges have been raised. Tolls have been introduced on numerous highways and toll roads are being expanded through a recently introduced BOT scheme. A power tariff award of 47% increase was proposed by MPSEB. The regulator is expected to make an award later in 2001.	Covenant fulfilled.	As the utilities commission was not established, rate revisions are not coordinated—except in the power sector where a regulatory authority is functioning.

Condition	Status at Tranche Release	PCR Status	PPER Status
(A.7) Rationalize and prioritize expenditure and strengthen expenditure management including: (i) preparation of CIP, and (ii) system for monitoring implementation of CIP and for periodic review of project performance.	Fully complied with. The Government has introduced and is updating a "top-down" MTFF while simultaneously introducing the corresponding "bottom-up" CIP. The MTTF plays an important role in steering expenditure patterns toward the medium-term goals, particularly in the social sector, while integrating current and capital expenditure decisions. The CIP is encouraging line departments and the Planning Department to identify wasteful projects while protecting priority investments from ad hoc budgetary cuts. The state CIP, which identifies 30–35% of total capital outlays as "core," has been approved by the line departments and the Finance Department and will be incorporated in GoMP's budgetary process. The system for monitoring implementation of the CIP and periodic review of project performance has been introduced, including quarterly review by an interdepartmental committee. The committee will review performance targets and funds flows, year-end assessments, and coordinate revisions on a 3-year rolling basis.	Covenant fulfilled.	Internal reviews and monitoring have become routine, and the treasury computation has helped greatly in monitoring financial flows. The priorities are, however, more informally integrated in the budgetary process with the signals emanating from the cabinet committee. Formal CIPs are no longer in use.
(A.8) Strengthen and extend the activities of the MCDD from 11,000 to 40,000 villages through local bodies.	Fully complied with. The activities of MCDD were extended beyond the 40,000 target to 51,000 villages. As 20,000 villages now reside in Chhattisgarh, the third tranche condition has also been met. The mission has since been wound up.	Covenant fulfilled.	No change.
(A.9) Make operational the technical secretariat for assisting in implementing PSU reform.	Substantially complied with. The decision to set up the technical secretariat was taken in October 2000. Based on the heavy program of divestment anticipated for the next 3 years, GoMP accepted ADB consultant recommendations to recruit international staff for the technical secretariat using DFID proposed funding for 3 years. Government order to establish the technical secretariat will be issued when funding from the United Kingdom DFID for 3 years. The Government order to establish the technical secretariat will be issued when funding becomes available, now estimated for November 2001. The technical secretariat will become fully operational following recruitment of consultants, estimated for January 2002. As an interim measure, DFID has agreed to extend the contract of the ADB consultants on a temporary basis to play the role of the technical secretariat.	Discussions with DFID are continuing.	Technical secretariat was never established during the life of the Program. Although DFID was interested in supporting the secretariat, it was a very small part of a larger investment package which did not eventuate. The proposal to establish a technical secretariat has been revived in recent discussions between GoMP and DFID although no firm decision had been made at the time of the OEM.

Condition	Status at Tranche Release	PCR Status	PPER Status
(A.10) Assign to the DPE the responsibility for reviewing candidates, on the basis of appropriate screening procedures, for the appointment of all functional directors to ensure that these appointments are made on a professional basis with due regard to the PSUs' service rules.	Fully complied with. The committee for reviewing candidates was set up under the chair of retired Chief Secretary Shri RN. Chopra. Other members of the committee include the principal secretary, DPE; principle secretary, commerce and industry; principle secretary of finance; and the principal secretary of the concerned department. The committee screens candidates and recommends appointments for higher level positions.	Covenant fulfilled.	This is no longer being applied.
(A.11) Introduce the financial criteria on return on investment for dividend payment; and establish and introduce investment limit for which PSUs do not need approval from the government to increase PSUs' operational freedom.	Fully complied with. The financial criteria introduced by order on 7 July 1998, which requires PSU dividends to be linked to 12% of net profits.	Covenant fulfilled.	No change.
(A.12) Review the existing practice of uniform pay scale for PSUs, and authorize the setting of enterprise-specific salary scales, including differentiation in remuneration linked to productivity and the financial	Fully complied with. PSUs no longer have the uniform pay scale. The order introduced on 3 October 1998 requires PSUs to link pay to company profits.	Covenant fulfilled.	No change.

Condition	Status at Tranche Release	PCR Status	PPER Status
performance of individual state public enterprises.			
(A.13) Initiate organizational and financial restructuring of MPSIDC.	Partially complied with. The restructuring plan developed to introduce a strategic partner was accepted by Infrastructure Leasing and Financial Services, Ltd., which agreed to restructure the company with 15% ownership, but the board of MPSIDC rejected the offer. The company downsized by 40% in 1998. The company is contemplating its options to reduce GoMP's shareholding through a strategic partner and a private dominated board of directors.	No new developments since last review.	MPSIDC currently has NPAs worth around Rs7.15 billion (including outstanding interest of about Rs3.15 billion). Negotiations for financial restructuring, both with borrowers and lenders, are in progress. One-time settlement schemes, one for term loans and another for inter corporate deposits extended by the SOE, have been approved by the Board and await GoMP clearance, before being taken up with borrowers. Some 80 employees have been offered VRS in FY2004 as part of the personnel restructuring exercise. Report of consultants appointed to suggest restructuring measures, has been placed before the state cabinet for approval. Currently, there is no proposal for inviting bids from the private sector for the SOE's shares, with the proposed restructuring measures under GoMP's consideration.
(A.14) Advertise by March 2000 for a joint sector partner in a large agricultural farm owned by MPSAIDC.	Fully complied with. The advertisement for a buyer of the agricultural farm was issued twice. The first did not bring enough bidders. The second led to two offers received on 28 May 2001. The offers have been presented to the chief minister with a cabinet note. Upon approval by the chief minister, the cabinet will decide on which of the offers to accept. The company, originally operating with 1,400 staff, is now utilizing only 800 positions, of which 17% will be allocated to Chhattisgarh and 50% will receive VRS compensation. The company is therefore operating with 50% of the original workforce.	Covenant fulfilled.	NABCONS, a subsidiary of NABARD, has recently valued the Babai farm at Rs520 million, with the final decision being left to the cabinet subcommittee and the option of offering different parts of the farm on lease to several parties for 3.5 years proposed.
(A.15) GoMP approval for the restructuring plan; close MPPHC and MPSCB; and transfer MPSCB's core activities to	Fully complied with. The restructuring plan is being incorporated through an amendment to the Housing Board Act, enabling the Housing Board to enter into public-private partnerships. The Housing Board is introducing (i) employee incentive schemes, (ii) management information system automation for	Covenant fulfilled.	All operations of MPSCB have been discontinued with surveying, execution, and monitoring of slum projects handed over to local bodies, to be carried out in coordination with the respective district administrations.

Condition	Status at Tranche Release	PCR Status	PPER Status
MPHB as per the plan.	accounts and accepted the VRS, with 115 choosing not to exercise the option. Of those choosing not to exercise their option, 22 remain as core staff to wind up the company, and the rest will be retrenched under the Industrial Development Act. Funds for VRS payments of Rs315 million covering 110 workers were disbursed on 10 September 2001. The order for closure of MPSCB was issued by the Urban Development Department, and the company dissolved on 31 March 2001; all 112 officers have been shifted to vacancies in urban local bodies.		MPPHC. In response to a program to modernize the state police force and construct police accommodation (funded by the Government), GoMP decided to revive MPPHC in 2004 to manage the housing construction aspect. The employees of MPPHC post-VRS, who reverted back to the police force on closure, have been reemployed by MPPHC on its revival.
(A.16) Prepare plans for organizational restructuring of MPSTDC, focusing on promotional activities, and advertise the sale and/or lease of its properties.	Fully complied with. Tenders were invited and 70 offers were received, of which 22 were found to be eligible. As the company did not receive offers from hotels, it decided to reject the offers. The company sought advice from the Confederation of Indian Industry, which arranged detailed discussions with a big hotel chain. The hotel chain indicated interest, but only when infrastructure facilities are provided. MPSTDC decided to wait until a roads improvement project is completed and will then invite tenders for its hotel properties. Concurrently, MPSTDC has undergone organizational restructuring to focus activities on ecotourism with the advice of the Confederation of Indian Industry.	Covenant fulfilled.	MPSTDC recorded an improvement in operating performance, indicated by an operating profit of Rs22.5 million during FY2005 (Provisional) compared to a loss of Rs1.6 million recorded in FY2004. This was primarily on account of the increasing tourist arrivals caused by an improvement in road infrastructure and better upkeep of properties at select heritage sites. Given the above, attempts to sell/lease out properties of the company have been shelved.
(A.17) Prepare report on the financial performance of cooperatives sector with assistance from ADB technical assistance.	Fully complied with. The report was prepared with the assistance of TA consultants in July 2001.	Covenant fulfilled.	No further action taken on cooperatives sector although it is well known that this sector requires reform. However, it is a politically difficult area to reform.
(A.18) Ensure that the MPERC budget provided to GoMP in accordance with Section 33 of the ERC Act is charged upon the Madhya Pradesh state budget.	Fully complied with. The budget for the newly created MPSERC is charged in the consolidated funds of GoMP. Under the new legislation, Madhya Pradesh Electricity Act 2000, Section 8 (3) provides that MPSERC will be charged in the consolidated fund of the state.	Covenant fulfilled.	No change.

Condition	Status at Tranche Release	PCR Status	PPER Status
(A.19) Prepare roads sector CIP on the basis of PWD's strategic options study for inclusion in the overall state CIP.	Fully complied with. PWD has framed various road development programs under national highways, central road funds, bond roads, normal plan roads, and nonplan works. These programs were included in the roads sector CIP and integrated into the overall state CIP.	Covenant fulfilled.	PWD no longer prepares CIP.
(A.20) Establish by March 2000 a private sector cell in PWD and make it fully operational.	Fully complied with. The private sector cell was established as orders were issued and postings made. The private sector cell now operates with five officers.	Covenant fulfilled.	The work of the private sector cell has been transferred to MPRDC, which is responsible for managing road development including public-private partnerships.
(A.21) Analyze options for distance-based toll rates and prepare a plan for establishing a utilities pricing commission.	Fully complied with. Distance-based tolls have been introduced and are being expanded throughout the state under the Program for 14 BOT roads being developed with private participation. A utility pricing commission is not considered feasible at this time because, in the concession agreement with entrepreneurs and/or firms, final toll rates have to be specified for the whole agreement period.	Covenant fulfilled.	Distance-based toll rates are defined in a policy.
(A.22) Enact the amendment to the State Rent Control Act upon approval by the Government.	Substantially complied with. The amendment to liberalize revisions of rents and the standard rent formula was reviewed by the legislature's select committee. Following the select committee's recommendations, the amendment was revised and sent to the Law Department on 6 August 2001. Final discussion on the draft amendment took place on 13 August 2001 in a meeting between the Law Department and the Housing and Environment Department. The amendment was submitted for passage during the 20 August–15 September 2001 legislative session.	The Rent Control Act was drafted, including a rent tribunal, and it was submitted to the legislature in 2000, where it was referred to a select committee in 2001. There have been no new developments since then.	No change.
(A.23) Implement the measures to strengthen the monitoring capacities of the PCB and its regional offices.	Fully complied with. Environmental Capacity Building Project for the state PCB is being implemented by the Ministry of Environment and Forest and the Central Pollution Control Board. In addition, monitoring has been implemented through a program of e-governance and computerization. The e-governance program operate through a website for PCB which was developed and regularly updated. Polluting units are put on a list and are continuously monitored. The public can make complaints to PCB regarding polluting units through e-mail. Some units have already been prosecuted, and a distillery has been shut down under the new system.	Covenant fulfilled.	PCB continues to monitor and website is regularly updated.

Condition	Status at Tranche Release	PCR Status	PPER Status
B. Covenants to be Achieved before Release of the Third Tranche			
(B.1) Computerize and network FD's treasury operations for effective payment and audit systems; complete management information system for improved expenditure control.	Substantially complied with. Networking of treasury operations and computerization of payment and audit systems is being undertaken. Software requirement specification for this purpose has been completed. Expenditure control systems have been upgraded.	Empowered Committee on Public Finance Reform has not met since covenant was met; activity ceased after MTFF was signed. SBFAU is not delivering according to its mandate. All treasuries networked and gone online, as of 1 April 2004. Using treasuries as monitoring mechanism for all expenditures and/or receipts; expenditures and receipts are rationalized on a monthly basis.	After full computerization, further improvements are regularly being made to the system. It now accepts sales tax payments online. The treasury database is accessible through the internet and the system is to include the departments so far outside the treasury system (irrigation, public works, and forest) in a limited way.
(B.2) Make progress in fiscal consolidation, with primary deficit to be below 0.7% of SDP in the FY2002 budget; and capital expenditure to be at least 2.3% of SDP.	Overall: Substantially complied with. (a) Fully complied with for primary deficit target. The policy matrix makes provision for adjusting the fiscal consolidation targets for the primary deficit, expressed as a percentage of NSDP, by any shortfall in the devolution of central taxes to the state relative to the amount assumed in the MTFF. For FY2002, this shortfall has been estimated to be equivalent to approximately 0.6% of NSDP. Accordingly, the adjusted program target for primary deficit in FY2002 becomes 1.3% of NSDP. The actual outturn was 0.97% of NSDP placing it well below this limit. (b) Substantially complied with for capital expenditure floor. The measured result for capital expenditure was 1.83% of NSDP in FY2002 compared to the program target of 2.3% of NSDP, thus reflecting a shortfall of 0.47% of NSDP. However, the state's bifurcation has caused significant costs of fiscal adjustment that are additional to the shortfall in central tax devolutions from the Government not included in the original fiscal framework. GoMP and ADB estimate that the fiscal costs of bifurcation amounted to 0.82% of FY2001 NSDP and that the fiscal costs remained in excess of 0.6% of NSDP in FY2002. FY2002 has also been a year of drought in Madhya Pradesh, leading to an unforeseen need for substantial drought relief expenditures on the current account. Because capital expenditures are treated as residual items of discretionary expenditure for Indian	Covenant fulfilled, after adjustments for bifurcation are made.	Final figures actually show a progressive rise in primary deficit as a ratio of SDP in 2 years after 2000–2001, without any adjustment. The costs of bifurcation and the droughts may explain it, as mentioned in the PCR. However, the overall improvement in fiscal balance is really visible only in 2004–2005, and not before.

Condition	Status at Tranche Release	PCR Status	PPER Status
	states, the unforeseen fiscal cost arising from bifurcation has absorbed financial resources in excess of the shortfall on capital expenditure.		
(B.3) Implement by December 2000, in consultation with the local bodies, property tax reform including preparation of ready reckons for tax assessment; strengthen the public finances of local bodies taking into consideration findings of ADB technical assistance.	Fully complied with. Ready reckoners were prepared with assistance from the TA, and implemented in municipal corporations and large municipalities. Local governments have also taken additional steps to strengthen their public finances, including through computerization.	Covenants have been fully met, capacity building at the local government level is ongoing (about 50% of them, and mostly larger local government bodies have done it); not all local government units have computerized their operations, neither are they networked to each other and to Bhopal.	The reforms have been made, but there does not appear to be a significant impact on local bodies' finances, despite substantial independence granted to them. The own resources of even urban local bodies continue to be totally inadequate to meet their expenditure responsibilities, resulting in poor O&M of assets.
(B.4) Sufficient provision in the FY2002 state budget to further reduce the backlog of capital expenditure and shortfall of non-personnel expenditure in existing rural health facilities.	Fully complied with. Non-personnel expenditure in rural health was Rs460 million in FY2001 and Rs350 million in FY2002, and has been increased substantially to Rs890 million in FY2003 through allocations under a supplementary budget. GoMP is also expanding health services in rural areas under the Rajiv Gandhi Health Mission that has a separate budget category.	Covenant fulfilled.	Primary health services substantially expanded in terms of infrastructure and remaining backlog is likely to be wiped out soon. However, the major bottleneck appears to be in the area of medical personnel. The state is even trying to enlist the services of the private doctors by giving cash subsidies to, for example, expectant mothers who get private medical attention for delivery.
(B.5) Review and implement the recommendations of the study on industrial incentives scheme; and complete system of expenditure management and control.	Fully complied with. No fiscal incentives have been provided for new industrial units following a decision by all Indian states to discontinue the granting of sales tax concessions as industrial incentives on 1 January 2000. GoMP is also phasing out power sector subsidies under the Madhya Pradesh Power Sector Development Program. GoMP has developed an MTFF to guide future budget formulation in anticipation of completing an agreement with the Government of India under the States' Fiscal Reforms Facility. This MTFF advances GoMP's system of public expenditure management.	No new incentives and/or exemptions granted since the third quarter of 2003; tax breaks that have been granted previously are grandfathered. The number of items granted exemptions were decreased to 39 in 1999 and to 34 in 2003.	No change.

Condition	Status at Tranche Release	PCR Status	PPER Status
(B.6) Extend the activities of the MCDD to all 71,000 villages in the state; monitor and evaluate the impact of the program and prepare recommendation for follow-up policy interventions.	Fully complied with. The activities of the MCDD, dedicated to reducing the incidence of diarrhea disease in children, were extended to all villages in the post-bifurcation state and recommendations for follow-up policy interventions were prepared.	Covenant fulfilled.	No change.
(B.7) Abolish the posts, other than technical positions in essential social services and police, vacated through natural attrition during that tranche period, and reassign the resources to poverty-reducing social services.	Fully complied with. The decision of GoMP not to fill the posts in nonessential services vacated through natural attrition has been implemented.	Natural attrition is adhered to. However, two conflicting measures are being undertaken in Madhya Pradesh at the moment. As a cost-saving measure, each department was tasked to identify 30% of the posts in their unit that could be abolished. Some 60,000 posts have been identified, 23,000 of which have already been abolished in the last 4 years. In 1998, GoMP had taken a decision to retrench 22,000 of the 28,000 daily wage earners—exception being those workers in public works, irrigation, and public health. The majority of these workers were retrenched. However, with the advent of the BJP government in December 2003, this decision was revisited. The high court of Jabalpur overturned the decision to retrench in 2003. A government order was issued on 21 January	No change.

Condition	Status at Tranche Release	PCR Status	PPER Status
		2004, titled "Procedure for Employment of Daily Wage Employees Discontinued after 31.12. 1988." Rehiring has begun; a total of 11,000 people are expected to be hired and a budget provision of Rs360 million has been made in FY2005 for their remunerations.	
(B.8) Implementation of SRF to be reviewed by Technical Secretariat and report to be submitted to PRMC and ADB.	Substantially complied with. In the absence of a technical secretariat, the TA consultants appointed to assist in the work of public enterprise reform reviewed the implementation of the SRF and provided their findings in reports submitted to the PRMC and ADB.	SRF has been dwindling, despite ample scope for its use, e.g., for VRS in MPSFC. Its allocation dropped from Rs230 million in FY2004 to Rs50 million in FY2005. GoMP looks to international aid agencies or the Government for replenishment of SRF.	Technical secretariat not established and GoMP decided to discontinue the SRF.
(B.9) The DPE will issue and publish annual report on the performance of PSUs.	Fully complied with. DPE has issued annual reports starting in FY2000. This report provides details on PSU performance, contains information on most recently completed audited accounts, and summarizes general issues of governance, including procedures for appointment of managing directors.	This is not done in a timely manner. PSU targets are published after actualization, often with 1-year lag.	Annual reports are not published because of lack of updated information from PSUs. A report on PSU performance for FY2003 was published in September 2005.
(B.10) The PSUs will set strategic targets on the basis of guidelines given by GoMP. The PSU boards will set qualitative and quantitative targets as basis for performance-related incentives for PSU management.	Fully complied with. Strategic targets are specified in the MOU, signed annually between PSUs and GoMP. Activity-specific targets are laid down along with percentile rankings of each activity, which serve as a scorecard of the performance of PSUs and their managing directors. A committee may also suggest actions in cases of noncompliance with targets.	MOU system does not work as originally foreseen (see note for B.9).	No change. The MOU system not operational so no accountability mechanisms are being practiced.

Condition	Status at Tranche Release	PCR Status	PPER Status
(B.11) The managing directors of PSUs will be appointed on professional basis (with particular emphasis on experience and performance) and for a minimum 3-year term; and the practice of combining the post of managing director with other posts in the government will be discontinued.	Fully complied with. A formal appointment committee, comprising three members, appoints all new managing directors through transparent procedures. Average tenure of all managing directors now exceeds 2 years and a general managerial policy exists to lengthen their tenure positions to a minimum of 3 years. On 6 June 2002, the cabinet decided that approval of the chief minister would be required in the case of transfer of an official who has not completed 2 years in a post. Hiring of professionals as managing director has begun. The practice of combining managing director posts with other government posts has been discontinued.	PSUs are still losing money; there is still no accountability or quality control mechanism by and of managing directors.	No change. The MOU system is not operational so no accountability mechanisms are being practiced.
(B.12) Reduce GoMP's 100% shareholdings in MPSIDC to 51% by inducting a strategic partner, and appoint the chair as well as a majority of directors on the Board from private and/or nongovernment sector.	In view of changed circumstances with respect to bifurcation, the policy condition is proposed to be amended to: "Take a cabinet decision to sell 51% of the assets of MPSIDC, if possible, and to restructure the enterprise through downsizing." A consultancy firm has been appointed to prepare a business plan for restructuring MPSIDC and its report has been sent to GoMP. In addition, MPSIDC has developed several initiatives for restructuring, including downsizing, with approximately 80 employees accepting voluntary retirement scheme and the accounting policy of the Reserve Bank of India has been adopted. If the policy condition is amended as proposed, the condition is fully met.	MPSIDC manages land for big industries, but started lending to SMEs under the name of "inter corporate deposits" and accumulated considerable NPAs. MPSIDC has negative net worth now (in debt for about Rs7.5 billion). Its mandate was realigned to include only promotional activities and stopped lending in 1995, but MPSIDC is still not privatized. The compancy Reliance made a strong bid for it initially, but since it wanted to take over MPSIDC fully in 3 years, GoMP refused Reliance's offer.	MPSIDC currently has NPAs worth around Rs7.15 billion (including outstanding interest of about Rs3.15 billion). Negotiations for financial restructuring, both with borrowers and lenders, are in progress. One-time settlement schemes, one for term loans and another for inter corporate deposits extended by the SOE, have been approved by the Board and await GoMP clearance, before these are taken up with borrowers. Some 80 employees were offered VRS in 2004 as part of the labor restructuring exercise. The report of consultants appointed to suggest restructuring measures has been placed before the state cabinet for approval. Currently, there is no proposal for inviting bids for MPSIDC's shares from the market with the proposed restructuring measures under government consideration.

