



Performance Evaluation Report

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Loan Number: 1506-IND
July 2007

India: Gujarat Public Sector 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 |
| APL | – | Agrocel Pesticides Limited |
| BIFR | – | Board for Industrial and Financial Reconstruction |
| BOO | – | build-own-operate |
| BOT | – | build-operate-transfer |
| CIP | – | core investment program |
| DMF | – | design and monitoring framework |
| FRA | – | Fiscal Responsibility Act |
| FY | – | fiscal year |
| GAIC | – | Gujarat Agro Industries Corporation |
| GCEL | – | Gujarat Communication and Electronic Limited |
| GDDC | – | Gujarat Dairy Development Corporation |
| GDP | – | gross domestic product |
| GEB | – | Gujarat Electricity Board |
| GERC | – | Gujarat Electricity Regulatory Commission |
| GFDC | – | Gujarat Fisheries Development Corporation |
| GHB | – | Gujarat Housing Board |
| GIDB | – | Gujarat Infrastructure Development Board |
| GIDC | – | Gujarat Industrial Development Corporation |
| GIF | – | Gujarat Infrastructure Facility |
| GIIC | – | Gujarat Industrial Investment Corporation |
| GMB | – | Gujarat Maritime Board |
| GMDC | – | Gujarat Mineral Development Corporation |
| GPDC | – | Gujarat Port Development Company |
| GPSDP | – | Gujarat Power Sector Development Program |
| GPSRMP | – | Gujarat Public Sector Resource Management Program |
| GSCB | – | Gujarat Slum Clearance Board |
| GSCC | – | Gujarat State Construction Corporation |
| GSEC | – | Gujarat State Export Corporation |
| GSFC | – | Gujarat State Finance Commission |
| GSG | – | Gujarat state government |
| GSTC | – | Gujarat State Textile Corporation |
| GTCL | – | Gujarat Tractor Corporation Limited |
| ICICI | – | Industrial Credit and Investment Corporation of India Limited |
| MTFP | – | medium-term fiscal plan |
| MTFPF | – | medium-term fiscal policy framework |
| MVT | – | motor vehicle tax |
| NSDP | – | net state domestic product |
| OED | – | Operations Evaluation Department |
| OEM | – | Operations Evaluation Mission |
| PCR | – | program completion report |

| | | |
|-------|---|--|
| PIA | – | poverty impact assessment |
| PPER | – | program performance evaluation report |
| PPP | – | public-private partnership |
| PSRP | – | public sector restructuring program |
| RRP | – | report and recommendation of the President |
| SAL | – | structural adjustment loan |
| SDP | – | state domestic product |
| SFC | – | state financial corporations |
| SOE | – | state-owned enterprise |
| SPFRC | – | State Public Finance Reform Committee |
| SRF | – | State Renewal Fund |
| SSN | – | social safety net |
| TA | – | technical assistance |
| TCGL | – | Tourism Corporation of Gujarat Limited |
| TCR | – | technical assistance completion report |
| TFC | – | Twelfth Finance Commission |
| TPER | – | technical assistance performance evaluation report |
| 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 begins on 1 April and ends 31 March. FY before a calendar year denotes the year in which the fiscal year begins, e.g., FY1996 begins on 1 April 1996.
- (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. Dr. Govinda Rao and Hari Sridhar were the consultants. To the knowledge of OED management, the persons preparing, reviewing, or approving this report had no conflict of interest.

BASIC DATA

Loan 1506-IND: Gujarat Public Resource Management Program

Program Preparation/Institution Building

| TA No. | TA Name | Type | No. of Person-Months | Amount (\$'000) | Approval Date |
|--------|---|------|----------------------|------------------|---------------|
| 2530 | Capacity Building of Public Sector Restructuring Program | ADTA | | 100 | 06 Feb 1996 |
| 2552 | Restructuring State-Owned Enterprises of Gujarat | ADTA | 34 | 600 | 02 Apr 1996 |
| 2579 | Capacity Enhancement of Gujarat Industrial Investment Corporation | ADTA | 24 | 500 | 30 May 1996 |
| 2668 | Support for Gujarat's Reform of Public Finances | ADTA | 75 ^a | 600 ^b | 23 Oct 1996 |
| 2716 | Institutional Strengthening of Gujarat Infrastructure Development Board | ADTA | 32 | 850 | 18 Dec 1996 |