Condition	Status at Tranche Release	PCR Status	PPER Status
(B.13) Hive off to joint sector holding large agricultural farm; reduce GoMP's shareholding in MPSAIDC to not more than 26% in a transparent manner, contingent upon a buy back of shares from Government of India.	Overall: Substantially complied with. (i) Partially complied with. Tenders were invited for Babai Agricultural Farm on three occasions—December 1997, July 1998, and April 2001. Tenders were received and negotiations held with the bidders in 1998, but because of the withdrawal of the first-ranked bidder, the deal could not be completed. On a subsequent tendering, the cabinet rejected the bids as too low. On 1 August 2002, the cabinet directed the Agricultural Department to develop new proposals for the future of Babai Farm. (ii) Fully complied with. In view of changed circumstances with respect to bifurcation, the policy condition is proposed to be amended to: "The Board of Directors of MPSAIDC will approve a resolution to reduce the share of GoMP ownership to 26%." The board of directors of MPSAIDC has approved a reduction in the share of GoMP's shareholding to 26%. Government approval for buyback of shares is being negotiated by GoMP. The Cabinet Sub-Committee on Economic Affairs has directed that a core group be formed to suggest additional organizational reforms. If the policy condition is amended as proposed, the condition is fully met.	Babai farm, the biggest entity under MPSAIDC, is still not hived off. "No takers" is the feedback given to the Mission. GoMP has not sanctioned a buyback of shares either.	Bids from the private sector for the Babai farm were rejected by GoMP as prices quoted were found to be unattractive. NABSCONS, a subsidiary company of NABARD, has recently valued the farm at Rs520 million, with the final decision being left to a cabinet subcommittee and the option of offering different parts of the farm on lease to several parties for 3.5 years having been suggested. While about 100 employees of MPSAIDC have submitted their acceptance of VRS, the scheme has not been executed because of insufficient funds. The Agriculture Production Commissioner has raised objections to the repurchase of the Government's shares in MPSAIDC by GoMP at a price of Rs75 per share, considering its current negative net worth, holding up the share buyback and consequent divestiture. While no organizational restructuring measures have been implemented, an MOU with MP Agro Food Industries Ltd., a private company, for the sale of a nutritional mix to Women & Child Development Dept. of GoMP, has been executed, with commission of Rs125 per ton slated to be received by MPSAIDC as sales commission.
(B.14) Divest 49% of MPSRTC's shareholding in the four incorporated units; further rationalize routes.	In view of changed circumstances with respect to bifurcation, the policy condition is proposed to be amended to: "Take a cabinet decision to reorganize MPSRTC into four incorporated units." GoMP decided through a cabinet decision on 18 April 2001 to restructure MPSRTC by dissolving the corporation and forming four corporate units under the Companies Act of 1956 and in a manner consistent with the Program. The order to form the new companies was issued on 26 August 2001. GoMP has also introduced efficiency measures for MPSRTC by (i) allowing the company to adjust tariffs up to 7.5% per year as of 13 February 2000; (ii) introducing commercial principles, including not offering new guarantees, and elimination of free services for special groups; (iii) substantially raising fees for bus passes; and (iv) offering VRS to a large number of workers. If the policy condition is amended as proposed, the condition is fully met.	MPSRTC is in dire financial condition. Adam Smith Institute, TA consultants, proposed that it should be closed. Cabinet did not accept this proposal. The state government has decided to denationalize 147 routes.	GoMP has decided to liquidate MPSRTC when the bifurcation of assets and liabilities between Madhya Pradesh and Chhattisgarh is completed. Out of the 10,600 employees of the corporation, 8,900 have been offered VRS, with disbursement to 8,300 employees having been completed and the VRS compensation for 600 employees scheduled to be disbursed shortly. Of the balance 1,700 employees, 500 who opted for VRS have been retained because of certain legal cases and the need for adequate human resources to carry out the winding-up process. Another VRS for the balance 1,200 employees has been announced, and the last date for submission of applications is 28 October 2006; 50–60% of these employees are

Condition	Status at Tranche Release	PCR Status	PPER Status
			expected to signify their acceptance. Around 510 routes have been leased to private companies, with lease rentals of approximately Rs27.5 million per month being received and applied toward meeting administrative expenses, financing court cases, and payment of old arrears. GoMP has attached assets of the company against the amount of around Rs800 crores outstanding from MPSRTC toward road tax. While creditors guaranteed by GoMP have been repaid, NBFCs that extended lease finance have been approached with a one-time settlement scheme. The process of auctioning the bus fleet has already commenced, while assets like machinery are being disposed of through open auction. The entire liquidation process is expected to be completed in a year, with approvals from various government agencies having been obtained.
(B.15) Reduce GoMP's shareholding in MPSFC by 25% through public issue as permissible under the State Financial Corporations Act of 1951, contingent upon amendment to the Act, reduce GoMP's shareholding further to not more than 26%.	In view of changed circumstances with respect to bifurcation, the policy condition is proposed to be amended to: "Take a cabinet decision to restructure MPSFC through reduction in staffing levels and actions to minimize the future contingent liabilities of GoMP." The bifurcation scheme was prepared by the board of MPSFC general body, endorsed by GoMP and approved on 17 July 2001. The scheme is now under consideration by the government of Chhattisgarh and GoMP. The classification of the assets of MPSFC revealed that more than 30% of assets were nonperforming and the company had negative equity of Rs1 billion. Because of the high level of liabilities, immediate liquidation was not possible. Therefore, GoMP has decided on downsizing and loss reduction rather than recapitalization. The company prepared an action plan in 2001 to close branches and reduce GoMP exposure. If the policy condition is amended as proposed, the condition is fully met.	MPSFC suffers from NPAs of 45% of its total loan portfolio, considering the principal component alone. Efforts to reduce losses and to downsize are ongoing. Negotiations are also in progress with lenders like SIDBI, to write off a portion of the principal besides waiving interest payments. The lending portfolio to SMEs is being restructured by offering a scheme, in respect of loans disbursed prior to 1990, of not charging interest for more than 2 years. The results of these measures have not yet fructified.	Post-bifurcation of assets and liabilities of MPSFC and the division of employees between Madhya Pradesh and Chhattisgarh, a VRS scheme was offered and accepted by 15 employees, with the disbursement having been effected out of MPSFC's own funds. Two loss-making branches have been closed down as part of organizational restructuring measures. An MOU was executed with SIDBI in 2003, facilitating reduction of interest on loans by 2% and the provision of refinance at concessional rates. Financial restructuring involving settlement of high-cost bonds worth Rs680 million placed with LIC, SBI & Bank of Baroda was completed. Moreover, while SLR Bonds amounting to around Rs770 million have been prepaid/redeemed, negotiations for restructuring/reduction of SLR bond liability of around Rs700 million, due to various public sector banks, are in progress. GoMP has also provided share capital support of Rs40 million besides a short-term loan of Rs600 million in FY2006 to finance the cash deficit.

Condition	Status at Tranche Release	PCR Status	PPER Status
			While disbursements have increased to Rs1.15 billion in FY2006 (Rs420 million in FY2004), recovery has marginally improved to Rs920 million from Rs830 million in FY2004. The capital adequacy ratio continues to be negative owing to accumulated losses of the SOE, which aggregated to Rs2.27 billion as on 31 March 2006 (Rs2.16 billion as on 31 March 2004). NPAs have declined to 25% of MPSFC's total loan portfolio as on 31 March 2006 from 47% as on 31 March 2004.
(B.16) Divest 49% of GoMP's share in MPHB following its incorporation.	In view of changed circumstances with respect to bifurcation, the policy condition is proposed to be amended to: "Take a cabinet decision to change all Acts, rules, and existing orders to permit private sector participation in MPHB." MPHB has a low rate of recovery on loans, particularly for low-income housing. By a cabinet decision dated 27 August 2002, the Housing and Environment Department has been directed to make changes to acts, rules, and existing orders as needed to permit private sector participation in MPHB. If the policy condition is amended as proposed, the condition is fully met.	MPPHC was given VRS, since MPHB could not absorb the massive human resources of MPPHC. MPHB still has negative net worth and could not be sold off. Mission was told "0% divestment to date."	The recommendations of a task force, headed by then principal secretary, Housing, on restructuring MPHB's operations, are expected to be approved once the scheme of bifurcation of assets and liabilities of MPHB between Madhya Pradesh and Chhattisgarh is cleared by the Government. The proposals for restructuring include: (i) VRS or redeployment of a substantial portion of the surplus employees, with Class 3 and Class 4 staff constituting around two thirds of the current employee strength of 2,700; and (ii) allocation of urban planning activities, e.g., roads and sewerage line development, rehabilitation of slum dwellers, etc. to MPHB, to improve the Board's margins and offset the impact of problems associated with construction of houses like non-recovery of sale proceeds, unsold flats, necessity to make payments for land long before its allotment, etc. Apart from the above, other measures for restructuring that have been implemented include: (i) public-private partnerships in re-densification schemes being executed (Re-densification of Indore Central Jail); (ii) undertaking commercial projects, e.g., Platinum Plaza, Centre Point etc., to offset the losses from construction of houses for economically weaker sections; and (iii) integrated project accounting system to monitor profitability of each project. Corporatization of MPHB and subsequent divestiture of 49% GoMP stake would be considered only after the restructuring measures are implemented.

Condition	Status at Tranche Release	PCR Status	PPER Status
(B.17) Sell or close the remaining units of MPSIC, and closure of the corporation.	Fully complied with. All 19 units of MPSIC have been closed. Two units have been sold to the private sector.	The cited entities have taken full VRS, and they have not been active since 2002. Under the Companies Act, for the company to be closed, all its assets and liabilities would have to be cleared. However, with the exception of MPSLandDC, which sold Rs2million–Rs3 million worth of its assets, assets have not been sold yet (since assets are outdated, out of order, etc.). The GoMP guarantees their debt to lenders. If they are sold, banks will ask for payment, hence GoMP is not too keen on expediting the closing of these companies.	All units of MPSIC, including the head office, have been closed down and all MPSIC employees, post-bifurcation, have been given VRS, with one employee's case pending in court. VRS compensation of Rs324 million, funded by the SRF, has been disbursed. Of the 19 manufacturing units under the SOE's control prior to the state's bifurcation, two units were transferred to Chhattisgarh, two sugar mills transferred to local cooperative societies, and two units are being operated through management contracts with private companies. Out of the balance 13 manufacturing units whose operations were discontinued, the assets of one have been transferred to a private company while the buildings of another unit, Brush and Sport Industry, have been surrendered to the Industry Department. Valuation reports in respect of the remaining 11 units have been forwarded to GoMP for perusal. No operations, other than recovery of old dues, are currently being carried out by MPSIC. A GoMP guarantee, to the effect that any shortfall in sale proceeds of assets to meet the outstanding liabilities would be made good by it, has been sought, to enable the directors to issue a solvency declaration, the first step toward legal closure. The liquidation process is expected to last 3 years from the date of its commencement. Creditors for supply of material amounting to around Rs30 million besides contingent liabilities from court cases estimated at Rs14 million have to be settled out of the proceeds of sale of assets of the SOE, with the balance proceeds reverting to GoMP.

Condition	Status at Tranche Release	PCR Status	PPER Status
(B.18) Complete restructuring of MPSTDC, including lease and/or sale of its properties; and close the MPSTC.	Substantially complied with. MPSTC has been closed. MPSTDC offered properties for long-term lease in 2002 but did not receive any suitable bids. As lack of infrastructure and/or road access has been a main factor behind lack of positive response to bid process, six unprofitable units have been closed and 44 staff redeployed.	The Government (Archeological Sites of India) has been injecting money to the Tourism Corporation for last 4 years (about Rs500 million) as well as the 11th Finance Commission, so most of the properties are in good condition. MPSTDC has not been too successful in lease and/or sale of its properties. Although three World Heritage Sites are located in Madhya Pradesh, lack of infrastructure makes it undesirable for the private sector to invest in these areas. The Oberoi Group was interested in a number of palaces, including Rajgar Palace, but an agreement has not been reached yet.	**MPSTDC** targeted turnover of during FY2006 is Rs300 million vis-à-vis sales of Rs170 million achieved in FY2005 (Provisional). With an improvement in operating performance, indicated by an operating profit of Rs22.5 million during FY2005 (Provisional) compared with a loss of Rs1.6 million recorded in FY2004, accumulated losses have decreased to Rs89 million in FY2005 (Provisional) from Rs128 million in FY2004, according to data available from the Department of PSU, GoMP. The sale/lease of properties of MPSTDC has not been carried out. **MPSTC** Status of court cases relating to VRS disbursement and the current position with regard to remaining employees are to be ascertained; confirmation regarding sale of assets and settlement of outstanding liabilities is to be obtained
(B.19) Review existing arrangements in cooperative societies and develop options and recommendations to enhance the operational freedom of cooperatives, while taking into consideration relevant proposals in other states.	Fully complied with. GoMP has enacted enabling provisions for cooperative societies based on the model multipurpose Cooperative Act of the Government and relevant acts in other states. Under this act, all previous GoMP control and restrictions have been removed. Cooperatives have been given full operational freedom in their business. New cooperatives, not receiving loan or share capital from GoMP or government guarantees, can register under this act and existing cooperatives can apply for conversion to this act.	Condition was complied with.	No further action taken on cooperatives sector reform.

Condition	Status at Tranche Release	PCR Status	PPER Status
(B.20) Prepare power sector CIP on the basis of a power sector master plan.	Fully complied with. A power sector investment plan has been prepared and is being implemented as part of the Madhya Pradesh Power Sector Development Program Loan.	MPSERC was formed and granted two tariff awards twice so far, in October 2001 and in November 2002. The total debt of MPSEB is Rs129 billion—all public debt, which is about 85% of total revenue receipts of Madhya Pradesh. Industry still cross-subsidizes agriculture. However, this is only anecdotal information from various government officials; actual figures have been requested by the Mission. The financial restructuring plan of MPSEB was accepted by the Finance Department, the chief secretary, and the chief minister. GoMP prepared a financial restructuring plan for restructuring of MPSEB, to be formally approved by the state cabinet. GoMP has taken over the liabilities of MPSEB relating to central PSUs of Rs28.1 billion, and toward the Rural Electrification Corporation of Rs17,000 million in October 2004, thus opening a line of credit for improvement of the infrastructure in rural areas. During the course of 2004–2005, the new Government settled the defaults of MPSEB of Rs5 billion to Banks and Financial Institutions in SLR Bonds.	CIP no longer prepared.

Condition	Status at Tranche Release	PCR Status	PPER Status
(B.21) Prepare report on PWD experience with roads and/or bridge construction and maintenance under BOT or similar arrangement, including recommendations for changes, if any, to the policy and regulatory framework for private sector road development, tender procedure, and PWD's organizational structure.	Fully complied with. In the context of the preparation of the Madhya Pradesh State Road Sector Development Program, TA for institutional strengthening and capacity building for the road sector of Madhya Pradesh is being provided. This TA will strengthen the capacity of the PWD in transport planning, project finance, and investment management and assist PWD with implementation. The Program aims to support the formation of a restructured PWD with an organizational structure and clearly defined responsibilities. The responsibility for implementation of road projects involving private sector participation, such as BOT, has been assigned to the Madhya Pradesh State Bridge Development Corporation, a statutory corporation under the PWD. The role of the corporation as a BOT coordinator will be evaluated under the TA.	Covenant was fulfilled.	No change.
(B.22) Establish a rent tribunal to exercise the powers of appeals authority; review the initial impact of the Amendment to the Rent Control Act on the level of rents and on investment in the housing sector.	Partially complied with. The proposed amendment to establish the rent tribunal was submitted for passage during the 20 August–15 September 2001 legislative session. The assembly returned the legislative proposal to the select committee and the select committee referred it back to GoMP for reconsideration of the structure of the rent tribunal and associated financial implications. The matter remains under consideration with GoMP. Establishment of the rent tribunal and other subsequent actions are contingent on passing of the legislation.	No new developments to date. The mission was informed that political resistance to the Rent Control Act exists, with the perception that this resistance would hinder private sector involvement in the residential construction sector.	No change.
(B.23) Implement integrated training program for PCB staff and industrial associations on environmental monitoring and environmental management.	Fully complied with. Environmental monitoring training for technical staff of PCB is occurring under the Government's program for enhanced environmental monitoring.	Covenant fulfilled.	No change. PCB continues to conduct environmental monitoring.

ADB = Asian Development Bank, BJP = Bharatiya Janata Party, BOT = build-operate-transfer, CIP = core investment program, DFID = Department for International Development, DPE = Department of Public Enterprises, ERC = electricity regulatory commission, FD = Finance Department, FY = fiscal year, GoMP = government of Madhya Pradesh, MCDD = mission on control of diarrheal diseases, MOU = memorandum of understanding, MP = Madhya Pradesh, MPERC = Madhya Pradesh Electricity Regulatory Commission, MPHB = Madhya Pradesh Housing Board, MPPHC = Madhya Pradesh Police Housing Corporation, MPRDC = Madhya Pradesh Road Development Corporation, MPSAIDC = Madhya Pradesh State Agro Industries Development Corporation, MPSCB = Madhya Pradesh Slum Clearance Board, MPSEB = Madhya Pradesh State Electricity Board, MPSERC = Madhya Pradesh State Electricity Regulatory Commission, MPSFC = Madhya Pradesh Sate Financial Corporation, MPSIC = Madhya Pradesh State Industries Corporation, MPSIDC = Madhya Pradesh State Industrial Development Corporation, MPSLandDC = Madhya Pradesh State Land Development Corporation, MPSRTC = Madhya Pradesh State Road Transport Corporation, MPSTC = Madhya Pradesh State Textile Corporation, MPSTDC = Madhya Pradesh State Tourism Development Corporation, MTFF = medium-term fiscal framework, NABARD = National Bank of Agriculture and Rural Development, NABSCONS = National Bank for Agriculture and Rural Development Consultancy Services, NBFC = nonbanking finance company, NPA = nonperforming asset, NSDP = net state domestic product, O&M = operation and maintenance, OEM = Operations Evaluation Mission, PCB = Pollution Control Board, PCR = project completion report, PPER = program/project performance evaluation report, PRMC = public resource management committee, PSU = public sector undertaking, PWD = Public Works Department, SBFAU = State Budgeting and Fiscal Analysis Unit, SBI = State Bank of India, SDP = state domestic product, SIDBI = Small Industries Development Bank of India, SLR = statutory liquidity ratio, SME = small and medium-sized enterprise, SOE = state-owned enterprise, SRF = State Renewal Fund, TA = technical assistance, VAT = value-added tax, VRS = voluntary retirement scheme.

Source: Operations Evaluation Mission.

IMPACT OF BIFURCATION

1. Madhya Pradesh was bifurcated in November 2000 into the new states of Madhya Pradesh and Chhattisgarh. Although not directly referred to in the program design, the Asian Development Bank (ADB) was [1]aware that proposals to bifurcate Madhya Pradesh had been around for some 20 years, and the decision to act relatively quickly in 2000 was heavily influenced by political considerations. An assumption identified in the Madhya Pradesh Public Resource Management Program (MPPRMP) program framework generically alludes to such a possibility in stating that the "program success is contingent on stable political and exogenous environment; exogenous shocks, including policy decisions by the Central Government could adversely affect economic development, environment for private sector, and implementation of State Renewal Fund."

2. The new state of Chhattisgarh was carved out of 16 southeastern districts of Madhya Pradesh with a population of almost 18 million people, almost 27% of the population of the pre-bifurcated state. Because of geography, Chhattisgarh gained significant natural resources. Conversely, most of the comparatively underdeveloped districts of Madhya Pradesh, generally with a higher than average scheduled tribe population, went to Chhattisgarh. These areas were also prone to public safety problems primarily because of activities of the Naxalite movement. Because of the inclusion of these districts, the new Madhya Pradesh did not have to spend large amounts of additional funds on the development of these areas or expenditure on specific public safety measures.