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

| Key Dates | Expected | Actual |
|--|-----------|----------------|
| Reconnaissance | | 11–25 Mar 1996 |
| Appraisal | | 17–25 Jun 1996 |
| Loan Negotiations | | 14–18 Nov 1996 |
| Board Approval | | 18 Dec 1996 |
| Loan Agreement | | 18 Dec 1996 |
| Loan Effectiveness | Dec 1996 | 20 Dec 1996 |
| First Tranche Release | Dec 1996 | Dec 1996 |
| Incentive Subtranche of the Second Tranche Release | June 1997 | Jul 1999 |
| Final Subtranche of the Second Tranche Release | Dec 1998 | Dec 2000 |
| Program Completion | Dec 1998 | 31 Dec 2000 |
| Loan Closing | Dec 1998 | 31 Dec 2000 |
| Months (effectiveness to completion) | 24.0 | 48.0 |

Borrower: India

Executing Agency: Finance Department of the Gujarat state government

| Type of Mission | No. of Missions | No. of Person-Days |
|-------------------------|-----------------|--------------------|
| Reconnaissance | 1 | 74 |
| Appraisal | 1 | 90 |
| Review | 9 | 155 |
| Consultation/Assessment | 3 | 51 |
| Program Completion | 1 | 18 |
| Operations Evaluation | 1 | 40 |

^a Of the 75 person-months, the Asian Development Bank financed 48 person-months of national consultants and 3 person-months of international consultants. The Government of Gujarat financed 24 person-months of national.

^b The amount pertains to the Asian Development Bank amount only.

EXECUTIVE SUMMARY

For some three and a half decades after independence, the Indian economy grew slowly, with annual gross domestic product (GDP) growth averaging around 3.5%. Economic liberalization reforms in the early 1980s stimulated growth to about 5% per year; however, the gross fiscal deficit of the national and state governments increased almost twofold through the 1980s, to reach about 9.4% of GDP by financial year 1990. The economic reforms created a competitive environment for domestic manufacturers and began to put pressure on the many state-owned enterprises (SOEs) that had been proliferating in national and state commercial and social development fields under the national Government's socialist policies. Containing the fiscal deficits of the national and state governments became the focus of structural adjustment reforms initiated in the 1990s. For the states, this included the need to improve the efficiency of public expenditure, and to create an environment to encourage private sector participation in economic growth, in particular infrastructure development.

Concerned at its dire fiscal condition the Gujarat state government (GSG) established a high level commission in 1992 with a broad mandate to make recommendations on reforms to improve the state's fiscal condition. The commission's 1994 report outlined a wide range of actions, but the state lacked the fiscal space to enact them. In the mid-1990s with national transfers to the states decreasing, the national Government agreed to allow reform-oriented states to negotiate loans from multilateral institutions.

Around the same time, the Asian Development Bank (ADB) was revising its India country strategy, and agreed for the first time to support state governments on the grounds that state-focused programs would (i) broaden and deepen lagging state economic and administrative reforms, (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 operating efficiency. In 1994, an ADB mission visited four states—Gujarat, Maharashtra, Punjab, and Tamil Nadu—and selected Gujarat as the first state for ADB assistance. The 1996 India country operational strategy study outlined a state strategy to provide support to public resource management reforms that would provide a foundation for sector-specific loans, particularly in the power and road sectors. The strategy study focused the scope of resource management support in three areas: fiscal consolidation, SOE reform, and enabling of private sector participation.

The Government agreed with ADB's choice of Gujarat, and together with GSG, requested program loan support to implement the reform program outlined in the 1994 GSG commission report, as the first stage of a state partnership. During 9 months in 1996, ADB and GSG formulated the Gujarat Public Sector Resource Management Program (GPSRMP) including approval of four technical assistance (TA) projects to support the program loan. The \$250 million GPSRMP, funded by ordinary capital resources and including an attached TA, was approved in December 1996 with a 2-year implementation period.

The GPSRMP's expected impact was improved public sector mobilization and allocation, and enhanced efficiency in promoting industrialization for the benefit of the population. The Program's three outcomes are consistent with the scope defined in the earlier country operational strategy study: (i) strengthened state finances and their prudent management, (ii) reformed SOEs contributing to the state economy, and (iii) private sector participation in infrastructure development in the state.

The Department of Finance of GSG was the Executing Agency, with a technical secretariat established to support implementation. Two cabinet subcommittees chaired by the chief minister were established—a policy level expenditure prioritization committee and an SOE reform committee, along with a senior state public finance reform committee. The Gujarat Infrastructure Development Board (GIDB) was established to promote privatization of key infrastructure sectors.