3. The most significant political effect was to reduce the size of the Madhya Pradesh state assembly, as representatives of the 16 former districts moved to the new Chhattisgarh assembly. Neither the chief minister nor the governor was changed. The Madhya Pradesh State Reorganization Act, 2000,[2] identified the new Madhya Pradesh as the sole successor state of pre-bifurcated Madhya Pradesh for purposes of obligations under the Program. However, section 44(1), which governs public debt liabilities, makes this ruling less definitive, requiring consultation among the Government of India (the Government), government of Madhya Pradesh (GoMP), and government of Chhattisgarh. In a letter dated 16 February 2001, the additional chief secretary of the government of Chhattisgarh informed the Government of the decision of the government of Chhattisgarh not to participate in the second and third tranches of MPPRMP, thus removing any legal constraints to new Madhya Pradesh having sole claim as the successor state for purposes of obligations and tranches of the Program.

4. The bifurcation posed challenges to the reform momentum and the truncated state's economy in several ways, the most notable being the impact on receipts, power availability, and expenditure. GoMP and ADB estimated the fiscal impact of bifurcation on the new Madhya Pradesh budget for FY2001 at 0.82% of net state domestic product (NSDP). The impact on receipts was mainly because much of the high value mineral bearing areas of the state went to Chhattisgarh, thus negatively affecting the tax and non-tax (royalties) receipts of the smaller Madhya Pradesh. Similarly, a larger share of the power plants went to Chhattisgarh on the basis of location, leaving the new Madhya Pradesh with a serious power shortage. In terms of expenditure responsibilities, there were mixed effects. The new Madhya Pradesh had a larger share of the population in comparison to the share in area, which implied larger public expenditure. Moreover, a large majority of government employees, given the choice of Chhattisgarh or Madhya Pradesh, chose the latter, resulting in a disproportionately higher salary burden on it. This resulted in a 2% increase in the share

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[1] The Naxalite movement is formed of radical, often violent, revolutionary communist groups following Maoist ideology born in 1967 out of the Sino-Soviet split in the Indian communist movement. Initially the movement had its epicenter in West Bengal but has spread into less developed areas of rural central and eastern India, including Chhattisgarh.

[2] Section 50 (1)(a).

of employees, in proportion to the population, and in additional expenditure of Rs1,50 billion per annum. GoMP also had to keep a high number of class III and class IV workers on its payroll, since the move to Chhattisgarh for these lower level workers was not feasible. GoMP was responsible for establishing the new Chhattisgarh capital in Raipur and was required to continue to transfer un-bifurcated organizations and corporations.

5. Perhaps the most contentious aspect of bifurcation was with the split of public sector undertakings (PSUs), which posed complex legal issues for GoMP's reforms. The Madhya Pradesh Reorganization Act, 2000, required assets and liabilities to be split according to mutual agreement between the two states. Most of the PSUs under the reform program were affected. For example, it was proposed the assets and liabilities of Madhya Pradesh Tourism Corporation would be partitioned at the ratio of 6:94 (Chhattisgarh:Madhya Pradesh), Madhya Pradesh State Industries Corporation at the rate of 10.29:89.71, and Madhya Pradesh State Agro Industries Development Corporation at the ratio of 17:83. All of these required approval from the Government for full implementation. The Madhya Pradesh State Financial Corporation (MPSFC) was apportioned 17.51:82.49 and the scheme was finally approved by the Government on 12 March 2003.

6. The delays in enterprise restructuring put additional strain on Madhya Pradesh's already precarious financial condition. Madhya Pradesh State Road Transport Corporation (MPSRTC) had been losing money for some time. A dispute initially occurred regarding the partition of MPSRTC between Chhattisgarh and Madhya Pradesh. Chhattisgarh proposed to take on only 18% of the assets and liabilities of MPSRTC, while Madhya Pradesh state proposed a 23.51% share for Chhattisgarh. On 27 December 2002, the Government ordered a provisional bifurcation formula of 76:24 to Madhya Pradesh and Chhattisgarh, respectively, until a final decision may be reached. At the time of the Operations Evaluation Mission, the issue was still not resolved although the GoMP had resolved to close MPSRTC and liquidate all assets once the split was resolved.

7. The split of Madhya Pradesh State Electricity Board (MPSEB) assets and liabilities was difficult, leading ultimately to the Government's arbitration in 23 May 2003. However, this led to charges by GoMP that the split left Madhya Pradesh with a disproportionate share of the liabilities, with 78% of liabilities allocated to Madhya Pradesh and the revenues allocated are only 64%, making it even more difficult for MPSEB to service these liabilities. Although the share of energy consumption of the new Madhya Pradesh state was about 78% of the combined states, the generation capacity allotted to the new Madhya Pradesh was just 68%. The new Madhya Pradesh had 94% of the agricultural consumers who need to be subsidized, and was incurring increased financial losses because of the low agricultural tariff and even lower recovery from farmers. With only 61% of industrial consumers remaining in Madhya Pradesh, the economics of electricity generation and cross-subsidizing agricultural and domestic consumers was adversely affected. As the high-cost electricity plants were located in Madhya Pradesh, the cost of generation in the state rose to Rs1.27 per kilowatt-hour against Rs0.77 per kilowatt-hour in Chhattisgarh. Finally, a majority of the employees (about 78%) were allocated to MPSEB, against only 22% to Chhattisgarh State Electricity Board.

8. The shadow cast by these ongoing disputes delayed the implementation of reforms and the MPPRMP took far longer to implement than envisioned. To resolve a continuing impasse, on 30 March 2003, an order from the Government was issued to form the R. P. Kapur Committee[3] to arbitrate on the division of PSUs.

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[3] The committee was formed on 31 July 2003, chaired by the former chief secretary of the composite Madhya Pradesh state with the chief secretaries of Madhya Pradesh and Chhattisgarh as members.

9. According to GoMP and ADB estimates, the adjustment costs associated with the reforms would fall from about $600 million to around $530 million. The revenue loss from tax reform associated with the introduction of the value-added tax was estimated to decline from $185 million to $150 million as a result of bifurcation, based on a reduction of the revenue loss from lowering input taxes and stamp duties by the same proportion as manufacturing output loss (assuming inputs are used principally in manufacturing) resulting from bifurcation. The revenue loss was assumed to cover March 1999 through June 2001, with the reduction in revenue loss occurring during November 2000–June 2001. Regarding costs associated with PSU restructuring, the effects on only MPSRTC and MPSFC were singled out. Madhya Pradesh was responsible for restructuring three of MPSRTC four units (the fourth was under the responsibility of Chhattisgarh). It offered a voluntary retirement scheme (VRS) to workers of the part of the company ultimately residing in Chhattisgarh. It was therefore estimated that bifurcation would reduce the MPSRTC restructuring costs by around $25 million. Shifting some MPSFC liabilities to Chhattisgarh would reduce adjustment costs by $12 million. However, the downsizing and use of the VRS was estimated to increase the adjustment cost by $2 million. Thus, the overall PSU adjustment costs were estimated to decline by $35 million as a result of bifurcation and may be higher, depending on the ultimate restructuring plan implemented for MPSRTC. As the loan size of $250 million was still less than 50% of the revised adjustment cost of $531 million, it was agreed that the loan size was justifiable on the basis of revised adjustment costs.

FISCAL CONSEQUENCES OF MULTILATERAL ADJUSTMENT LENDING TO STATES IN INDIA[1]

A. Introduction

1. Large and increasing fiscal imbalances at the state level, had adverse consequences for macroeconomic stability, and raised major concerns about growth and equity by impacting on efficiency in resource allocation, technological progress, and the intergenerational distribution of tax burden. Wide differences in the fiscal health of the states, failure of the fiscal transfer system to offset states' genuine fiscal disadvantages, and significant interstate differences in standards of governance and delivery systems have led to increasing inequalities in the provision of social services and physical infrastructure. Moreover, the transition from a planned to a market economy has created unequal opportunities for different states, as states with greater market development, access, and good infrastructure facilities are better able to take advantage of the opportunities. At the same time, coalition governments supported by parties with varied ideological persuasions and the emergence of regional parties in states aligned to the Government of India have put tremendous strain on the institutions of federal governance. The problem was exacerbated by the short electoral cycle governing the political parties and politicians.

2. Uncontrolled subnational deficits and contingent liabilities have made the task of macroeconomic stabilization[2] much more difficult and complex. The pro-cyclical pattern of spending when the subnational deficits are uncontrolled is even more concerning. When an attempt is made to control the borrowing through the budget, states resort to borrowing through special purpose vehicles and accumulate liabilities in public sector enterprises, particularly power utilities. Some states control their deficits by compressing outlays on essential public services. Finally, the involvement of many actors in subnational fiscal consolidation, particularly bilateral and multilateral agencies besides the central Government, makes the incentive structure unclear and complex.

3. The consequences of states' fiscal stress are not confined to the deficit measures alone; there are significant repercussions on revenues and expenditures as well. When states are unable to soften the budget constraints, the fiscal stress shows itself in compressed expenditure allocation to basic public services. In fact, the sociology of fiscal politics is such that the fiscal stress in a state invariably results in compressing productive spending on maintenance and creation of physical infrastructure, with significant adverse impacts on economic growth in the state.

4. For the same reason, fiscal adjustment focusing on any measure of deficit reduction is inadequate, as it ignores the possibility of keeping deficits low by cutting down spending on essential public services. Many quantitative and qualitative aspects of a fiscal imbalance need to be taken into account in calibrating fiscal adjustment to prevent inappropriate policy responses. Second, the ability of states to achieve fiscal correction depends on economic and political constraints. Third, it is important to understand whether the stringent conditions of structural adjustment lending by the World Bank and Asian Development Bank (ADB) have succeeded in hastening the process of subnational fiscal consolidation, or resulted in softening

[1] Prepared by G. M. Rao, Operations Evaluation Mission (OEM) consultant, and P. Chakraborty, Senior Economist, National Institute of Public Finance and Policy, New Delhi.

[2] Macroeconomic stabilization is a central government function as macro policy instruments have countrywide spillover Oates, W. E. 1999. An Essay on Fiscal Federalism. *Journal of Economic Literature*. Vol. XXXVII (3), pp. 1120–1149.

the recipient states' budget constraints. This study undertakes econometric analysis to unravel the effects of adjustment lending on states' finances in the medium term. The results of the paper are preliminary and tentative, as adjustment lending is a relatively recent phenomenon.

5. Evaluating fiscal adjustment by states is difficult because fiscal policy consists of a long vector of components including public investment, consumption, transfers to households, and the structure of the tax system.[3] It becomes even more complex as fiscal adjustment measures have both quantitative and qualitative dimensions.[4] The problem is compounded as states conceal their actual fiscal positions through various off-budget borrowings.

B. Fiscal Imbalances in States: Quantitative and Qualitative Dimensions

1. State level Fiscal Imbalance: Recent Developments

6. Table A4.1 presents the trends in revenue and fiscal deficits of the states taken together. The analysis shows that, despite severe pressures on their finances, the states tried to contain their revenue and fiscal deficits until FY1997. However, the pressure of salary and pension revision increased both revenue and fiscal deficits sharply from FY1997. The problem was not helped by the steadily declining tax devolution from the center, of over 1% to gross domestic product (GDP) over the period from FY1990 to FY2001. Similarly, a sharp increase in indebtedness and the rising cost of borrowing led to a significant increase in interest payments. The period since the late 1990s has also seen a sharp increase in contingent liabilities incurred through public enterprises and special purpose vehicles. These are well recorded and analyzed.[5]

Table A4.1: Fiscal Trends in States
FY2001–FY2006

	Description	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006
1.	Revenue Deficit	2.59	2.25	2.22	1.17	0.49	0.05
2.	Gross Fiscal Deficit	4.21	4.17	4.46	3.50	3.20	2.71
3.	Primary Deficit	1.47	1.31	1.50	0.68	0.70	0.16
4.	Revenue Receipts	11.21	11.44	11.47	11.92	12.74	13.12
5.	Current Transfers	4.18	4.18	4.29	4.34	5.13	5.31
6.	Revenue Expenditure	13.80	13.69	13.68	13.09	13.22	13.16
7.	Interest Payments	2.74	2.86	2.96	2.82	2.50	2.54
8.	Capital Outlay	1.41	1.49	1.90	1.97	2.39	2.43
9.	Development Expenditure[a]	9.50	9.32	10.15	9.40	10.16	9.81
10.	Non-Development Expenditure [a]	6.05	6.20	6.12	6.03	5.70	5.83
11.	Social Sector Expenditure [a]	5.78	5.60	5.42	5.39	5.95	5.82
12.	Social Services[a]	5.13	5.00	4.82	4.71	5.19	5.13
	of which:						

3 de Castro. A. S., I. Goldin and L. A. P. da Silva. 2002. Relative Returns to Policy Reform: Evidence from Controlled Cross-Country Regression. *World Bank Policy Research Working Paper No. 2898*. The World Bank. Washington.

4 See, Alam, A. and M. Sundberg 2002. A Decade of Fiscal Transition. *World Bank Policy Research Working Paper No. 2835*. The World Bank. Washington D.C.; and Rao, G. M. and M. W. Sundberg. 2003. *The Quality of Fiscal Adjustment and Subnational Fiscal Reform*. Mimeo.

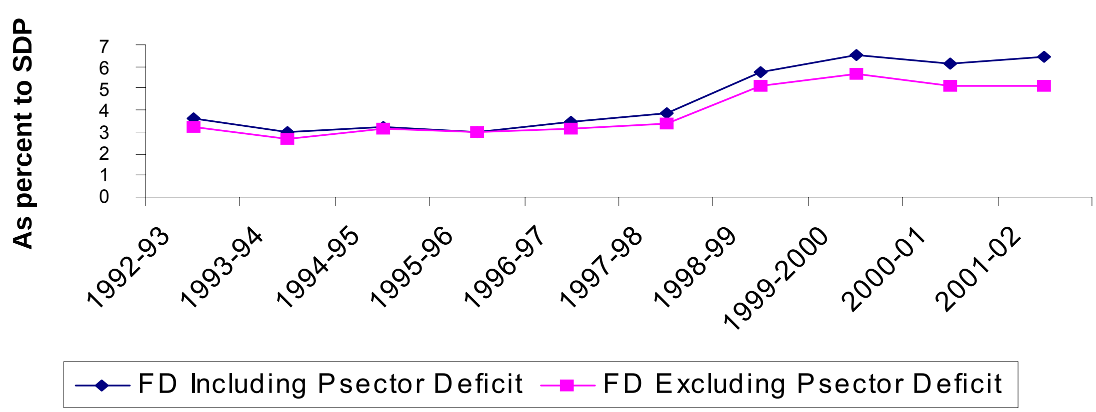
5 See Rao, G. M. 2002. State Finances in India. *Economic and Political Weekly* Vol. XXXVII (31) August 3–9, and World Bank. 2005. *State Fiscal Reforms in India: Progress and Prospects, A World Bank Report.* Macmillan India Ltd. New Delhi.

Description	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006
a. Education, Sports, Art, and Culture	2.66	2.57	2.40	2.31	2.33	2.91
b. Medical, Public Health, and Family Welfare	0.73	0.70	0.66	0.63	0.72	0.73

Note: Figures are percentage of gross domestic product (GDP).
[a] GDP for FY2006 has been estimated from Government of India. 2006. Budget at a Glance 2006–07, New Dehli.
Source: Reserve Bank of India.

7. Even if deficits are taken to measure the fiscal health of the states, considering the deficits in the consolidated accounts alone could be misleading. This is because, while some states provide for the losses in power utilities through subsidies, others do not. The fiscal deficit in the states, reworked to include the losses in power utilities, is shown alongside the fiscal deficits in the consolidated accounts in Figure A4.1. It shows that the deficits on account of power utilities are high and increasing; in FY2001, while the combined fiscal deficits of the states as a ratio of GDP was about 5.1%, the fiscal deficits (including the power sector deficit) was 6.45%. It also illustrates that the power sector deficits have shown a steady increase over the years. In the mid-1990s, deficits on account of the power sector—not included in the state budgets—was virtually zero. However, by FY2001, it was about 1.4% of GDP. This implies that any attempt to infer the severity of fiscal stress in the states, only on the basis of budgetary measures of deficits, may not be appropriate.

Figure A4.1: Fiscal Deficit with and without Power Sector Deficit
(A Comparison)



FD = fiscal deficit, SDP = state domestic product.
Source: Reserve Bank of India.

8. Concerned with the steadily deteriorating fiscal health of the states, the Eleventh Finance Commission (EFC) was required to "…draw a monitorable fiscal reforms programme aimed at reduction in revenue deficits of the states.…"[6] However, the monitorable program of linking grants to fiscal performance indicators, recommended by the EFC, had serious shortcomings in the way it was designed and did not help to improve the situation much. Therefore, the Twelfth Finance Commission (TFC) was required to "…review the state of the

[6] Public Finance. 2000. *Report of the Eleventh Finance Commission*. June. Available: http://www.tn.gov.in/tsfc/11threport.pdf.

finances of the Union and the States and suggest a plan by which the governments, collectively and severally, may bring about a restructuring of the public finances restoring budgetary balance, achieving macro-economic stability and debt reduction along with equitable growth."[7]

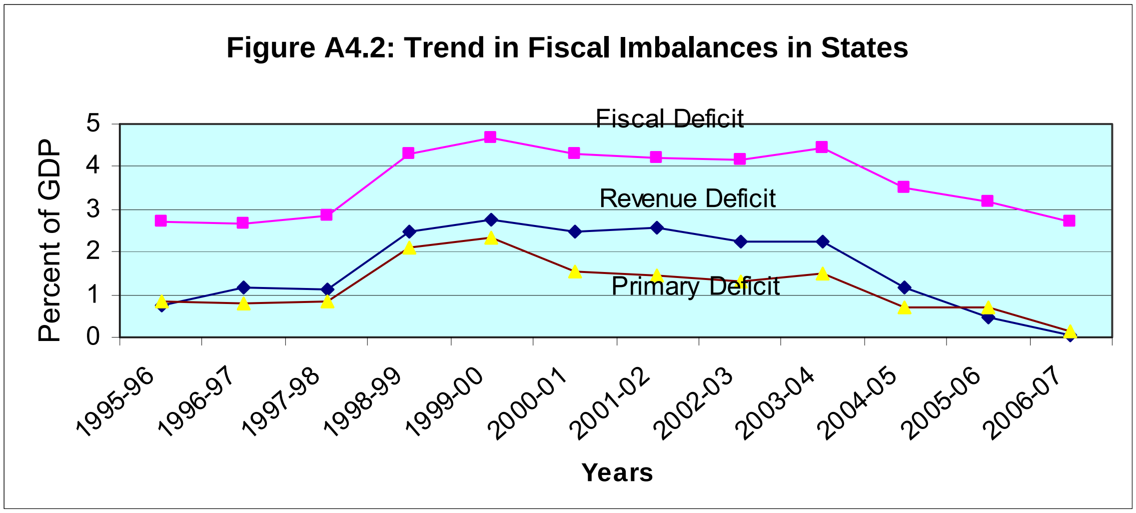
9. The fiscal restructuring plan recommended by the TFC requires that combined revenue deficits of the center and states should be eliminated by FY2008, and aggregate fiscal deficit should be contained at 6% of GDP. The state governments on their part would have to restructure their finances to eliminate the revenue deficit and contain the fiscal deficit at 3% of GDP by FY2008. While the revenue deficits would have to be phased out—not only in the aggregate but in each of the states—fiscal deficit targets for individual states would have to be set on the basis of the sustainability conditions of each state (based on the ratio of interest payments to revenue receipts).

10. The TFC made detailed recommendations on the measures to accelerate the growth of revenues and decelerate the growth of expenditures in states to achieve fiscal consolidation. It also recommended that the states should enact state fiscal responsibility acts (FRA), and work out medium-term fiscal plans to achieve revenue and fiscal deficit targets. This would entitle them to avail of the benefits of debt restructuring, involving consolidation of debt for a fresh term of 20 years at a reduced interest rate of 7.5%. The states have acted swiftly to join the fiscal restructuring program and 23 states have passed FRAs. Another incentive component—writing off the repayments of central loans due from FY2005 to FY2009—was linked to progress in the reduction in revenue deficits.

2. Recent Trends in State Finances

11. The aggregate fiscal trend in state finances shows significant improvement, particularly since FY2003 (Figure A4.2). The aggregate revenue and fiscal deficits of the states have shown a sharp decline. The revenue deficit in FY2005 is estimated at just about 0.5% of GDP, about 2% lower than in FY2001 (Table A4.1). Similarly, the fiscal deficit for FY2005, estimated at 3.2% of GDP, is marginally higher than the target set for FY2008. The states' capital expenditure relative to GDP has also increased from 1.5% in FY2002 to 2.4% in FY2005. Even if the final accounts of revenue and fiscal deficits for FY2006 are marginally higher, it is clear that the fiscal health of the states has shown a significant improvement and they are well on their way to achieving the targets set by the TFC.

[7] Public Finance. 2002. *Report of the Twelfth Finance Commission.* November. Available: http://indiabudget.nic.in/es2004-05/chapt2005/chap25.pdf.



GDP = gross domestic product.
Source: Reserve Bank of India.

12. Is the improvement in state finances caused by states' own efforts or is it due to exogenous factors? The states' own efforts include measures to improve revenue productivity from tax and non-tax sources assigned to them, and those initiated to compress expenditures. The exogenous factors with favorable impact on state finances include the introduction of debt swap scheme, larger tax devolution from increased buoyancy of central taxes, larger transfers for various central schemes, and those arising from the TFC's recommendations.

13. The disaggregated analysis of the sources of improvements in state finances presented in Table A4.2 shows that of the 2.1% improvement, increase in revenues contributed to 1.5% and the remaining 0.6% was due to compression of expenditures. About 1% of the improvement was due to increased devolution recommended by the TFC, higher buoyancy of central taxes since FY2002, and increased grants for various central schemes. On the expenditure side, reduction in interest payments following the debt swap scheme and later caused by adoption of the TFC's scheme of debt restructuring and write-off, contributed to a 0.24% improvement in revenue deficit. The interest payment as a ratio of GDP declined from 2.96% in FY2003 to 2.82% in FY2004 and is estimated at 2.5% in FY2005.

Table A4.2: Fiscal Consolidation: Contribution of Different Factors

Description	**Percentage point changes in the fiscal variables as a ratio of SDP over the previous year in**				**Cumulative Improvement in FY2005 over FY2001**	**Contribution to the improvement in revenue deficit** (%)
Fiscal Variables	FY2002	FY2003	FY2004	FY2005		
Revenue Deficit	(0.34)	(0.03)	(1.05)	(0.68)	(2.1)	
Fiscal Deficit	(0.04)	0.29	(0.96)	(0.3)	(1.01)	
Primary Deficit	(0.16)	0.19	(0.82)	0.02	(0.77)	
Revenue Receipts	0.23	0.03	0.45	0.82	1.53	(72.9)
Own revenues	0.23	(0.08)	0.4	0.03	0.58	(27.6)
Current Transfers	0	0.11	0.05	0.79	0.95	(45.2)

Description	Percentage point changes in the fiscal variables as a ratio of SDP over the previous year in				Cumulative Improvement in FY2005 over FY2001	Contribution to the improvement in revenue deficit (%)
Revenue Expenditure	(0.11)	(0.01)	(0.59)	0.13	(0.58)	27.6
Interest Payments	0.12	0.1	(0.14)	(0.32)	(0.24)	11.4
Capital Outlay	0.08	0.41	0.07	0.42	0.98	
Developmental Expenditure	(0.18)	0.83	(0.75)	0.76	0.66	

SDP = gross state domestic product.
Note: Figures in parenthesis are negative.
Source: Reserve Bank of India.

14. In contrast, cumulative improvement in revenue deficit in FY2005 over FY2001, resulting from increase in states' own revenues was about 0.6% and compression of noninterest expenditures was 0.34%. Thus, states' own effort contributed 43% to the reduction in revenue deficit and 57% of the reduction is attributable to exogenous factors. While this is lower than the reduction caused by central transfers and savings because of debt swap, it is still important. Higher transfers are likely to continue and, more importantly, higher buoyancy of central taxes is also likely to show buoyancy in tax devolution. The benefits of debt restructuring implemented on the basis of the TFC's recommendations will continue in the future. Thus, in the medium term, the improvement in the fiscal situation is likely to continue.

15. The reduction in the revenue deficit has had a favorable effect—not only in reducing fiscal and primary deficits but also in increasing capital outlay in the states. Of the 2% reduction in revenue deficit-gross state domestic product (SDP) ratio, 1% was used to reduce fiscal deficits and the remainder was used to increase capital outlay in the states. Despite this, the increase in development expenditure, which includes social services with a large revenue expenditure component, has been lower than the capital outlay (0.66%). In other words, there was no increase in states' developmental expenditure as a ratio of SDP in FY2005 over that of FY2002. In some social sectors such as education, the expenditure-SDP ratio was actually lower in 2005–2006 than in 2002–2003. This may be partly because some central transfers, such as that for the national primary education scheme (SSA), do not pass through state budgets and are given directly to districts or spending agencies. Nevertheless, it is important that the focus on reducing deficits should not cause compression of social sector expenditures.

16. While the improvement in the fiscal health of the states is noteworthy, some recent developments threaten to reverse the trend. The first is the risk of pay revision. Some state governments have already appointed pay commissions (Karnataka and Punjab), and the Government's decision to appoint a pay commission would cause ripple effects. Revision in pay and pensions contributed to an increase of over 2% in revenue expenditures in states from FY1997 to FY2000. A similar increase could destabilize the finances of the states again. Second, the era of low interest rates seems to be over. Although the average rate of interest has fallen significantly because of the TFC debt restructuring plan, new loans by states will have higher interest rates. Third, some states have not shown any inclination to adopt the path of fiscal discipline recommended by the TFC. The recent assembly election in Tamil Nadu showed political parties' inclination to resort to competitive populism to come to power, which is a sure route to fiscal profligacy. Finally, the pressure to generate larger resources for the 11th Five Year Plan has led to the idea that the deficits do not matter. Combined with the recent experience of a fast-growing economy, despite persisting deficits, this has led to the belief that it is not necessary to adhere to the fiscal adjustment path recommended by the TFC.

17. The introduction of value-added tax (VAT) in place of a cascading type sales tax is an important positive development at the state level and it is expected to improve the buoyancy of the state tax system significantly. In general, the VAT revenue registered over 15% growth in FY2005 over the previous year. It was feared that the introduction of VAT could result in substantial loss of revenue in the initial years, and a provision of Rs60.5 billion was made to compensate states in the budget for FY2005. However, the actual compensation was significantly lower. Despite having revenue reducing the VAT rate structure, the revenue increase in VAT states in the first year was similar to those in states that did not switch to VAT.

18. The increase in revenue productivity from the introduction of VAT is shown more clearly when the revenue collections from VAT are observed during April–August 2006. By April 2006, all the states except Uttar Pradesh and Tamil Nadu had switched to the VAT regime and the collections during the first 5 months show a revenue increase of 28% over the same period the previous year. All states, except Arunachal Pradesh, have registered significant increases in revenues. In Andhra Pradesh, Chhattisgarh, Gujarat, and Jharkhand, growth or revenues from VAT during the first 5 months of FY2006 were more than 30% compared with the same period in FY2005. Although the increase in FY2005 was lower than the trend growth in states such as Andhra Pradesh, Karnataka, and Kerala, the growth rate accelerated significantly in FY2006, and the first 5 months of FY2006 have seen growth of over 30% in Andhra Pradesh, 18% in Karnataka, and 24% in Kerala. Thus, VAT reform is likely to increase the revenue productivity of the tax system significantly in the medium term.

19. There is no room for complacency, however. The available evidence shows that traders are slowly adjusting to the new tax system and discovering ways to evade the tax, as the information system required for effective administration and enforcement has not proceeded alongside structural reform. Evasion is done by keeping the entire chain of transactions outside the tax net. The chain is also circumvented by showing resales to registered dealers as sales to final consumers. The success in the implementation of VAT will depend on taking immediate measures to strengthen the information system. The success of the tax information network in garnering significant additional revenues from income taxes at the central level should be the eye-opener for the states.

20. Overall improvement in state finances should not obscure serious fiscal problems in individual states. Table A4.3 shows that fiscal problems in West Bengal, Kerala, Jharkhand, and even Punjab are worrisome. In Kerala, there was hardly any improvement in revenue deficits since FY2003, and revenue deficit continues to be as high as 4% of SDP. The fiscal deficit relative to SDP declined from 6.2% in FY2003 to 4.4% in FY2004, but increased the next year to 5.2%. In West Bengal, despite improvement by 1.2%, the revenue deficit was 3.7% of SDP. The fiscal deficit declined from 6.8% to 4.6% during the period. Yet, with almost 3.5% going to bridge revenue deficit, the capital outlay was just about 1.1% of SDP. In Jharkhand, a state with very high revenue and fiscal deficits, the revenue deficit is budgeted to decline to 1.4% in FY2006 from 3.3% in the previous year.

21. Implementation of the TFC's debt restructuring scheme has substantially reduced states' outstanding liabilities. Besides, reduction in the effective interest rates on states' borrowings, combined with high growth rate of SDP in most states, has ensured a reduction, albeit marginal, in debt-SDP ratio in recent years. Some 23 states have passed FRAs, as recommended by the TFC, and are eligible for benefits under the debt restructuring plan; others are likely to pass the legislation within the next few months. West Bengal is a notable exception—despite its severe imbalance, it has not passed the FRA. Kerala passed the act but, with the change in the party in

power, the new government has not shown any inclination to adhere to the set targets of fiscal and revenue deficit reduction.

Table A4.3: Fiscal Health of Individual States

	Percentage of Fiscal Deficit to SDP				Percentage of Revenue Deficit to SDP			
Item	**2003–2004 Actual**	**2004–2005 Actual**	**2005–2006 RE**	**2006–2007 BE**	**2003–2004 Actual**	**2004–2005 Actual**	**2005–2006 RE**	**2006–2007 BE**
General Category States								
Andhra Pradesh	(4.04)	(4.04)	(3.61)	(3.21)	(1.61)	(1.26)	(0.49)	(0.39)
Bihar	(8.34)	(2.17)	(8.05)	(5.19)	(0.49)	(1.88)	0.24	(0.86)
Chhattisgarh	(5.72)	(2.92)	(2.84)	(2.84)	(1.66)	0.35	1.69	2.37
Goa	(4.61)	(4.86)	(5.32)	(5.04)	(1.45)	(1.1)	(0.54)	(0.23)
Gujarat	(5.53)	(0.35)	(3)	(3.12)	(2.24)	2.25	0.17	0
Haryana	(3.97)	(1.45)	(2.01)	(1.76)	(0.37)	(0.31)	(0.65)	(0.3)
Jharkhand	(4.17)	0.57	(10.33)	(9.37)	0.36	1.33	(3.26)	(1.37)
Karnataka	(3.46)	(2.42)	(2.86)	(2.79)	(0.4)	1.1	0.71	0.82
Kerala	(6.19)	(4.43)	(5.2)	(5.38)	(4.11)	(3.65)	(3.98)	(3.73)
Madhya Pradesh	(7.46)	(6.3)	(4.23)	(3.95)	(4.56)	1.67	(0.02)	0.79
Maharashtra	(5.47)	(5.01)	(4.01)	(1.85)	(2.53)	(2.7)	(0.35)	0.07
Orissa	(6.57)	(8.54)	(5.33)	(5.32)	(2.61)	(0.88)	(0.88)	(0.66)
Punjab	(6.01)	(4.66)	(3.75)	(3.32)	(4.39)	(3.84)	(1.75)	(1.29)
Rajasthan	(7.02)	(5.56)	(4.96)	(3.79)	(3.26)	(1.25)	0.18	0.51
Tamil Nadu	(3.32)	(2.95)	(2.59)	(2.39)	(0.93)	(0.37)	(0.17)	(0.09)
Uttar Pradesh	(7.74)	(5.51)	(5.09)	(4.47)	(8.64)	(2.97)	(1.21)	0.4
West Bengal	(6.9)	(5.15)	(4.79)	(4.47)	(4.91)	(3.98)	(3.67)	(3.08)
Special Category States								
Arunachal Pradesh	(10.31)	(15.23)	0.33	(3.93)	7.59	(0.31)	20.62	6.19
Assam	(3.46)	(0.43)	(0.580	(0.51)	(1.7)	0.39	0.41	0.47
Himachal Pradesh	(13.2)	(9.01)	(4.09)	(3.82)	(8.9)	(5.77)	(0.41)	(0.97)
Jammu & Kashmir	0.09	(4.83)	(5.41)	0	9.96	7.55	9.04	0
Manipur	(7.8)	(11.14)	(7.090	(2.15)	(1.19)	2.27	10.7	15.88
Meghalaya	(4.19)	(5.95)	(3.640	(1.28)	1.77	(0.95)	2.2	5.09
Mizoram	(12.15)	(7.91)	(10.23)	(3.91)	3.34	3.76	5.57	3.71
Nagaland	2.9	8.51	16.98	15	10.07	2.5	6.5	6.49
Sikkim	(3.61)	(12.12)	(16.09)	(13.74)	11.54	11.03	11.47	12.61
Tripura	(4.76)	(2.89)	(5.7)	(5.58)0	1.48	4.74	4.92	3.75
Uttaranchal	(8.1)	(10.75)	(10.87)	(11.43)	(4.38)	(4.7)	(1.89)	(0.63)

BE = budget estimate, SDP = state domestic product, RE = revised estimate.
Note: Figures in parenthesis are negative.
Source: Budget documents of state governments.

22. Interestingly, fiscal stress as measured by revenue and fiscal deficits is not related to the level of development of the states as measured by their per capita SDP. The analysis shows that, in FY2003, the correlation between revenue deficit and per capita SDP was –0.07 and between fiscal deficit and per capita SDP, it was 0.236. However, this does not mean that fiscal stress in poorer states is any less or that their fiscal discipline is any better. The simple fact is that their spending on social and economic services is extremely low. For example, Bihar shows a revenue surplus of 0.24% in FY2005, Rajasthan shows a revenue surplus, and the revenue deficits in Orissa and Madhya Pradesh are small. However, per capita expenditure on social and economic services in all these states was well below average. In Bihar, it was Rs1,075, which was only 48% of the non-special category average (Rs 2,035). In Uttar Pradesh, revenue deficit was reduced from 2.98% of SDP in FY2000 to 1.21% in FY2005, but per capita expenditure on social and economic services (Rs1,187) was 42% lower than the all-state average.

23. Table A4.4 summarizes the fiscal situation in Madhya Pradesh during the mid-1990s and subsequent years. It shows that, barring the last 2 years of the series, the highest deficit figures are for FY1998. Afterward, there was a fiscal correction until FY2002, coinciding with the ADB program. Subsequent years show some deterioration, but the deficit figures may be the results of one-time entries. In FY2003, almost the entire increase in the deficit can be traced to a jump in the non-plan revenue (roughly the same as current) expenditures on economic services. In FY2004, the sharp drop in revenue deficit, changing it to a surplus, is mainly attributable to a large (probably one-time) receipt in the power sector. Similarly, the fiscal deficit of 6.01% of SDP, despite a revenue surplus, is the result of a large increase in capital expenditure on economic services.

Table A4.4: Madhya Pradesh Summary Fiscal Variables as Percentages of Gross State Domestic Product, FY1995–FY2004

Budget Head/Description	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Gross Fiscal Deficit	3.41	3.50	3.03	5.96	5.02	4.80	4.32	4.92	7.25	6.01
Revenue Deficit	1.00	2.63	0.78	4.15	3.76	2.91	3.75	1.42	4.43	(1.59)
Primary Deficit	0.99	1.00	0.27	3.31	2.28	1.53	1.65	1.89	4.07	2.62
Own Tax Revenue	7.35	7.45	7.60	7.38	7.44	7.65	5.56	7.47	6.72	7.20
Own Non-Tax Revenue	3.72	3.59	3.36	2.57	3.17	2.34	1.90	1.98	1.46	4.13
Total Revenue Expenditure	19.09	20.82	19.52	20.54	20.71	20.33	17.07	17.64	18.57	16.70
Total Capital Outlay	1.80	1.85	2.79	1.46	1.22	1.51	1.75	2.97	2.65	4.59
Public Expenditure Ratio	20.88	22.68	22.32	22.00	21.93	21.83	18.81	20.62	21.23	21.29
Social Allocation Ratio	32.90	30.98	30.25	34.28	34.24	33.70	26.86	28.94	23.71	23.71
Social Priority Ratio	55.26	55.14	57.25	57.20	53.80	57.73	59.50	55.77	57.03	57.99
Human Expenditure Ratio	3.80	3.87	3.87	4.31	4.04	4.25	3.01	3.33	2.87	2.93

FY = financial year.
Note: Figure in parenthesis is negative.
Source: Government of Madhya Pradesh Finance Accounts for the relevant years.

C. Explaining Fiscal Stress: Economic and Political Factors

24. The finances of every single state deteriorated during the latter half of the 1990s, although they have improved in the last couple of years because of higher transfers from the center. The reasons for the deterioration were (i) sharp increases in wages, salaries, and pensions following the implementation of the Fifth Pay Commission's recommendations at the central level; (ii) an increase in the debt servicing burden, with the increase in their cost of borrowing; (iii) an increase in explicit and implicit subsidies and transfers because of inadequate cost recoveries in the provision of quasi-public services; (iv) declining buoyancy in state taxes in the 1990s over the previous decade; (v) a decline in the transfers from the center following deceleration in tax devolution; and (vi) a sharp deterioration in power sector finances.

25. The fiscal stress was partly because the states did not undertake systematic tax reforms after the economy was liberalized in 1991 (footnote 6). The changes in their tax policy and administration have been largely ad hoc. Of course, the major reform—the introduction of state level VAT—was implemented only from April 2005.[8]

26. The revenue from states' own taxes grew substantially more slowly, and there was a sharp decline in the tax buoyancy in every state except Bihar in the 1990s compared with the previous decade (Table A4.5). The buoyancy of tax revenue, which was more than one in every state during the 1980s, declined in the 1990s to less than one in all the states except Assam, Bihar, Madhya Pradesh, and Uttar Pradesh. This is not surprising since over 70% of the growth in GDP during the latter half of the 1990s was attributable to growth in the services sector,[9] a large proportion of the production and consumption of which is not taxed by states. The case of West Bengal is striking as it had the lowest buoyancy in the 1990s (0.76).

Table A4.5: Growth and Buoyancy of States' Own Tax Revenues

State	Compound Growth Rate		Buoyancy Coefficients	
	1980–1990	1991–2002	1980–1990	1991–2002
Andhra Pradesh	16.16	14.36	1.13	0.93
Assam	19.41	13.16	1.32	1.14
Bihar	14.75	12.90	1.01	1.12
Gujarat	14.45	14.68	1.07	0.91
Haryana	14.70	13.63	1.06	0.89
Karnataka	15.62	14.54	1.13	0.90
Kerala	15.10	15.30	1.20	0.89
Madhya Pradesh	15.45	13.71	1.12	1.24
Maharashtra	14.84	13.89	1.06	0.90
Orissa	15.71	12.56	1.22	0.84
Punjab	13.52	12.47	0.98	0.94
Rajasthan	16.06	14.66	1.12	0.89
Tamil Nadu	14.19	14.36	0.99	0.86
Uttar Pradesh	15.72	13.57	1.19	1.04
West Bengal	15.20	11.64	1.16	0.76

Source: (Basic Data) State Finance Accounts.

[8] Rao, G. M. and R. K. Rao. 2005. *Trends and Issues in Tax Policy and Reform in India*. Paper presented at the Conference on India Policy Forum 2005, July 25–26, 2005.

[9] Acharya, S. 2001. *India's Macroeconomic Management in the Nineties.* Indian Council of Research in International Economic Relations. New Dehli.

27. Reforms on the expenditure side were difficult in the latter part of the 1990s, an era of coalition politics and competitive populism. While the effect of pay revision was felt in all the states, some states (such as Karnataka) tried to contain the damage by not entirely adhering to central pay scales and not filling vacancies created by natural attrition. On the other hand, pay revision in Punjab was even more liberal than the revision of the Government's pay scales. The effect of savings on debt servicing as a result of the debt swap scheme is yet to unfold fully. This will benefit more states with a large stock of small saving loans at high interest rates.

28. Variations in the intensity of the stress among the states depend on the structure of expenditures. The burden of salary revision varied depended on the share of salaries in total government expenditures and the extent of pay revision granted by the state government. Similarly, the interest burden depended on the stock of debt, its composition, time profile, and average interest rate payable. There were also exogenous shocks such as earthquakes in states like Maharashtra and Gujarat. Most of the states responded to the fiscal stress by compressing expenditures, and compressed most maintenance expenditure and creation of infrastructure, as support in the states on these is relatively weak. The ability to compress expenditures depends on the political strength and complexion of the state government. Recent developments, such as the emergence of coalition governments at the center and in some of the states, which increases the dependence of the main ruling party at the center on other political parties, and the short electoral cycle of political parties affects the prospects for fiscal consolidation. The emergence of regional parties and their "pivotal" role in the central coalition results in the adoption of asymmetric and discretionary fiscal arrangements. A pro-labor government as in West Bengal or coalition governments in the states could not implement policies to compress wages, salaries, and pensions. In contrast, some states such as Haryana, Karnataka, and Tamil Nadu did well to both increase revenues from own sources and manage expenditures to contain the size of revenue and fiscal deficits.

29. The important fiscal implications of these political developments may be summarized. In general, lowering of the time horizon has resulted in (i) greater competitive populism with reluctance to raise revenue from taxes and user charges, and (ii) an increase in expenditures with short-term political gains rather than long-term benefits for development. Second, coalition governments at the center with several parties including left wing parties has made it extremely difficult to undertake any rationalization of employment and wages, salaries, and pensions. At the same time, the common minimum wage program adopted by the United Progressive Alliance government has the potential to increase expenditures substantially. As many of the programs are within states' control, this has serious consequences for states' fiscal health. Third, bipolarization of the polity at the center has divided the ruling parties in the states as friendly and unfriendly to the center. States with strong central support could allow their fiscal situation to drift and have high deficits, and use the levers of their bargaining power to get larger transfers and bailouts. Even a rule-based system of intergovernmental finance has considerable scope for asymmetry and discretion.[10]

D. Structural Adjustment Loans and Fiscal Consolidation

30. This section analyses the impact of structural adjustment lending on states' finances. The experience with subnational adjustment lending from multilateral institutions is relatively recent. According to Article 293 of the Constitution, states cannot contract exogenous loans and even in the case of domestic loans, they have to seek permission from the central Government

[10] Rao, G. M. and N. Singh. 2005. *Political Economy of Indian Federalism*, Oxford University Press, New Delhi.

as long as they are indebted to it. Thus, even though detailed loan negotiations are conducted by multilateral institutions with state governments, the final contract is with the central Government, which onlends to the states. This creates an incentive problem, as the ultimate borrower has no repayment liability to the lender, and the enforcement of the contract will be the responsibility of the central Government despite the level of detail of the conditions imposed by the lending institutions.