The program loan was disbursed in three tranches: \$100 million on effectiveness, a second tranche of \$50 million, and a \$100 million final tranche. Release of the second tranche was delayed by 2 years, which subsequently affected the release of the final tranche and program closure. The GPSRMP had a total of 104 policy actions; 42 were satisfied upon loan effectiveness. Of the remaining 62 policy actions, 28 were tranche release conditions. The 34 covenants were sequenced with but not tied to tranche release. Three conditions were amended to enable the release of the final tranche in December 2000, with the planned 2-year implementation becoming 4 years.

The GPSRMP is rated as "relevant", being consistent with both the central and state governments' overall reform agenda, and ADB's country strategy. The program design was heavily influenced by GSG's own diagnostics and recommendations, contributing to strong government ownership. Despite several changes of ruling party and chief minister during the GPSRMP, the Government's commitment to reforms remained. The GPSRMP was designed by ADB over a relatively short design period, with the TA approved in 1996 providing little substantive input to the design. Although the overall program logic was sound, the description in various parts of the report and recommendation of the President was inconsistent, and insufficient attention was given to the impact of assumptions and risks. As ADB's first subnational program loan, few lessons can be identified. However, although the considerable body of experience in national structural adjustment and SOE reform programs was not overtly drawn upon, the design addressed many international lessons available at that time.

The GPSRMP is rated as "effective", providing GSG with the impetus to implement reforms it defined in the early 1990s. Significant exogenous shocks required ex post adjustment of the Program's fixed nominal fiscal targets. Revenue generation marginally improved, and the limited expenditure interventions had a limited positive effect. Overall SOE reforms to fully privatize, merge, or close the operations of SOEs have been more effective than those to partially privatize. Corporate governance changes have been less successful. Identifying specific SOEs to be privatized in tranche release conditions was not effective.

The reforms to encourage private sector participation in the state's infrastructure development were highly successful, with Gujarat being the first state to enact a law to regulate private sector participation. This act also gave GIDB statutory authority to develop and oversee the state's strategic infrastructure development plans. The establishment of an independent electricity regulatory authority and unbundling of the electricity board provided the foundations for longer term power sector reform, supported by ADB power sector loans in 2000 and 2006. Similarly the unbundling of the maritime board opened the door for considerable private investment in the port sector. Over \$5 billion of private capital has been invested in the power, ports, and roads sectors since the late 1990s. A study of the counterfactual, found in the short term that the loan did not lead to any significant improvement in the overall fiscal situation in Gujarat. This econometric analysis needs to be balanced with the impact of the Program on the culture of reform, including the significant private investment drawn to the state.

The GPSRMP is rated as “efficient”. The actual GSG-financed adjustment costs were close to the *ex ante* estimates. Overall TA resources were used in an efficient manner. The respective policy and technical committees provided appropriate oversight and support.

The Program is rated as “sustainable” with GSG continuing reforms beyond the life of the GPSRMP. The Program provided a timely boost to Gujarat’s reform agenda in the mid-1990s, which later suffered as a result of natural disasters and communal disturbances during 2000–2002. The increased pace of private sector investment affirmed the value of establishing key policy and legal frameworks, and well-resourced institutional mechanisms. The fiscal consolidation efforts eventually have shown positive results, with the revenue deficit being phased out by FY2005, and the fiscal deficit down from 8.9% in FY2001 to a more sustainable 3.5% in FY2005. This is consistent with the general trend across India’s states, where significant improvement has resulted from higher Government transfers, implementing the Government’s state debt-restructuring plan, and Gujarat’s own efforts. The expectation that the Program would be replicated in other states was achieved with the World Bank supporting similar programs in three states and ADB following up in three other states. These experiences assisted the national Government in revising policies and legislation affecting center–state fiscal relations.

Based on these assessments the GPSRMP is rated as “successful.”

The institutional, socioeconomic, environmental, and anticorruption impacts have been varied. Overall the impact on institutions has been positive with the most significant aspect being the work of GIDB. All but one of the ad hoc committees performed their functions satisfactorily. GSG instituted a second phase of SOE reforms under a different institutional arrangement, drawing respected business leaders into an advisory body. Although the GPSRMP did not explicitly aim for fiscal space to be used to improve social sector expenditure, the Operations Evaluation Mission (OEM) found that the socioeconomic impact was neutral, with social expenditure not being sacrificed to improve the fiscal deficit. Although the Program did not include interventions focused on the environment, the significant investment by the private sector in infrastructure has had some negative environmental (and social) implications. GSG has not yet approved an environment or resettlement policy to regulate these aspects of development. Although not explicitly included in the design, a number of the GPSRMP’s actions had positive anticorruption impacts.