31. Wide-ranging international experiences of structural adjustment loans (SAL) have produced mixed outcomes. A World Bank review[11] conducted in 1992 observed that adjustment lending was associated with fiscal deficit reduction and increase in revenue, but the general spending cuts were often at the expense of critically important operation and maintenance (O&M) and overspending on salary relative to non-salary inputs. While analyzing the effect of development assistance on public sector behavior, Mavrotas and Quattara[12] observed that official development assistance reduced revenues in the short run but raised them in the long run. The study by Gupta, Clements, Pivovarsky, and Tiongson[13] of foreign aid in 107 countries during 1970–2000 found that, while concessional loans were associated with higher domestic revenue mobilization, grants had the opposite effect.

32. The states in India that have availed of the SAL facility and the year of introduction of the SAL-induced fiscal reform program in those states are in Table A4.6. To date, Gujarat, Madhya Pradesh, and Kerala have availed of SAL assistance from ADB;[14] and the World Bank has assisted Andhra Pradesh, Karnataka, Uttar Pradesh, and Orissa. The relative fiscal performance of these states vis-à-vis states that did not avail of an SAL is now examined.[15]

Table A4.6: Year of Fiscal Intervention through SAL

State	Year of Fiscal Intervention	SAL Facility Provided by
Andhra Pradesh	2002	World Bank
Gujarat	1996	ADB
Karnataka	2001	World Bank
Kerala	2002	ADB
Madhya Pradesh	1999	ADB
Uttar Pradesh	2000	World Bank

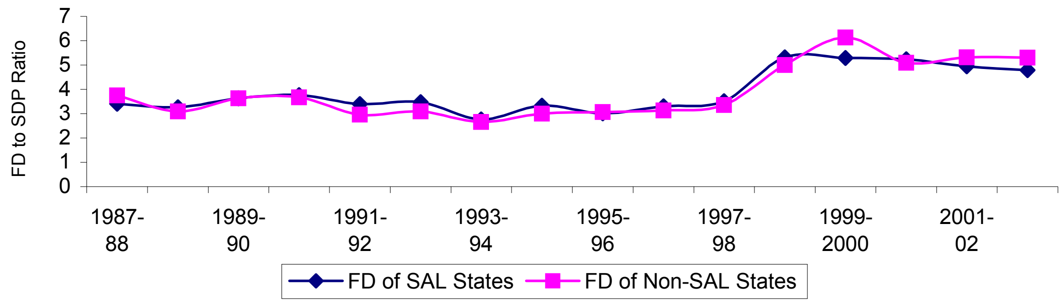
ADB = Asian Development Bank, SAL = structural adjustment loan.
Sources: ADB and World Bank documents.

33. The combined fiscal deficits to SDP ratio became marginally lower in SAL states than the rest of the states from FY2000 onward (Figure A4.3), and tended to decline. However, as far as revenue deficits are concerned, there was not much difference between SAL and non-SAL states.[16] The ratio of fiscal deficit to SDP ratio remained stagnant during FY2000 to FY2002 for the non-SAL states. By 2001, all five states had introduced fiscal reform except Andhra

[11] Cited in World Bank. 2005. *State Fiscal Reforms in India: Progress and Prospects, A World Bank Report.* New Delhi: Macmillan India Ltd.
[12] Mavrotas G. and B. Quattara. 2004. *Public Sector Revenue Response to Development Assistance, Time Series Evidence from Costarica, Cote D Ivorie, The Philippines.* Available: http://hkkk.fi/~haaparan/NNDE/Ouattara.pdf.
[13] Gupta, S., B. Clements, A. Pivovarsky, and E.R. Tiongson. 2003. Foreign Aid and Revenue Response: Does the Composition of Aid Matter? *International Monetary Fund Working Paper No. 3176*. New York.
[14] ADB also approved an SAL in Assam in 2004.
[15] The analysis is confined to the 15 major states in India, leaving aside the special category states excluding Assam. These 15 major states comprise all of the non-special category states, excluding Goa, and one special category state, i. e., Assam.
[16] There was a decline in the SAL states in FY2002, the last year for which date is available.

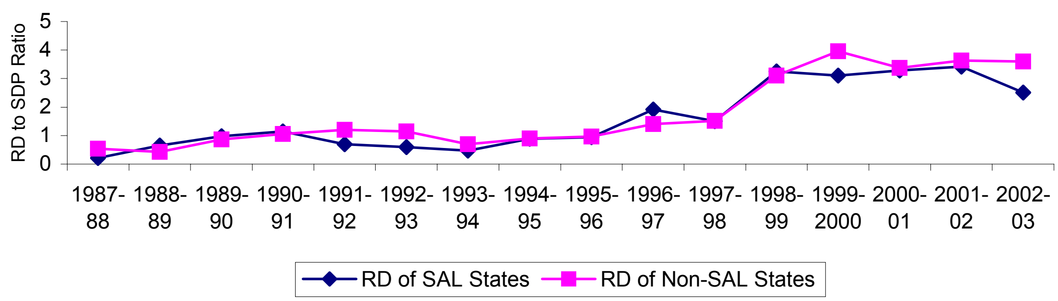
Pradesh, which followed in 2002. A similar trend is observed concerning revenue and primary deficits to SDP ratio of both categories of states (Figures A4.4 and A4.5). However, unlike fiscal and revenue deficits, the primary deficit to SDP ratio declined for both categories of states from the late 1990s—the fall is sharper in the case of states with SAL. The World Bank study (footnote 5) also noted that there has been a sustained reduction in the revenue deficits of states that availed of SAL-induced fiscal reform.

Figure A4.3: Fiscal Deficit to SDP Ratio
A Comparison of States with and without SAL

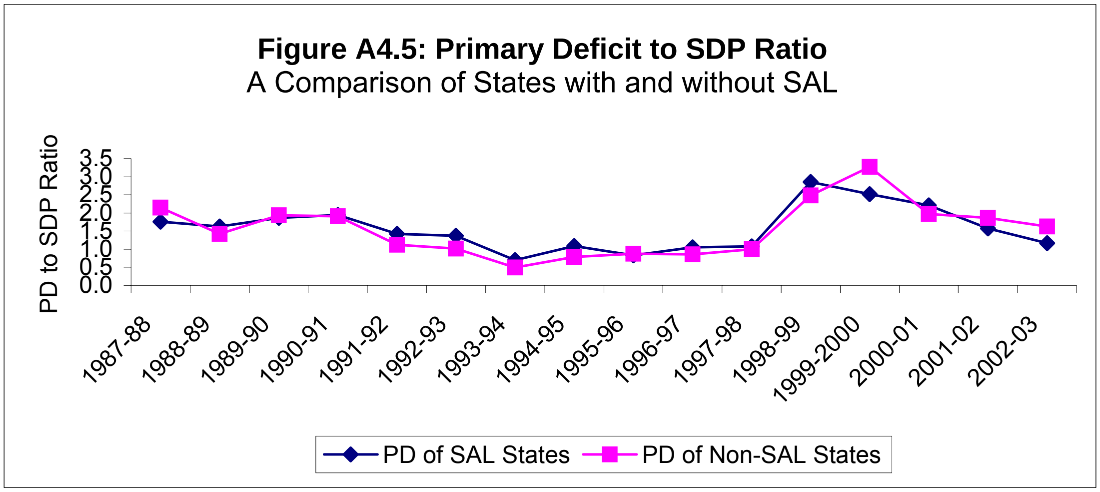


FD = fiscal deficit, non-SAL = non-structural adjustment loan, SAL = structural adjustment loan, SDP = gross state domestic product.
Source: Reserve Bank of India.

Figure A4.4: Revenue Deficit to SDP Ratio
A Comparison of States with and without SAL



non-SAL = non-structural adjustment loan, RD = revenue deficit, SAL = structural adjustment loan, SDP = gross state domestic product.
Source: Reserve Bank of India.



non-SAL = non-structural adjustment loan, PD = primary deficit, SAL = structural adjustment loan, SDP = gross state domestic product.
Source: Reserve Bank of India

34. Overall, the upward movement of revenue, fiscal, and primary deficits have been on hold or there has been a marginal improvement in these deficits in SAL states subsequent to structural adjustment lending. However, it would be misleading to conclude that there are clear trends as the analysis period is not long enough and the reduction in the deficits is not clear and decisive.

35. It is important to find out whether and to what extent fiscal intervention through SAL resulted in the expected improvement of revenues and rationalization of expenditures.[17] Before model specification and estimation, an exploratory analysis of state level fiscal variables was undertaken in the pre- and post-reform period in these six SAL states. The period chosen was from FY1987 to FY2002.

36. There are a spectrum of indicators to judge fiscal reform. To start with, the pre- and post-reform tax buoyancy is compared. In all states, except Madhya Pradesh and Uttar Pradesh, own tax buoyancy was higher in the post-fiscal intervention year than the pre-fiscal intervention year (Table A4.7). However, there are sharp interstate differences in the pre- and post-reform buoyancies. The revenue buoyancy was highest in Karnataka, followed by Kerala, Andhra Pradesh, and Gujarat.

[17] Orissa is excluded from the analysis, as the SAL-induced fiscal reform has just been introduced in the last fiscal year.

Table A4.7: Buoyancy of Own Tax Revenues: Comparison of Pre- and Post-Fiscal Intervention Years

State	Pre Fiscal Intervention Year Buoyancy	Post Fiscal Intervention Year Buoyancy	Difference of post and pre reform buoyancies	Buoyancy of the combined period
Andhra Pradesh	0.910	1.617	0.707	0.938
Gujarat	0.921	0.976	0.055	0.932
Karnataka	0.964	4.397	3.433	0.984
Kerala	1.007	1.980	0.973	1.015
Madhya Pradesh	1.027	0.978	(0.049)	1.075
Uttar Pradesh	0.997	0.792	(0.204)	1.078

Note: Figures in parenthesis are negative.
Source: (Basic Data) State Finance Accounts.

37. However, when the buoyancy of non-tax revenues of the state is analyzed, higher buoyancy is observed in the post-reform period in the states, except in Andhra Pradesh where it declined and in Uttar Pradesh where it was negative (Table A4.8).

Table A4.8: Buoyancy of Own Non-Tax Revenues: Comparison of Pre- and Post-Fiscal Intervention Years

State	Pre-Fiscal Intervention Year Buoyancy	Post-Fiscal Intervention Year Buoyancy	Difference of Post- and Pre-Reform Buoyancies	Buoyancy of the Combined Period
Andhra Pradesh	0.799	0.027	(0.772)	0.781
Gujarat	1.005	1.879	0.874	0.934
Karnataka	0.733	0.763	0.03	0.689
Kerala	0.736	2.111	1.375	0.728
Madhya Pradesh	0.818	3.405	2.587	0.813
Uttar Pradesh	0.679	(0287)	(0.966)	0.626

Note: Figures in parenthesis are negative.
Source: (Basic Data) State Finance Accounts.

38. To assess the performance on the expenditure side, the non-interest expenditure elasticity was estimated in pre- and post-reform periods.[18] Inclusion of interest payment in the expenditure model may give spurious results, as it is sticky upwards and committed in nature. Interest payment in the states also increased because of the increase in the average cost of debt caused by financial liberalization during the 1990s. The expenditure elasticity declined significantly in Andhra Pradesh and Uttar Pradesh (Table A4.9), while it increased in Karnataka, followed by Kerala and Gujarat. These increases reflect softening of the budget constraint because of the fresh infusion of resources via SAL.

[18] Interest payment being a committed expenditure, will not vary by whether a debt state undertakes fiscal reform unless reform is accompanied by aggressive debt restructuring. Furthermore, the benefits from a softening of interest rates would accrue to all the states.

Table A4.9: Elasticity of Non-Interest Expenditure: Comparison of Pre- and Post-Fiscal Intervention Years

State	Pre-Fiscal Intervention Year Elasticity	Post-Fiscal Intervention Year Elasticity	Difference Of Post- and Pre-Reform Elasticity	Buoyancy of the Combined Period
Andhra Pradesh	0.947	(0.007)	(0.954)	0.932
Gujarat	0.701	1.186	0.485	0.910
Karnataka	0.948	6.523	5.575	0.982
Kerala	0.948	2.46	1.512	0.955
Madhya Pradesh	0.925	0.986	0.061	0.972
Uttar Pradesh	0.934	0.674	-0.26	0.943

Note: Figures in parenthesis are negative.
Source: (Basic Data) State Finance Accounts.

1. Model Specification and Estimation

39. The econometric analysis of the impact follows a modeling strategy that controls for state-specific factors, including unanticipated shocks other than the fiscal intervention through SAL. In the present context, unanticipated shocks were the Gujarat earthquake and the bifurcation of the states of Madhya Pradesh and Uttar Pradesh.[19] In addition, the specification includes the effects of pay revision caused by implementation of the Fifth Pay Commission's award, the earthquake in Gujarat, and the bifurcation of Madhya Pradesh and Uttar Pradesh. The period chosen for the analysis was FY1987 to FY2004.

40. The following expenditure model has been specified for Andhra Pradesh, Karnataka, and Kerala:

$$\ln iex = \alpha + \beta \lg sdp + \chi \ln ix_{t-1} + \delta f_{du} + \varepsilon S_{du} + U_t$$

For Gujarat, the expenditure model shocks is specified as:

$$\ln iex = \alpha + \beta \lg sdp + \chi \ln ix_{t-1} + \delta f_{du} + \varepsilon S_{du} + \gamma E_{du} + U_t$$

For Madhya Pradesh and Uttar Pradesh, the specification is:

$$\ln iex = \alpha + \beta \lg sdp + \chi \ln ix_{t-1} + \delta f_{du} + \varepsilon S_{du} + \mu b_{du} + U_t$$

Where, $\lg sdp = \log of\ gross\ state\ domestic\ product$

$f_{du} =$ $fiscal\ \text{int}ervention\ dummy$

$S_{du} = Salary\ revision\ dummy$

$E_{du} = Earthquake\ dummy$

$b_{du} = State\ bifurcation\ dummy$

[19] The states of Madhya Pradesh and Uttar Pradesh were carved to form two other states—Chhattisgarh and Uttaranchal respectively.

41. According to the expenditure models specified above, the primary government expenditure is expected to be positively related to the SDP and the lag of its own expenditure. The sign of fiscal intervention dummy would primarily depend on the nature of fiscal intervention. If the intervention focused more on expenditure restructuring rather than expenditure contraction, a positive coefficient may be produced, implying enhancement of primary expenditure. The sign of the dummy for salary revision is expected to be positive, as well as the earthquake dummy for Gujarat. It is difficult to predict the sign of the state bifurcation dummy used for Madhya Pradesh and Uttar Pradesh, as it would depend primarily on whether the bifurcation of the state leads to a fiscal loss or gain.

42. The results of the state-specific expenditure models presented in Table A4.10 reveal that the coefficient of lagged expenditure variable was positive and significant in Andhra Pradesh, Gujarat, Madhya Pradesh, and Uttar Pradesh. In other words, past expenditure determined the level of the current fiscal year expenditure. The fiscal intervention dummy shows a negative sign for Andhra Pradesh, Gujarat, and Madhya Pradesh, implying that fiscal intervention induced contraction of expenditure, although the coefficients are not statistically significant. In Uttar Pradesh, however, the sign of the fiscal intervention dummy is positive but not significant. In Gujarat, the earthquake dummy is positive but not statistically significant.

43. The coefficient of the fiscal intervention dummy is positive and statistically significant in only in Kerala. This implies that fiscal intervention has helped increase the share of non-interest or the primary expenditure in Kerala, and the coefficient is 0.097. Exploratory analysis for Kerala showed that the dummy used to capture the Fifth Pay Commission recommendation induced salary revision.

Table A4.10: Results of the State-Specific Expenditure Models
1987–2005

States	C	LSDP	LNIEX(-1)	F_{du}	S_{du}	E_{du}	b_{du}
Andhra Pradesh	(0.427)	0.167	0.858[a]	(0.043)		(0.018)	
		0.619	*2.936*				
Gujarat	(0.335)	0.331	0.640[a]	(0.004)	(0.004)	0.082	
		1.751	*3.449*				
Karnataka	(1.338)[a]	0.723[a]	0.281	0.030		(0.062)	
	(2.426)	*3.154*	*1.222*				
Kerala	(1.262)[a]	1.076[a]	(0.167)	0.097[b]		0.118[a]	
	(2.143)	*4.097*	*(0.634)*	*1.836*		*2.613*	
Madhya Pradesh	(0.551)	0.266	0.750[a]	0.022		(0.030)	(0.189)[b]
		0.985	*2.946*				*(2.013)*
Uttar Pradesh	(0.581)	0.332	0.670[a]	0.056		(0.035)	(0.080)
		1.159	*2.509*				

b_{du} = state bifurcation dummy, C = control, E_{du} = earthquake dummy, F_{du} = fiscal intervention dummy, LSDP = lagged gross state domestic product, LNIEX = expenditure model, S_{du} = salary revision dummy.
Note: Figures in parenthesis are negative and figures italicized are the t-statistics.
[a] Indicates significance of the variable.
[b] Indicates significance at 10%.
Source: (Basic Data) State Finance Accounts.

44. The state-specific revenue side models were then estimated separately for own tax revenues and own non-tax revenues. The following model was specified for Andhra Pradesh, Gujarat, Karnataka, and Kerala:

$$lotr = \alpha + \beta gsdp + f_{du} + u_t$$
$$lontr = \alpha + \beta gsdp + f_{du} + u_t$$

45. In the case of Madhya Pradesh and Uttar Pradesh, the state bifurcation dummy was also incorporated:

$$lotr = \alpha + \beta gsdp + f_{du} + b_{du} + u_t$$
$$lontr = \alpha + \beta gsdp + f_{du} + b_{du} + u_t$$

Where, $otr = own\ tax\ revenues$
$ontr = own\ non\ tax\ revenues$

46. The results of state-specific revenue models are presented in Tables A4.11 (own tax revenues) and A4.12 (non-tax revenues). Own tax revenues are a positive function of state income, and statistically significant for all the states, unlike in the expenditure model. The fiscal intervention dummy has a negative sign for Gujarat, but not significant. This could be partly due to the natural calamities and communal problems. It is significant with a positive sign for all other states. This implies that the intervention and associated reforms did not bring about significant improvement in the revenues in Gujarat.

47. In the case of non-tax revenues, the fiscal intervention dummy is significant with a negative sign in Gujarat (Table A4.12), indicating that the non-tax revenues showed a decline after the structural adjustment reforms were introduced. It is positive and significant in Andhra Pradesh and Uttar Pradesh, and is not significant in the remaining states. The state bifurcation dummy, though negative, remained statistically insignificant in both Madhya Pradesh and Uttar Pradesh.

Table A4.11: States' Own Tax revenues

State	C	LSDP	FD	BD
Andhra Pradesh	(1.544)[a]	0.898[a]	0.274[a]	
	(2.542)	*16.283*	*3.071*	
Gujarat	(1.898)[a]	0.940[a]	(0.024)	
	(3.733)	*19.298*		
Karnataka	(2.340)[a]	0.992[a]	0.157[a]	
	(5.829)	*26.427*	*2.592*	
Kerala	(2.534)[a]	1.006[a]	0.044[b]	
	(16.253)	*66.811*	*1.707*	
Madhya Pradesh	(3.433)[a]	1.047[a]	0.242[a]	(0.204)[b]
	(5.086)	*16.680*	*3.556*	*(1.866)*
Uttar Pradesh	(3.387)[a]	1.032[a]	0.271[a]	(0.026)[b]
	(4.953)	*17.096*	*3.602*	*(0.247)*

BD = budget deficit, C = control, FD = fiscal deficit, LSDP = lagged gross state domestic product.
Note: Figures in parenthesis are negative and figures italicized are the t-statistics.
[a] Indicates significance of the variable.
[b] Indicates significance at 10%.
Source: (Basic Data) Finance Accounts.

Table A4.12: Own Non-Tax Revenue Model

State	C	LSDP	FD	BD
Andhra Pradesh	(2.236)	0.814 [a]	0.581[a]	
		9.815	*4.331*	
Gujarat	(6.234)[a]	1.211[a]	(2.451)[a]	
	(5.334)	*10.819*	*(2.451)*	
Karnataka	(1.536)[b]	0.744[a]	0.002	
	(1.709)	*8.847*		
Kerala	(1.779)[a]	0.740[a]	(0.014)	
	(3.675)	*15.825*		
Madhya Pradesh	(1.752)	0.827[a]	(0.094)	(0.205)
		5.810		
Uttar Pradesh	(2.870)[a]	0.822[a]	0.479[a]	0.048
	(2.962)	*9.613*	*4.496*	

BD = budget deficit, C = control, FD = fiscal deficit, LSDP = lagged gross state domestic product.

Note: Figures in parenthesis are negative and figures italicized are the t-statistics.

[a] Indicates significance of the variable.

[b] Indicates significance at 10%.

Source: (Basic Data) Finance Accounts.

E. Concluding Remarks

48. This study has analyzed the nature and causes of fiscal stress in state governments in India, and has examined the impact of fiscal reform initiated through structural adjustment lending to selected state governments. The study shows that there has been a steady deterioration in the deficit indicators of the states during the 1990s, with a turnaround in recent years. However, the deficits shown in the budgets do not reveal a complete picture, since off-budget deficits are not included because of the power sector and other utilities. The study noted that off-budget deficits caused by power sector loss have increased steadily in recent years to constitute about 1.4% of GDP, and should be added to the deficits measures derived from the budget to get a realistic picture of the deficits. Thus, the deterioration in state finances is worse than what the deficit figures derived from the budgets reveal.

49. The analysis of revenue and fiscal deficits show significant interstate variations. The performance of West Bengal, in terms of both the size of deficits and their change over time, is worrisome. Other badly performing states include Punjab and Gujarat, the latter mainly because of adverse fiscal fallout from the earthquake in 2001. At the other end of the spectrum, Haryana and Tamil Nadu have performed well in terms of containing their deficits. Curiously, some of the low-income states such as Bihar and Uttar Pradesh have also contained their deficits—raising serious doubts on the appropriateness of taking only these measures to understand fiscal stress in the states. Given the structure of incentives, many of the poorer states have preferred to reduce their expenditures, particularly on social and economic services, with adverse growth implications for the future, as a route to contain the deficit. There is no significant relationship between the level of development expenditure and the size of revenue or fiscal deficits in states.

50. The study shows that the response to fiscal stress could differ, depending on the structure of incentives faced by states and their political environment and alignments. States that cannot easily soften their budget constraints by increasing the off-budget liabilities or bargain and secure larger grants from the center, have to increase revenues, cut expenditures,

or incur larger deficits. States such as Haryana, Karnataka, Tamil Nadu, and Andhra Pradesh have tried to contain their deficits, partly by containing expenditures and partly by raising revenues. In contrast, states such as Bihar and Uttar Pradesh have cut developmental expenditures, given the weak constituency for these expenditures. States such as West Bengal and Punjab did not increase revenues but continued to incur expenditures, so they incurred large deficits.

51. The emergence of coalition governments at the center, and regional parties in the states that became "pivotal" partners in the central Government, can have important implications for the fiscal health of the states but the state response to fiscal stresses. The bipolarization of the polity and asymmetric treatment of various states by the center also influences the fiscal response of the states. Above all, lowering of the time horizon of the political parties has imparted competitive populism to the policy environment. All these factors have adversely affected fiscal discipline in the states.

52. The state-specific effect of SAL has been mixed in terms of fiscal consolidation. The exploratory data analysis of key fiscal variables across states revealed some improvement in the expenditure structure and revenue effort for a subset of states that have introduced SAL-induced fiscal reform. The econometric analysis shows that, while fiscal intervention had a positive and statistically significant impact on own tax revenues in Karnataka and Kerala, the impact on the expenditure side was insignificant. Although there was evidence of softening of the budget constraints in some states in terms of non-interest expenditure, overall, there seems to have been some fiscal gain in terms of reduction in revenue and fiscal deficits of SAL states vis-à-vis non-SAL states. This remains true even when the consolidated fiscal deficits, including power sector deficits, of non-SAL and SAL induced states is compared. Many of the gains seem to have occurred in terms of improved revenue productivity of the tax system and not through expenditure compression.

53. These results are tentative. The impact of interventions on revenue productivity and expenditure economy cannot be immediate, but must take place in the medium term. More analytical work is necessary before conclusions are drawn. Nevertheless, initial results are not very encouraging since adjustment lending did not result in expenditure economy in any of the states. However, in two of the four states analyzed, the revenue productivity of the tax system improved following adjustment lending.

REFORMING PUBLIC SECTOR UNDERTAKINGS

A. Background

1. India's states replicated the Government of India's model of using public sector undertakings (PSU) to spur industrial and socioeconomic development. Currently, state PSUs contribute around 5% of gross domestic product (GDP) in terms of aggregate revenues, against 10% in the case of central Government PSUs. The total investment in state PSUs is estimated to have been over Rs3.6 trillion in 2003. Among the states, Andhra Pradesh had the largest investment in PSUs, accounting for 8% of the state's total investment, followed by Jammu and Kashmir (7%), and Delhi and Maharashtra (5% each).

2. Most state governments emulated the Government in setting up manufacturing enterprises to increase industrialization in their states. State PSUs have also been used to achieve a number of objectives, ranging from employment creation to supply of subsidized services such as power and transport. Out of 1,068 state PSUs, over 50% was engaged in manufacturing activities. Other categories in which state level PSUs operate include promotional and development activities (16% of total number of state PSUs), utilities primarily comprising power utilities and road transport corporations (12%), welfare enterprises providing economic support to the poor (8%), financial enterprises (7%), and trade and services.

3. Kerala has the largest number of state PSUs at 109, with 77 enterprises engaged in manufacturing. Uttar Pradesh, with 104 PSUs, has the second largest concentration, but accounts for the largest number of enterprises engaged in promotional and welfare activities amongst the states. In 2003, the total revenues earned by all state PSUs was Rs862.84 billion with net losses of Rs69.97 billion. Most state PSUs continue to depend on annual budgetary support from their state governments. Given the budgetary constraints faced by most states, many initiated PSU reforms to reduce the recurring budgetary support required to sustain the PSUs and allocate additional resources to infrastructure, health, and education.

4. Gujarat, Andhra Pradesh, and Karnataka have been pioneers in PSU reforms in India. Madhya Pradesh's total investments in 31 PSUs were estimated at Rs33 billion in FY1997, accounting for 5.4% of the state domestic product (SDP). These enterprises employed 134,000 persons, about 10% of the state's total public sector workforce. Like other states, Madhya Pradesh provides recurring budgetary support to sustain its underperforming PSUs. For example, in FY1995, budgetary support to PSUs was over Rs4 billion in the form of loans, grants, write-off of debt service payment, and equity infusion and funds for investment plans.

5. The Madhya Pradesh Department of Public Enterprises (DPE) was established through a government order issued in March 2000, with the mandate to be the nodal agency for PSU reforms in the state. The key responsibilities of DPE included: (i) leading efforts to close or restructure unviable PSUs identified under a program initiated with ADB funding; (ii) introducing better corporate governance and performance-based enhancements to the management of PSUs covered under the above program; (iii) formulating memoranda of understanding (MOU) with identified PSUs and monitoring performance, on a quarterly basis, vis-à-vis targets delineated in the MOUs; and (iv) publishing annual reports on the performance of PSUs.

6. Prior to 1997, in the absence of a PSU policy on restructuring and divestment, the government of Madhya Pradesh (GoMP) adopted a case-by-case approach to PSU reform. Selected enterprises that were not perceived to be serving social objectives were closed and certain units of enterprises were transferred to the private sector on a management contract. A

processing mill of Madhya Pradesh Textile Corporation was also privatized as part of public enterprise reform. However, the absence of an institutional mechanism for developing and implementing a PSU restructuring program and a lack of focus on corporate governance, besides the limited availability of funds for implementing the restructuring, hampered PSU reforms.

7. In January 1998, GoMP approved a policy on public sector reforms and restructuring in preparation for the ADB-financed Madhya Pradesh Public Resource Management Program (MPPRMP) loan supporting fiscal reforms. The salient features of this policy were (i) establishment of a state renewal fund (SRF) to finance the voluntary resettlement scheme (VRS) in respect of employees displaced by the PSU reforms, to mitigate the adverse social impact of PSU restructuring; (ii) formation of a public resource management committee (PRMC) chaired by the chief minister, supported by an Empowered Committee on PSU Reform (ECPR) chaired by the chief secretary with high-level representation from key sector departments, to systematically review and implement PSU reform in the state; and (iii) formulation of a VRS policy in respect of employees likely to be discharged from service on account of the closure or restructuring of identified PSUs.

B. Program Design

1. Rationale for PSU component of the Program

8. In the 1990s, GoMP was facing difficulties meeting mounting expenditure pressures because of stagnating revenues from its own sources and from central government transfers, in form of grants and share in national taxes. Government expenditure was increasing, mainly because of the rising wage bill, high interest burden, and rising losses of PSUs—including conversion of loan to equity through capital grants. This resulted in a change in expenditure composition, as public investment was compressed and outlays for operation and maintenance were squeezed. This affected both the expansion and maintenance of infrastructure and other capital assets. In addition, resources available for allocation to social services were limited, which otherwise could have facilitated progress in the state's social development. With more than one third of its population under the poverty line—the highest proportion among all Indian states—GoMP was increasingly focusing on achieving public financial stability in the medium term by redirecting its expenditure to ensure basic human needs as well as social and infrastructure development.

9. MPPRMP was launched with the primary objective of fostering social development and sustainable economic growth by addressing prevailing resource and implementation constraints in Madhya Pradesh. Consequently, the Program adopted a three-pronged approach: (i) enhancing resource allocation to social sectors through focused social sector interventions to support human development; (ii) implementing public sector reforms, including capacity building and institutional strengthening for improved fiscal capabilities and management, and policy and operational frameworks for restructuring of public enterprises; and (iii) promoting an enabling environment for private sector participation in key sectors. By the late 1990s, GoMP had invested Rs3.3 trillion in PSUs. However, their operational and financial performance had been extremely weak in FY1998, with the public enterprise sector (excluding the state electricity board [MPEB]) as a whole incurring after-tax losses of Rs570 million or 0.1% of SDP, and an accumulated loss of more than Rs5 billion (about 0.9% of SDP). Dividend payments amounted to Rs47 million in FY1998, equivalent to only about 0.5% of GoMP's share in total paid-up capital. Consequently, the state budget bore a heavy burden as it underwrote losses of PSUs

through budgetary support for loans, grants, or write-off of debt service payment. In addition, equity injection in PSUs and funding of PSU investment plans had reached Rs.68 billion.

10. Undertaking PSU reforms was critical to reduce the adverse impact of PSUs on government finances, thereby freeing up resources for investment in health, education, infrastructure, and other social sectors, in line with the developmental priorities of GoMP; and allowing the private sector to take the lead in commercial activities through divestment. The 14 PSUs targeted for reform under the MPPRMP had a workforce of 37,000 (27% of total PSU employment in the state), accounted for 80% of total paid-up capital, and represented 85% of GoMP's shareholding in PSUs (excluding MPEB).

2. Policy measures for PSU reforms under the MPPRMP

11. **Framework to Categorize PSUs.** Three categories of PSUs were identified to be reformed under the MPPRMP.

(i) **Partial divestment.** Enterprises that can achieve greater efficiencies in their operations through induction of private partners or benefit from adopting corporate governance measures through wider dispersion of ownership to be divested after implementing appropriate restructuring measures. Enterprises requiring induction of a strategic partner from the private sector to ensure their sustainable viability will be divested through a process of joint venture transformation, with other enterprises being partially divested with part of GoMP shares being offered to the public.

(ii) **Closure**. Enterprises identified as financially unviable and not fulfilling any social objective were to be subject to closure after implementing a VRS for its employees.

(iii) **Restructuring enterprises through sale/lease of properties together with the transfer of employees to private sector lessees/owners, to the extent possible**. This strategy was envisaged only in respect of the Madhya Pradesh State Tourism Development Corporation (MPSTDC), in accordance with the state's tourism policy.

12. **Institutional Framework to Support PSU Reform.** Three institutions were central to implementing, and monitoring the PSU reforms process.

(i) The ECPR headed by the chief secretary with high-level representation from key GoMP departments was established with a mandate to review and approve (a) the extent of shareholding to be divested in those enterprises identified for privatization or divestment, and (b) enterprises to be closed.

(ii) Two cabinet subcommittees were established—one on VRS and another on SRF—to ensure smooth operation of these two components. The VRS subcommittee, established in 2001, was mandated to design the VRS scheme as part of the MPPRMP. The SRF subcommittee, established as part of the Program and chaired by the finance minister, approved allocations to the SRF from the state budget.

(iii) DPE was to be the nodal government agency for implementing PSU reforms in the state. With the objective of facilitating coordination and reducing possible conflicts of interest in implementing reform measures, the nodal responsibility for implementing reforms measures for PSUs covered under the program was to be transferred to DPE from their respective line departments. DPE was to be strengthened by appointing qualified professionals with the appropriate experience to take on the responsibility as the nodal agency for implementing PSU reforms.

A technical secretariat was to act as an advisory body to the empowered committee responsible to (a) undertake preparatory and technical analysis of PSUs, (b) conduct valuation of PSUs, and (c) provide technical assistance (TA) on reform options including restructuring and divestment. However, the secretariat was not established.

13. **State Renewal Fund for Voluntary Retirement Scheme and Social Safety Net for Displaced Workers.** GoMP instituted a VRS under the MPPRMP to be applicable to all workers being displaced as a result of implementation of PSU reforms. An SRF was set up to fund the VRS payments, cost of redeployment of surplus personnel, and financial restructuring plans of PSUs. The SRF was to be financed through contributions from GoMP, the proceeds from the sale of GoMP shareholding in PSUs, and sale of assets of closed PSUs. The applications from individual PSUs for VRS disbursement were vetted by the secretary of the institutional finance department, before being forwarded to the finance department for approval. The finance department forwarded sanctioned applications to the SRF subcommittee for ratification of the required fund allocation from the state budget to the SRF.[1] The VRS entitlement in respect of individual employees was calculated based on years of service (Table A5.1), with the disbursements being effected by the concerned PSUs on the release of funds from the SRF.

Table A5.1: Formula for Computation of VRS Compensation to Employees

Tenure of Service of Employees	VRS Compensation
Employees with less than 10 years of service	Aggregate of 18 months of salary, composed of 75% of the last drawn salary disbursed during the first year post-VRS, 50% of the last drawn salary disbursed during the second year post-VRS, and 25% of the last drawn salary disbursed during the third year post-VRS.
Employees with 10 years or more of service	2 months salary for every completed year of service or the equivalent of salary for the remaining period of service, whichever is lower.

VRS = voluntary retirement scheme.
Source: Interview with Social Safety Net Program Expert.

14. A social safety net (SSN) scheme was to offer training to re-skill displaced employees to enable them to seek alternate employment opportunities, with a committee intended to be established to prepare and implement the SSN scheme, besides conducting a socioeconomic survey of the affected groups for benefit monitoring. The MPPRMP design estimated that the total cost of the VRS and SSN would total $120.4 million, with the estimated 16,500 staff to be retrenched, based on information provided by GoMP and the individual PSUs. However, GoMP decided, in FY2002, not to undertake a SSN, on the grounds that the scheme would create a

[1] Interview with social safety net program expert.

precedent for all public and private bodies wishing to undertake downsizing with commensurate cost implications.

3. Assessment of Policy Measures

15. The proposed PSU policy reform measures were based on three key risks and constraints identified during the MPPRMP design phase: (i) political and labor union resistance to the displacement of surplus PSU employees proposed to be undertaken under the Program; (ii) government support and commitment to the SSN mechanism; and (iii) lack of experience of GoMP and the respective enterprises in PSU reforms. The first risk would be addressed through regular consultations with key stakeholders, together with financial and training support provided through the SRF to displaced employees. Almost 9,000 employees of PSUs identified for reform under the Program were offered a VRS,[2] with a total of Rs2.575 billion disbursed as VRS compensation from the SRF. It is understood that there have not been any instances of labor resistance to the personnel restructuring measures initiated as part of the reforms, suggesting that the VRS amount was considered reasonable. The second was intended to be mitigated by setting up the technical secretariat, supported by consultants with specialized skills to manage the SSN, and the two cabinet subcommittees on VRS and SRF wereestablished to ensure smooth operation of these two program components. However, as GoMP decided not to undertake the SSN, apparently because of fund constraints, the counseling and re-skilling of displaced workers was not accomplished. The third risk was proposed to be addressed through an ADB-financed TA to build GoMP capacity to undertake PSU reform.

16. However, there appear to be a few areas where a slight fine-tuning of the program design may have increased its effectiveness further. While the categorization of PSUs covered by the Program appears to have been based on an analysis of the respective mandates for individual PSUs, there is scope for improvement regarding the reform/restructuring strategy for each category. For example, offering a majority stake (with management control) to prospective private partners for enterprises with limited socioeconomic obligations, such as MPSRTC, may have increased the chances of successful divestment.

17. Limited expert inputs seem to have been utilized for specialized functions such as marketing the proposed divestment to potential investors, negotiations with prospective bidders and with industry bodies like the Confederation of Indian Industries in the case of MPSTDC. Based on our experience in similar engagements, the chances of successful consummation of the transaction increase significantly when expert inputs are leveraged.

4. Effectiveness of PSU Reforms

18. The relevant loan conditions, covenants, and status of the individual enterprises identified for reform were presented in Appendix 2 in the program performance evaluation report (PPER).

19. **PSU Restructuring – Partial Divestment.** Although five PSUs were identified in this category, GoMP did not succeed in divesting its stake in any of the enterprises.

20. **Madhya Pradesh State Industrial Development Corporation.** (MPSIDC). GoMP proposed to reduce its share to 51% after the initiation of organizational and financial restructuring. MPSIDC prepared a restructuring plan involving the induction of a strategic

[2] Note on VRS by the Project Management Unit, Department of Finance, Government of Madhya Pradesh.

partner, Infrastructure Leasing and Finance Services Ltd., chosen based on its track record of turning around enterprises with suboptimal performance. Infrastructure Leasing and Finance Services Ltd. agreed to restructure the corporation with 15% ownership, but the MPSIDC board rejected the offer. A bid for the company by Reliance group was rejected by GoMP, as the offer included a proposal for complete privatization of MPSIDC in 3 years. The report of a consultancy firm, appointed to prepare a business plan for restructuring the corporation, still awaits GoMP approval. However, in 1998, MPSIDC downsized by 40%, followed by a further 80 employees accepting VRS in 2004. The corporation's exposure to the small and medium-sized enterprise (SME) sector, in the form of intercorporate deposits, resulted in significant levels of nonperforming assets (NPAs), consequent to the adoption of Reserve Bank of India (RBI) norms relating to provisioning for nonperforming accounts. According to MPSIDC management estimates, the NPAs currently stand at around Rs7.15 billion. One-time settlement schemes with term lenders and borrowers of intercorporate deposits have been approved by the board as part of financial restructuring measures but also await GoMP approval.

21. **Madhya Pradesh State Agro Industries Development Corporation Ltd.** (MPSAIDC). The corporation was to divest its holding in a large agricultural farm to the joint sector, involving the participation of both government and private investors. This was to be followed by GoMP's equity stake in the corporation being reduced to not more than 26%. Two attempts to privatize Babai farm, a large agricultural farm owned by MPSAIDC, did not succeed—in 1998, the highest bidder withdrew, and in 2001, the bids were lower than the reserve price. At the request of GoMP, the National Bank for Agriculture and Rural Development Consultancy Services recently valued Babai Farm at Rs520 million and recommended leasing the farm gradually to several parties for 3.5 years. As a result of the bifurcation of Madhya Pradesh in 2000, 130 employees were transferred to the new state of Chhattisgarh. However, in FY2000, another 100 employees who agreed on a VRS package could not be discharged because the SRF had inadequate funds. While the MPSAIDC board approved a resolution to reduce GoMP's stake to 26%, GoMP commenced negotiations with the Government to buy back the Government's 36% share in the corporation. However, the agricultural production commissioner raised objections to the repurchase of the Government's shares at Rs75 per share, citing the corporation's negative net worth. As part of business restructuring measures, an MOU has been executed by the corporation with Madhya Pradesh Agro Food Industries Ltd., a private company, for the sale of a nutritional mix to the women and child development department, with a commission of Rs125 per ton proposed to be paid to MPSAIDC for facilitating the sale.

22. **Madhya Pradesh State Road Transport Corporation** (MPSRTC). The corporation was to be restructured through the formation of four geographically based corporate units to facilitate better management and operational autonomy. This was to be followed by a 49% divestment of the corporation's stake in the units. Assets and liabilities of the corporation were being divided among the units, pending bifurcation of the state. However, the corporate units were not created as envisaged. While 510 routes were opened to the private sector as part of the restructuring of MPSRTC, GoMP proposed to raise tariffs up to 7.5% per annum and introduce market-linked practices, including elimination of exemptions from bus tickets for special groups, etc. However, the tariff revision could not be effected and, with increased fuel costs, the corporation was unable to provide wages to about 30% of employees. Consequently, GoMP decided to liquidate MPSRTC after the division of assets and liabilities once the bifurcation of Madhya Pradesh and Chhattisgarh was settled. Of the 10,600 employees, 8,900 were offered VRS, and the disbursements are still in progress. Around 500 employees have been retained to follow up pending legal cases and close the finances. Another VRS package was announced in FY2006 for the remaining 1,200 employees, and management expects 50–60% of them to accept. As part of the settlement of financial obligations, the creditors guaranteed by GoMP have been

repaid and one-time settlement schemes are being negotiated with nonbanking finance companies (NBFCs) that had extended lease finance. GoMP has also attached assets of the corporation against Rs8 billion outstanding to it by MPSRTC. Pending liquidation, the rental earned through the lease of selected routes to private companies is being applied toward meeting the administrative expenses and costs of legal cases, besides the settlement of arrears.

23. **Madhya Pradesh State Financial Corporation** (MPSFC). GoMP's stake in the corporation was to be reduced initially by 25% through a public issue, and subsequently to be brought down to not more than 26% after an amendment to the State Financial Corporation Act. However, as a result of the bifurcation of Madhya Pradesh, the policy covenant was amended to provide for a cabinet decision to restructure the corporation through a reduction in personnel and actions to minimize future contingent liabilities of GoMP. Significant exposure to NBFCs caused MPSFC NPAs to increase from 30% in FY1999 to 45% in FY2004, resulting in recapitalization through injection of fresh equity or immediate liquidation being rendered difficult. MPSFC prepared a restructuring plan in FY2001, incorporating measures including performance indicators being monitored by third parties, branch closures accompanied by early retirement schemes for employees, and a cap on GoMP guarantees. The retirement age was reduced from 60 to 58 years and four unviable branch offices were closed, resulting in savings in administrative overheads. A total of 15 employees, representing around 5% of the total manpower, accepted a VRS. As part of financial restructuring, an MOU was executed with the Small Industries Development Bank of India in 2003, reducing the interest on loans and providing refinancing at concessionary rates. High-cost bonds were settled, while negotiations for restructuring the statutory liquidity ratio bond liability is in progress. Moreover, a scheme of not charging interest for more than 2 years in respect of loans disbursed prior to 1990 has been adopted as part of the exercise to reduce the exposure tof the SME sector.

24. **Madhya Pradesh Housing Board** (MPHB). After corporatizing and restructuring the MPHB, 49% of GoMP's share it was to be divested. Amendments to the Housing Board Act, 1972,enabling MPHB to participate in public-private partnerships, were contemplated in FY2002, with a cabinet decision seeking the housing and environment directorate to effect changes to the act. However, corporatization of the board and divestment of the GoMP stake in MPHB could not be effected because of the board's negative net worth. MPHB initiated restructuring measures including automation of management information systems, increased use of private architects on contract, and personnel rationalization through attrition and abolishment of posts. While MPHB continues to be engaged in low-cost housing projects—as well as construction of commercial complexes such as Centre Point, Platinum Plaza etc., and re-densification of old properties such as Indore Central Jail—the recommendations of a task force on the further restructuring of MPHB's operations have been submitted to GoMP. The recommended measures include: (i) a VRS or redeployment covering a substantial number of employees; (ii) urban planning activities, including development of roads, sewerage lines, etc. being allocated to MPHB; and (iii) exploring public-private partnerships in re-densification schemes. The Government's approval is awaited on proposals to split MPHB's assets and liabilities between Madhya Pradesh and Chhattisgarh.

25. Highlights of the financial performance of the four enterprises before (FY2000) and after restructuring (FY2003) are in Table A5.2.

Table A5.2: Highlights of Financial Performance of Enterprises Identified for Partial Divestment

	Govt investment - before reforms			Govt investment - after reforms			Performance before		Performance after	
State Department	Loans	Equity	Guarantee	Loans	Equity	Guarantee	PAT	Accumulated Profit/Loss	PAT	Accumulated Profit/Loss
(in Rs. Lakhs)										
MPSIndDC	1,365	8,109	1,843	1,364	8,109	1,820	(4,594)	(22,495)	(27,781)	(58,845)
MPSAIDC	198	210	-	197	210	-	31	(34)	(77)	(256)
MPSRTC	2,250	14,140	7,341	18,929	14,140	2,572	(6,490)	(63,934)	(10,003)	(68,830)
MPSFC	347	6,254	41,059	173	6,254	48,695	202	(13,403)	(2,812)	(23,872)
MPHB	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

- = zero, NA = not available, MPSFC = Madhya Pradesh Financial Corporation, MPHB = Madhya Pradesh Housing Board, MPSAIDC = Madhya Pradesh State Agro Industries Development Corporation, MPSFC = Madhya Pradesh State Financial Corporation, MPSIDC = Madhya Pradesh State Industrial Development Corporation, MPSRTC = Madhya Pradesh State Road Transport Corporation, PAT = profit after tax.
Source: Reports of the Comptroller and Auditor General of India.

26. Over 2001–2003, the performance of these selected PSUs has been disappointing, without exception. Primarily because of the provisioning for NPAs, the operating performance of MPSIDC showed a significant deterioration—a net loss of Rs2.78 billion was recorded in FY2003 compared with a net loss of Rs460 million in FY2001. The performance of MPSAIDC also deteriorated—a net loss of Rs7.7 million was recorded in FY2004 compared with a net profit of Rs3.1 million in FY2000. This resulted from operating losses, as revenues have been more or less static. The net losses of MPSRTC increased from Rs650 million in FY2001 to Rs1 billion in FY2003, mainly because of a decline in revenues coupled with rising fuel costs and relatively fixed employee costs. MPSFC recorded a net loss of Rs280 million in FY2003 compared with a net profit of Rs20 million in FY2001, because of a reduction in revenues and relatively fixed interest costs. All four PSUs continue to be a drain on scarce state budget resources.

27. **PSU Restructuring – Closure.** Eight enterprises were identified for closure. The program design did not specify what closure entailed, and there are at least three interpretations: (i) closing down operations of the PSU and retrenching all but a core team of staff necessary to achieve financial closure; (ii) closing the finances of the PSU, including receipt of the funds from the sale of assets and meeting all creditor's obligations, include the possibility of a court appointed liquidator being involved; and (iii) the legal closure of the PSU in accordance with the relevant law. This led to GoMP requesting clarification from ADB on the interpretation with regard to meeting tranche conditions and non-tranche covenants. It was mutually agreed that closure would mean the operational closure of the respective PSUs. While GoMP succeeded in effecting operational closure of the selected PSUs, the final liquidation of the enterprises and recovery of proceeds in respect of their assets has not been completed. In the case of the Madhya Pradesh Police Housing Corporation Limited, after achieving operational closure, GoMP decided to revive it to manage a central Government-funded police modernization program to construct police housing in the state.

28. **Madhya Pradesh State Industries Corporation Limited** (MPSIC). All MPSIC units, including the head office, were closed down and all employees extended VRS; one employee's case is still pending in the court. While two MPSIC sugar mills have been transferred to local cooperatives, two other units are currently being managed by private companies on a contract basis. The valuation reports for 11 units, compiled by authorized chartered engineers in FY2006, have been forwarded to GoMP for further action. While no activity, other than recovery of old receivables, is being carried out, a GoMP guarantee is being sought to facilitate submission of a solvency declaration by the directors, to facilitate initiation of closure proceedings in respect of the company. The legal process to wind up MPSIC cannot begin until the estimated Rs30 million owed to creditors and expenses relating to court cases of around Rs14 million have been settled from the proceeds of asset sales.

29. **Madhya Pradesh Slum Clearance Board** (MPSCB). The order to close MPSCB was issued by the administrative department concerned in March 2001 and all officers were shifted to vacancies in urban local bodies. All MPSCB operations have been discontinued, and local bodies have been given the responsibility for land survey, execution, and monitoring of slum projects in conjunction with the respective district administration.

30. **Madhya Pradesh Police Housing Corporation Limited** (MPPHC). The order to close MPPHC operations was issued in FY1998 and all employees were offered VRS. Some core staff were retained to assist in winding up MPPHC, and other staff returned to the police ranks. In 2004, the Government implemented a nationwide police modernization program, including construction of police housing. GoMP decided to revive MPPHC to manage the construction of police housing complexes. Former employees were posted back from the police or rehired in the revived MPPHC.

31. **Madhya Pradesh State Leather Development Corporation Limited** (MPSLDC). Orders to close MPLeaDC were issued in FY1999 and operations were discontinued in FY2000, with VRS to all employees, save a core team, and statutory dues being paid. However, an official liquidator is yet to be appointed for the company, and the PSU lacks legal and secretarial assistance to implement the legal procedures relating to winding up. While the auction process for selected properties is being carried out, decisions by GoMP and the respective district administrations are awaited for disposal of certain assets. A claim has been preferred with GoMP for a grant to meet legal expenses and for settlement of certain creditor claims.

32. **Madhya Pradesh State Export Corporation Limited** (MPSEC). The closure order was issued in July 2001 and all employees, except for a core team of 12, were offered VRS. MPEC funded the VRS from its own resources; it was the only PSU to have done so, having adopted a VRS scheme that envisaged offering a higher compensation package to severed employees than the GoMP scheme. MPEC has been subject to operational and financial closure; its assets and liabilities were initially vested in MPSIDC before being transferred to Madhya Pradesh Trade and Investment Facilitation Corporation Limited in June 2004.

33. **Madhya Pradesh State Fisheries Development Corporation** (MPSFDC). Consequent to the issue of the closure order for the PSU in March 1998, the activities of MPFDC were assigned to the Fisheries Federation, an autonomous apex body of the Fisheries Cooperative Union. MPFDC was merged with the Federation on 31 August 1999.[3]

[3] Note of Project Management Unit, Department of Finance, Government of Madhya Pradesh.

34. **Madhya Pradesh State Land Development Corporation** (MPSLandDC). Operations of MPSLandDC were discontinued in June 2001, after receipt of the order for closure. With the settlement of the issue of interim relief, all employees except 15 were offered VRS and the disbursements took place in September 2001. However, information on recovery of sale proceeds regarding the assets and settlement of liabilities is not available.

35. **Madhya Pradesh State Textile Corporation Limited** (MPSTC). Operations at an owned mill and two mills managed by private players under management contract were discontinued and the concerned employees were retrenched. Closure of the head office was ordered in July 1998, and VRS was disbursed to the majority of employees. The release of the balance amount was delayed because of cases filed by individual employees. The status on sale of assets of the company and settlement of outstanding liabilities, besides the position regarding litigation pertaining to employees, is unascertained. Certain key parameters regarding the above enterprises that were subject to closure are presented in Table A5.3.

Table A5.3: Key Parameters in Respect of GoMP Enterprises Subject to Closure

State Department	VRS payout (Rs.Lakhs)	No.of employees for VRS	Capital blocked at the time of closure (Rs.Lakhs)	Payback (Years)
MPSIC	3,208	1,822	4,232	6.4
MPSCB	NA	NA	NA	
MPPHC	153	67	NA	
MPSLDC	168	145	158	7.4
MPEC	-	-	80	
MPSFDC	NA	NA	NA	
MPSLandDC	1,651	522	NA	
MPSTC	3,975	1,907	8,566	

- = zero, NA = not available, GoMP = Government of Madhya Pradesh, MPEC = Madhya Pradesh Export Corporation Limited, MPSFDC = Madhya Pradesh State Fisheries Development Corporation, MPPHC = Madhya Pradesh Police Housing Corporation, MPSCB = Madhya Pradesh Slum Clearance Board, MPSIC = Madhya Pradesh State Industries Corporation, MPSLDC = Madhya Pradesh State Leather Development Corporation, MPSLandDC = Madhya Pradesh State Land Development Corporation, MPSTC = Madhya Pradesh State Textile Corporation, VRS = voluntary retirement scheme.

Source: Note on VRS from the Project Management Unit, Department of Finance, Government of Madhya Pradesh and Report of the Comptroller and Auditor General of India.

36. A total of Rs1.3 billion is blocked in the enterprises in the form of GoMP investments in equity and loans. VRS payments totaling Rs916 million have been disbursed to 4,463 employees out of the SRF. The VRS for 48 employees of MPEC, totaling Rs21 million, was funded out of MPEC own resources. Moreover, the VRS payback period was 6.4 years for MPSIC and 7.4 years for MPLeaDC, considering the VRS payout vis-à-vis the reduction in annual recurring GoMP support, after closure. Since the extent of support from the Government to MPSTC actually increased after operational closure, the computation of the payback period for the enterprise is not relevant.

5. PSU Restructuring – Lease/Sale of Property

37. Madhya Pradesh State Tourism Development Corporation Limited (MPSTDC) was the only PSU identified under this category. Of the 70 tenders initially received for sale of individual properties, 22 were found to be eligible, but no offers were received from players in the hospitality sector so the offers were rejected. The Confederation of Indian Industries arranged

for interactions between MPSTDC and a major private hotel chain, but there was no progress in the negotiations because of the poor infrastructure at many properties. However, as a number of MPSTDC properties have heritage status, the Government's Archaeological Survey of India has invested in their upgrading over the past 4 years. A combination of improved upkeep of the properties and upgraded road infrastructure at major tourist locations in the state has resulted in increased numbers of foreign and local tourists, and encouraged GoMP to shelve attempts to sell or lease out properties. As a result, the operating performance of the company has improved. Net profit of Rs2.7 million was recorded in FY2003 (FY2002 net loss: Rs3.6 million), compared with a net loss of about Rs16 million in FY2000. This was primarily because of improved operating margins, although revenues declined by around 9% during the period (Table A5.4).

Table A5.4: Highlights of Financial Performance of MPSTDC Before and After Restructuring

State	Government Investment - before reforms			Government Investment - after reforms			Performance - before		Performance - after	
(in Rs. Lakhs	Loans	Equity	Guarantee	Loans	Equity	Guarantee	PAT	Accumulated Profit/Loss	PAT	Accumulated Profit/Loss
MPSTDC	-	2,324	-	-	2,497	-	(158)	(1,103)	27	(1,224)

- = zero, MPSTDC = Madhya Pradesh State Tourism Development Corporation, PAT = profit after tax.
Source: Report of the Comptroller and Auditor General of India.

6. Social Safety Net Mechanism

3 MPSTDC status of VRS disbursements from the SRF for the PSUs identified for reform under the MPPRMP is outlined in Table A5.5.

Table A5.5: Details of Voluntary Retirement Scheme Disbursement in GoMP Enterprises

PSU	Total Number of Displaced Employees	Number of Employees Availing of VRS	VRS Disbursed (Rs million)	VRS per Employee (Rs)
MP State Land Development Corporation	556	522	165	320,000
MP Leather Development Corporation Ltd.	145	145	17	120,000
MP Road Transport Corporation	5,000	4,453	1,648	370,000
MP State Industries Corporation Ltd.	1,822	1,822	321	180,000
MP State Textile Corporation Ltd.	1,948	1,907	398	210,000
MP Police Housing Corporation Ltd.	215	67	15	230,000
MP Fisheries Development Corporation	53	53	11	210,000
Total	**9,739**	**8,969**	**2,575**	

GoMP = Government of Madhya Pradesh, MP = Madhya Pradesh, PSU = public sector undertaking, VRS = voluntary retirement scheme.
Source: Note of the Project Management Unit, Department of Finance, Government of Madhya Pradesh.

39. The average payout on VRS was Rs180,000–Rs370,000 per employee, computed in line with the VRS formula (para. 22). In addition, MPEC spent about Rs21 million on a self-designed VRS program for 48 employees, implemented from its own resources, with the average payout being about Rs440,000 per employee. In all, almost 9,000 employees received VRS, compared with a design estimate of 16,500.

40. Contrary to the MPPRMP design, the SSN did not proceed. Not one displaced employee was retrained as the GoMP decided it did not wish to set a precedent of funding such training; in so doing, the budget impact was minimized. Given that $120.4 million was estimated in the design for the costs of the VRS and SSN, and a total of around $57 million was spent on the VRS, the commitment of the GoMP to provide retrenched employees with the support envisaged is in question. While institutions such as Madhya Pradesh State Consultancy Services, Bhopal and Small Industries Services Institute, Indore were engaged in offering counseling and retraining for employees displaced by restructuring of the Government's PSUs in Madhya Pradesh, no such SSN programs were undertaken for employees affected by the restructuring of state PSUs. The OEM was informed that the VRS disbursed, together with the alternative employment opportunities in the informal sector, is estimated to have provided for around 65% of the remuneration that was being earned by the employees prior to retrenchment.[4]

7. Sustainability of PSU Reforms

41. Finance department officials associated with the PSU reforms indicated to the OEM that the GoMP remains committed to pursue reforms. For enterprises that are not providing social services, the consensus has been that in the event of a failure to effect divestment of identified enterprises, the GoMP should close them to save budget resources. The Financial Responsibility and Budget Management Act, 2005, which forms the basis of the allocation of the Government's incentive funds to GoMP, requires states to curtail government expenditure, reinforcing the value of PSU reform as a key component of expenditure reduction.

42. However, unlike other states such as Gujarat and Karnataka, which have adopted proactive strategies for PSU reforms, it appears that there has been no significant activity to continue or expand the ambit of PSU reforms in Madhya Pradesh beyond the life of the MPPRMP. The existing coordination mechanisms with individual administrative departments are weak, and DPE has little power to ensure its mandated responsibilities are achieved.

43. While DPE was created as part of the MPPRMP, it has neither the human resources nor the administrative authority to meet its mandated responsibilities effectively. It is staffed by two officers reporting to a secretary. Inadequate coordination with the administrative departments that have jurisdiction over the PSUs identified for restructuring, limits DPE's ability to oversee reforms. PSU targets were often published with a 1-year time lag, and after the actual performance data was available. Moreover, annual reports on the performance of PSUs are delayed—the report for FY2003 was published only in September 2005—indicating the absence of timely inputs to DPE from concerned PSUs and line departments. A system of monitoring PSU performance through MOUs exists on paper, but the MOUs for FY2006 were not finalized until October 2006, showing the obstacles faced by DPE in terms of inadequate information and limited support from the PSUs and GoMP line departments.

44. The MPPRMP design envisaged the establishment of a technical secretariat as an advisory body to (i) undertake preparatory measures and technical analysis regarding PSUs identified for restructuring, including valuation; and (ii) provide assistance on technical aspects of restructuring and divestment. However, the secretariat was not set up, resulting in the absence of expert guidance in restructuring PSUs identified for reforms.

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[4] Interview with social safety net program expert. As no surveys have been conducted, this is conjecture.

C. Issues

45. Most PSUs (MPSIDC, MPSAIDC, MPSRTC, etc.) continue to be a major source of concern, given the deterioration in their operational performance after reforms; continued dependence on GoMP resources; and inadequate operational processes, controls, and professional capabilities which have led to high NPA levels.

46. While it may be necessary to retain some PSUs under government ownership because of their socioeconomic mandate, which may be dischargeable only by Government, it is fairly well accepted that existing government practices suffer inherent limitations in specific areas such as recruiting qualified and experienced professionals, enforcing adequate accountability, motivating high performance while discouraging underperformance, etc. Consequently, for any PSU reform initiative to be sustainable, it is necessary to put in place appropriate frameworks and mechanisms to improve corporate governance, human resources management, and operations. For example, some state governments are exploring options of hiring experts for key PSU positions at market-linked salaries, implementing formal performance management systems as in private sector companies, and maintaining an arm's length relationship between the GoMP and the PSU.

47. Experience suggests that there needs to be a nodal agency for PSU reforms to ensure proper implementation, as the administrative departments lack the requisite expertise and time for this purpose. While the MPPRMP design envisaged establishing a technical secretariat for offering technical advice and support for implementing PSU reforms, it was not set up and DPE was designated the nodal agency for PSU reforms. To ensure sustainability, it is necessary to have a nodal agency with representation from multiple departments and equipped with requisite skill sets (some of which are likely to be contracted exogenously), as demonstrated in other similar programs. In addition to acting as a central repository of knowledge and experience, the nodal agency usually plays a key role in identifying relevant best practices; standardizing processes, practices, and documentation; and acting as a secretariat to the forum empowered to take key decisions on the PSU reform initiative. However, DPE's limited staffing and restricted powers do not equip it with sufficient ability to carry out the functions required of the nodal agency.

48. The classification of PSUs into three categories—partial divestment, closure, and restructuring through sale/lease of properties—does not appear to have been preceded by an audit or an in-depth study of the operational and financial performance of the PSUs concerned. Hence, the decision on categorization at the program design stage was probably based on insufficient or incomplete information on the status of the enterprises, thereby limiting the effectiveness of the program measures.

49. It may have been possible to optimize outcomes further in some cases, through adoption of alternate PSU reforms strategies. Thus, while retention of a 51% equity stake by the GoMP (with management control) may be advisable for selected enterprises with a predominantly socioeconomic mandate, offering a majority stake (and management control) to the private sector partner for other enterprises would have probably increased the chances of successful divestment. In the existing scheme of things, all PSUs in the partial divestment category would continue to be controlled by the state government and managed by bureaucrats after listing, thereby severely limiting opportunities for effective corporate governance reform and the necessary performance improvement. Similarly, around Rs6.75 billion of outstanding GoMP investments are currently blocked in the 10 PSUs undergoing closure through liquidation, a process which takes 1–5 years. Possible options that could have been explored to free up

capital invested by GoMP earlier include a 100% equity stake sale to potential private sector investors, with GoMP underwriting all existing liabilities until the date of the transaction.

50. The operational performance of almost all enterprises has deteriorated at least through 2003, resulting in increased GoMP budgetary support. Experience in similar situations suggests that, unless some of the fundamental issues associated with government ownership—such as inadequate accountability, managerial bandwidth, and excessive interference—are effectively addressed, a one-time exercise involving financial, operational, and personnel restructuring is insufficient to generate sustainable viability.

51. For many of the enterprises undergoing partial divestment, a two-stage process of divestment was adopted, with the GoMP initially selling a part of its stake, followed by a second tranche of divestment after an interval of 1–2 years. While a two-phase divestment may potentially enable higher value realization, it also has associated risks such as the potential for GoMP to lose interest in divesting the balance because of policy changes, changes to elected representatives, or transfer of key officials. There is also a risk of a change in interests and prerogatives of the private sector investor because of internal policies or market forces.

52. While some key corporate governance measures—such as providing performance incentives through differential remuneration, etc.—were envisaged as part of the program design, there was limited implementation. The MOUs between individual enterprises and DPE were used primarily for performance reporting instead of an actionable performance monitoring mechanism for facilitating an arm's length relationship between GoMP and the PSU. It was proposed that district primary education officials assess candidates for the positions of functional directors and senior managerial positions. However, a mechanism of constituting expert committees—comprising a mix of prominent public and private sector officials—is likely to yield superior results given the nature and depth of experience of its members. The availability of suitable candidates for key managerial positions is also likely to be an issue until market-linked compensation is adopted.

53. The PSU component of the Program appeared to have limited emphasis on assessing the socioeconomic impact of large-scale personnel displacement. No tracer studies were conducted to assess the impact of PSU reforms on the displaced workers under the MPPRMP. Failure to implement the SSN because of high support costs and a view that the displaced workers would proactively adopt alternate livelihoods raises a question as to the commitment of GoMP with regard to the long-term welfare of retrenched employees. Experience in similar programs in states like West Bengal suggests that a formal program for counseling and retraining of displaced workers usually goes a long way in mitigating the associated trauma and adverse socioeconomic impact of retrenchment.

54. The dwindling allocation to the SRF from the state budget appears to have adversely affected the settlement of employees under the VRS scheme. The allocation to the SRF declined from Rs230 million in FY2004 to Rs50 million in FY2005, with GoMP seeking funds from international aid agencies and the Government for replenishment of the SRF. Moreover, access to the SRF was becoming progressively limited despite continuing demand from PSUs for VRS assistance. For example, VRS to 100 employees of MPSAIDC, who had opted for the scheme, could not be effected because the SRF had inadequate funds.

55. The Program did not unambiguously define "closure," resulting in the agencies in charge of program implementation interpreting the term to mean operational closure, rather than financial and legal closure. The relative ease with which GoMP revived the MPPHC, which had

discontinued all its operations, points to the need for greater clarity on the definition of “closure” at the program design stage. However, given the cumbersome process involved in the legal closure of enterprises and the fact that the Program only had a 3-year tenure, while legal closure of the identified PSUs could not possibly have been identified as an outcome of the Program, financial closure should have probably been mandated to prevent the revival of operationally closed PSUs.

D. Recommendations

56. Decisions on the most appropriate type of reform for a PSU must include an audit to ensure that financial records are in order, and involve outside experts in PSU reform at an early stage to ensure that the most appropriate options are considered.

57. Given the technically complex and politically sensitive nature of PSU reform, a policy body (chaired by political leaders, chief minister, and ministers of relevant departments) should be advised by a technical secretariat headed by a senior civil servant reporting to the principal secretary, with sufficient resources to engage experienced consultants as required.

58. Using budgetary impact parameters as tranche release conditions instead of divestment milestones for specific PSUs is likely to provide greater flexibility to the GoMP in implementing PSU reform. If milestones are necessary, then it is important to recognize the time and resources required to close a PSU and ensure that at least financial closure is achieved.

59. Extensive policy dialogue with government officials is required to ensure that they understand that a formal mechanism for counseling and training of displaced workers and their dependents will mitigate adverse socioeconomic outcomes is positively received by all stakeholders.

60. Conducting periodic studies to assess the socioeconomic impact of retrenchment on the displaced workers will provide valuable inputs to revise appropriate SSN interventions, such as providing insurance and training support for mitigating adverse socioeconomic impacts.

THE USE OF MADHYA PRADESH ENVIRONMENT AND REHABILITATION POLICIES IN ASIAN DEVELOPMENT BANK SECTOR LOANS

1. Under the Madhya Pradesh Public Resource Management Program (MPPRMP), the government of Madhya Pradesh (GoMP) approved an environment policy in 1999, and a rehabilitation policy in 2002. The intent behind formulating these policies was to ensure that the state government had policies in place to guide the impact of development projects on the environment and people who were required to resettle. The Environment (Protection) Act, 1986 (EPA), of the Government of India (the Government) provides a framework for the coordination of central and state authorities, as was established under the Water (Prevention and Control) Act, 1974, and Air (Prevention and Control) Act, 1981. Under the EPA, the Government is empowered to take the necessary measures to protect and improve the quality of the environment by setting standards for emissions and discharges; regulating the location of industries; management of hazardous wastes, and protection of public health and welfare. From time to time, the Government issues notifications under the EPA for the protection of ecologically sensitive areas or issues guidelines for matters under the EPA. The EPA and other central and state level legislation and regulations provide the legal and regulatory framework for the state's environment policy.

A. Environment

2. In addition to conditions to formulate and implement the state's environment policy and action plan, the MPPRMP legal agreement included three specific covenants relating to the environment, two of which had broader implications for the institutionalization and sustainability of the policy. In particular, the Borrower (the Government) was required to ensure that, in formulating infrastructure policy and regulatory reforms, the state would make adequate provisions for enforcement of environmental mitigation measures consistent with the applicable state laws and monitoring of environmental impact in key infrastructure sectors, and also to cause the state to support the environmental sustainability of economic growth by adoption of a state environment policy that would stipulate a time-bound action plan for implementation of market-based instruments for environmental management.

3. Asian Development Bank (ADB) projects financing of infrastructure development in the state refer to relevant laws and regulations of the Government in their respective project loan environmental assessments. It may also be expected that the state government's environment policy would also be a reference document. However, the Madhya Pradesh environment policy is not referred to in the main text of the Report and recommendation to the President to the Board of Directors (RRP) or in the relevant appendix addressing environment issues of the three sector loans processed after the policy's approval.

4. The first power sector loan[1] approved in 2001 was classified category B according to ADB's environmental assessment guidelines.[2] The summary initial environmental examination appended to the RRP refers to the Environmental Protection Act, 1986, and includes a table evaluating the degree to which the Madhya Pradesh Power Reform Act, 2001, addresses potential environmental impacts. No reference is made to the Madhya Pradesh environment policy.

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[1] ADB. 2001. *Report and Recommendations of the President to the Board of Directors on a Proposed Loan to India for Madhya Pradesh Power Sector Development Program*. Manila.

[2] ADB. 2003. *Environmental Assessment Guidelines.* Manila. Available: www.adb.org/documents/guidelines/environmental_assessment/ Environmental_Assessment_Guidelines.pdf

5. The roads sector project[3] approved in 2002 was classified category B, as the project was financing the rehabilitation of existing roads with no additional right-of-way required. The initial environment examination verified that the limited environmental impacts during construction and operation could be mitigated by implementing the environmental management action plan recommended in the initial environment examination. No environmentally sensitive areas were to be disrupted by the project, mainly because the criteria for selecting subprojects excluded roads in environmentally sensitive areas.[4]

6. The first and second tranche components of the second power sector loan[5] are classified category B. The summary initial environmental examination appended to the RRP states that the environmental assessment is being conducted following ADB and central government environmental assessment regulations and guidelines. Schedule 5, Clause 8 of the Framework Financing Agreement states "the State will ensure that environmental assessment of the Subprojects are conducted according to the ADB's Environment Policy, 2002; INDIA and the State's environmental laws, regulations, and standards; and the EARF" (footnote 5).

B. Resettlement

7. Neither the first power sector nor road sector projects required any resettlement. However, the power sector loan approved in December 2006 required resettlement. Unlike the environment policy, the RRP recognizes the existence of the state's rehabilitation policy. The summary resettlement plan appendix contains a comparative analysis of the Madhya Pradesh rehabilitation policy, the Government's national policy on resettlement and rehabilitation for project affected persons, and ADB's *Involuntary Resettlement Policy* (1995) against 18 policy principles. The Madhya Pradesh policy matches ADB's in 13 principles. Of the five where a difference is identified, only the principle related to entitlements under the policy does not fulfill ADB's specifications. Regarding the other four principles, the table notes the status in the Madhya Pradesh policy but makes no comment in the remarks column as to the significance of the difference.

8. In the absence of a commentary on the findings of the comparative assessment, the reader must assume that the major constraint to adopting the state government's policy is the entitlements arrangements. The only statement that is made is that the resettlement framework will be revised if there are major changes to relevant policies and laws during project implementation—implying that the Madhya Pradesh policy is not acceptable. The framework assumes that ADB's policy will be implemented.

9. With increasing concern from ADB's developing member countries for use of country systems, including for resettlement, the challenge facing the governments of India and Madhya Pradesh is the implementation and successful enforcement of the policy rather than its content. The Operations Evaluation Mission (OEM) notes that a recent review of the application of rehabilitation measures for families affected by the Sardar Sarovar Project is scathing about the application of the measures and the findings of an oversight group commissioned by the

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3 ADB. 2002. *Report and Recommendations of the President to the Board of Directors for Proposed Loans and Technical Assistance Grant for Madhya Pradesh State Roads Sector Development Program*. Manila (Loan 1959-IND).

4 The implications of this decision are discussed more fully in the recently completed special evaluation study of environmental safeguards. Available: http://www.adb.org/Documents/SES/REG/sst-reg-2006-13/ses-es.asp.

5 ADB. 2006. *Report and Recommendations of the President to the Board of Directors for the Proposed Multitranche Financing Facility India: Madhya Pradesh Power Sector Investment Program*. Manila.

Government, endorsed by the Indian Supreme Court, to survey damage affected villages and report to the court and prime minister.[6] Levien argues the project illustrates a fundamental problem with the "paradigm of giganticism" where the social and environmental consequences of operating at such a large scale are beyond the ability of governments to respond to ensure that citizens' rights and entitlements are protected in accordance with their own laws. In this case—with the project displacing over 35,000 families (500,000 people)—given the land shortage in India, it was simply impossible to meet the legally required rehabilitation of 2 hectares of cultivatable, irrigable land, and community resettlement sites with civic amenities, let alone restoring people's livelihoods. The issue then is not necessarily the rehabilitation measures per se, but their implications for large-scale development projects affecting such large numbers of people. Although Levien does not excuse the failings of the Government to rehabilitate displaced families, the study argues that the task of uprooting and reestablishing communities fails "because the social, economic, and ecological relationships that characterize any village, much less hundreds of villages, cannot be adequately understood (and therefore replicated) from above." The results illustrate the failings of human institutions overwhelmed by the scale of a challenge, which from the outset was an "impossible undertaking for a half million people."

[6] Levien, M. 2006. Narmada and the Myth of Rehabilitation. *Economic and Political Weekly*. XLI (33): 3581–3585.

CAPACITY BUILDING FOR PUBLIC ENTERPRISE REFORM AND SOCIAL SAFETY NET IN MADHYA PRADESH

A. Background

1. Basic Data

Cost ($)	**Estimated**	**Actual**
Foreign Exchange	350,000.00	327,982.12
Local Currency	250,000.00	242,417.00
Total	**600,000.00**	**570,399.12**
Number of Person-Months (consultants)	43.0	42.0
Executing Agency The State Development Planning Commission		
Milestones		**Date**
President's/Board Approval		14 December 1999
Signing of TA Agreement		7 April 2000
Fielding of Consultants		3 July 2000
TA Completion: Expected		3 April 2001
Actual		31 October 2001
TCR Circulation		28 December 2004
Mission Type	**Number**	**Date**
Inception	1	August 2000
Operations Evaluation	1	2–28 October 2006

TA = technical assistance, TCR = technical assistance completion report.

2. Rationale

1. In the early 1980s, India embarked on a path of economic liberalization, which gained pace in the 1990s when the Government of India (the Government) and some state governments began reforming their respective public sector undertakings, as a part of broader fiscal reform measures. Following support to Gujarat government's reforms in 1996, in 1997 the Asian Development Bank (ADB) provided technical assistance (TA) to the fiscal reforms of the government of Madhya Pradesh (GoMP). Two TA projects[1] were approved during the design of the Madhya Pradesh Public Resource Management Program (MPPRMP) loan. One TA supported public finance reform, and the other TA supported strengthening local government institutional capacity. Based on their preliminary findings, it was apparent that additional TA[2] would be required for the loan component reforming public sector undertakings (PSUs). The TA under review was approved, as part of the MPPRMP on 14 December 1999.

3. Objectives and Scope of the TA

[1] ADB. 1997. *Technical Assistance to India for Support for the Government of Madhya Pradesh Public Finance Reform and Institutional Strengthening*. Manila (for $780,000, approved on 15 December); and ADB. 1997. *Technical Assistance to India for Strengthening Local Government in Madhya Pradesh*. Manila (for $700,000, approved on 15 December).

[2] ADB. 1999. *Technical Assistance to India for the Capacity Building for Public Enterprise Reform and Social Safety Net in Madhya Pradesh*. Manila (for $600,000, approved on 14 December 1999).

2. The outcome (objective) of the TA was to support the GoMP's efforts to develop and implement a comprehensive and socially sustainable program of PSU reform.[3] There were three outputs: (i) institutional mechanisms effectively managing PSU reform, including the social safety net (SSN); (ii) improved PSU corporate governance, including strengthening accounting and information systems; and (iii) government officials capable of undertaking PSU reform. The scope of the TA includes: (i) providing advice on PSU divestment (including valuation, tendering and bid evaluation, and labor issues), and restructuring (including reviewing existing corporate governance structures and accounting systems and reporting requirements and enhancing operational autonomy and accountability); (ii) training policy makers, PSU managers, staff of the Department of Public Enterprise (DPE), and a technical secretariat (including strategies and establishing links to local institutions for long-term sustainability); and (iii) designing suitable institutional mechanisms for the SSN.

4. TA Completion Report

3. The TA completion report (TCR) rated the TA "partly successful." The TCR noted that the TA contributions could have been more effective if ADB monitoring had been more frequent, and advice on the client's concerns had been addressed more quickly. GoMP was expected to establish a technical secretariat to act as an advisory body, undertaking technical analysis of PSUs and providing technical advice on restructuring and divestment implementation. The TA consultants were expected to work in close collaboration with DPE and the technical secretariat, in addition to being the resource persons during seminars and training. As the technical secretariat was not established, the consultants worked with the finance department and DPE regarding PSU restructuring and SSN. The TCR found that the inputs were used efficiently, and that the original outputs were delivered, with the exception of activities related to the technical secretariat. The TCR observed that progress in the restructuring of Madhya Pradesh State Road Transportation Corporation (MPSRTC) and Madhya Pradesh Finance Corporation (MPSFC) was slow because of limited availability of funds to offer a voluntary retirement scheme (VRS) to their employees. The same pace was also observed in identifying additional PSUs for restructuring.

B. Assessment of Implementation Performance

1. Design of the TA

4. The TA was attached to a 3-year program loan. However, its 9-month time frame was overly ambitious, as a number of the manuals and reports to be produced by the TA complemented MPPRMP loan conditions or covenants. Further, this was the first time GoMP had undertaken PSU reform, which takes time, is technically complex, and requires attitudinal changes—particularly among PSU managers and government officials. The output statements could have been more clearly defined, with indicators identified and monitored throughout the TA.

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[3] A TA framework was not included in the TA paper, although the TA was approved 2 years after the TA framework was required.

2. Engagement of Consultants

5. Six firms were short-listed and three proposals were submitted. Adam Smith International was engaged in accordance with ADB's *Guidelines on the Use of Consultants* (2006, as amended from time to time) to provide consultancy services. Consultants were fielded in July 2000. A total of five contract variations were made during the period of engagement, including provision for government officials' attendance at a privatization conference in Hyderabad. A total of 12 consultants (international and national) were provided by Adam Smith International. By the time of TA completion, consultants' inputs totaled 42 person-months (31.59 national and 10.41 international) of the 43 person-months proposed consulting services.

3. Organization and Management

6. The GoMP finance department was the Executing Agency (EA). GoMP established a policy level public resource management committee chaired by the chief minister to guide reforms, and PSU reforms were overseen by a technical level empowered committee chaired by the chief secretary. In the absence of the technical secretariat, the finance department and DPE supported the committee.

4. Implementation Schedule and Financing Arrangements

7. The TA was extended by 13.5 months and was completed 22.5 months after approval. Consultants were fielded 3 months after the TA became effective. However, the TA design underestimated the time required to restructure or close PSUs. Further, as the consultants took responsibility for many of the tasks expected of the technical secretariat, additional time was required. It was also reported that TA completion was delayed because of additional information required to support consultant's final statement of eligible expenses. The total cost of the TA was estimated at $750,000 equivalent, including $350,000 of foreign exchange, and $400,000 equivalent of local currency. ADB provided $600,000, on a grant basis, from the ADB-funded TA program to finance the entire foreign exchange costs, and $250,000 equivalent in local currency to cover remuneration of national consultants, and the in-country training activities. The actual disbursement by ADB was $570,399, almost 13% of the estimated cost.

5. Supervision

8. The TA was supervised from ADB headquarters through an inception mission and two review missions. India resident mission staff provided in-country monitoring support.

C. Evaluation of Outputs

1. Outputs (i) PSU reform institutional mechanisms, and (ii) improving corporate governance

9. High quality diagnostic and advisory reports were produced, including: (i) restructuring PSUs, e.g., MPSRTC, MPSFC and Madhya Pradesh State Export Corporation (MPSEC); (ii) a framework for implementing the SSN program; (iii) improving PSU corporate governance; (iv) technical manuals on valuation of assets, tender procedures, accounting standards, and PSU closure procedures; (v) an analysis of the cooperative sector; (vi) an analysis of the small and medium-sized enterprise sector; and (vii) the institutional framework to establish the technical secretariat. The technical assistance institutional framework report was an additional task, prepared as part of discussions with the United Kingdom Department for International

Development (DFID) to support the technical secretariat. The planned training program budget was reallocated to fund this. However, DFID funding did not eventuate. While the consultant's reports contained appropriate advice, the failure to establish the technical secretariat and to implement the SSN meant that the ability to strengthen a key institution was negated. Corporate governance reforms supported by the MPPRMP were not successful, despite the advice provided through the TA.

2. Output (iii) Capacity Building

10. The consultants conducted a 2-day workshop on SSN in December 2000, which explored future SSN options with public sector and private sector organizations involved in training and employment placement in Madhya Pradesh. A study tour to Hyderabad in November 2000 was undertaken by the Department of Finance assistant director, to learn from their privatization experiences, PSU reform institutional arrangements, and implementation of the SSN. The training approach was changed to on-the-job training, including specific presentations. Consultants worked with "core staff" of PSUs, including Madhya Pradesh Land Development Corporation (MPSLandDC), Madhya Pradesh Leather Development Corporation (MPSLDC), Madhya Pradesh State Textile Corporation (MPSTC), MPSExC, and Madhya Pradesh State Industries Corporation (MPSIC). This created a pool of government officials familiar with implementing VRSs and closing PSUs.

3. Performance of Consultants

11. Both the Government and ADB found the performance of consultants "satisfactory." The consultants were flexible, adapting well to the changes required after the technical secretariat was not established.

4. Outcomes and Impact of the TA

12. The quality of TA reports, PSU analysis, technical manuals, and training advice was commendable. However, the impact of the TA was constrained by the failure to establish the technical secretariat. Further, DPE had insufficient staff to effectively take over these responsibilities and, while the consultants performed a number of these tasks, they can not replace government officials. The formulation of SSN procedures was completed, but not utilized, as GoMP chose not to implement the SSN. Advice on corporate governance improvements was sound, but neither PSU management nor the responsible government officials were rigorous in enforcing change management measures. Practically, the considerable effort expended through the TA had little impact on the overall effectiveness of PSU reforms.

D. Overall Assessment

13. Overall, the Operations Evaluation Mission rated the TA "partly successful."[4] The TA was "relevant," supporting GoMP's reform agenda, MPPRMP implementation, and being consistent with ADB's India country strategy (footnote 4). The TA was rated "less effective."[5] The

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[4] Overall performance is based on four criterion: "relevance," "effectiveness," "efficiency," and "sustainability." Each criterion was scored on a four-point scale, from 0 to 3, for example: "irrelevant" (0), "less relevant" (1), "relevant" (2), and "highly relevant" (3). The weighted scores are then computed for the overall assessment with "highly successful" $\geq$ 2.7, "successful" 1.6 $\leq$ S < 2.7, "partly successful" 0.8 $\leq$ PS < 1.6, and "unsuccessful" < 0.8. ADB. 2006. *Guidelines for Preparing Program Performance Evaluation Reports for Public Sector Operations*. Manila.

[5] Based on a four-point scale, from 0 to 3, as follows: "ineffective" (0), "less effective" (1), "effective" (2), and "highly effective" (3).

production of reports was not sufficient to achieve the outputs, as GoMP and ADB failed to ensure that the necessary institutional mechanisms were in place to implement the advice. Refocusing training to on-the-job was appropriate. However, with the high turnover of GoMP officials, the study tour and workshops were less effective, since those staff trained in the finance department and DPE have moved. The TA was rated "less efficient."[6] Despite the fact that the consultants produced quality advice, and adjusted the changed situation, the failure to achieve outputs questions the TA's value for money. The TA was rated "less likely sustainable."[7] Although the reports and manuals remain relevant today, their use will depend on GoMP's commitment to sustain PSU reforms, and the provision of exogenous resources to provide the level of technical advice required to assist GoMP to complete the reforms begun under the MPPRMP.

E. Conclusions

1. Key Issues and Lessons

14. Two issues arise from implementing the TA. First, expecting a 9-month TA to support reforms to be implemented through a 3-year program loan, suggests the designers underestimated the complexity of the reforms and the scale of support that would be required. Second, the failure to establish the technical secretariat undermined the effectiveness of the TA. The technical secretariat was established in August 1998, but delays in ADB's approval of the program loan resulted in it being disbanded within 3 months. Although DFID had been in discussions with both GoMP and ADB to support the reforms with a grant of up to £70 million, this did not eventuate after significant time and effort being expended by all parties. Given that the technical secretariat was a key feature of both the program loan and this TA design, it is unfortunate that ADB did not find the necessary resources to ensure that it was established.

15. These two issues point to one lesson, i.e., the need to ensure that sufficient TA resources are provided to support complex reform programs.

2. Follow-Up Actions and Recommendations

16. No actions are proposed.

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[6] Based on a four-point scale, from 0 to 3, as follows: "inefficient" (0), "less efficient" (1), "efficient" (2), and "highly efficient" (3).

[7] Based on a four-point scale, from 0 to 3, as follows: "unlikely sustainable" (0), "less likely sustainable" (1), "sustainable" (2), and "most likely sustainable" (3).