The three TA projects assessed by the OEM were rated as highly successful, successful, and unsuccessful. In each case, the original time frame was overly ambitious, given the TA scope, and their linkage to a 2-year program loan. Key features of the TA rated highly successful were (i) strong government commitment to the success of the institution being strengthened, (ii) ability of staff to take advantage of high quality consultant advice, and (iii) readiness of the private sector to take advantage of opportunities to invest in public infrastructure if the conditions were right. The TA rated as unsuccessful was provided to an institution that subsequent to TA approval was found to be incapable of performing the functions for which the TA was designed to strengthen, and the consultants did not perform to the expected level.

A number of issues can be identified from the GPSRMP experience. First, the iterative, long-term nature of reform provides opportunities, but also presents challenges for ADB to adjust during implementation, and engage beyond the life of a program loan. Second, while nominal fiscal targets provide a focus for reforms, transparent mechanisms are required to address the impact of exogenous factors and to ensure conditions are not at variance with

changing government policies. Third, SOE reform requires time, and naming specific SOEs to be privatized as tranche release conditions holds significant risk. Fourth, a broader range of opportunities for expenditure reform need to be pursued to complement revenue reform. Fifth, ADB's resident missions have a significant role to ensure continuous policy dialogue within the country in complex reform programs; and sixth, how the ADB Board monitors that its concerns are addressed by Management during program implementation.

Lessons include (i) public sector reforms require a long-term commitment with flexibility to respond to their iterative nature, (ii) mechanisms to respond to the effect of exogenous factors on conditions should be agreed during design, and (iii) public resource management programs create opportunities to strengthen government's anticorruption efforts.

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

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I. INTRODUCTION

1. During 1996, the India country operational strategy study¹ of the Asian Development Bank (ADB) was revised to include, for the first time, an agreement to direct a portion of financing to the states. The Government of India agreed with ADB's fourfold rationale that state-focused programs would (i) broaden and deepen lagging state economic and administrative reforms, (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 operating efficiency. A strategy to support state fiscal reforms in preparation for sector-specific loans was proposed. To this end, the ADB Board's approval of a \$250 million loan from ordinary capital resources for the Gujarat Public Sector Resource Management Program² (GPSRMP) in December 1996 marked the beginning of a strategic shift in ADB operations in India. This was the first program loan provided by a multilateral development bank to a subnational government in India or any ADB developing member country.³

A. Evaluation Purpose and Process

2. ADB's Operations Evaluation Mission (OEM) was conducted 5 years after GPSRMP closure to assess the achievement of outcomes and impact as defined in the Report and recommendation of the President to the Board of Directors (RRP) (footnote 2). In doing so, the counterfactual—the effect on fiscal stability in the absence of the program—was explored. Five technical assistance (TA) projects were provided to support the reforms; the OEM provided an in-depth assessment and rating for the three focusing on support for public enterprise reform.⁴ The findings from an earlier TA performance evaluation report on fiscal management in India, which assessed the TA supporting finance reforms, is also drawn on.⁵ The OEM used four United Nations Development Programme (UNDP) human development report expenditure ratios to assess changes in public expenditure on social development.⁶ In response to a Government, soon after GPSRMP closure, to conduct an independent program assessment, ADB engaged an Indian research institute to conduct the study. The institute's report formed the basis of an

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, United Kingdom Department for International Development, and Japan Bank for International Cooperation followed ADB's lead in targeting assistance to states.

⁴ The OEM assessed the following TA projects: (i) ADB. 1996. *Technical Assistance to India for Restructuring State-Owned Enterprises of Gujarat*. Manila (TA 2552-IND, for \$600,000, approved on 2 April); (ii) ADB. 1996. *Technical Assistance to India for Capacity Enhancement of Gujarat Industrial Investment Corporation*. Manila (TA 2579-IND, for \$500,000, approved on 30 May); (iii) ADB. 1996. *Technical Assistance to India for Institutional Strengthening of Gujarat Infrastructure Development Board*. Manila (TA 2716-IND, for \$930,000, approved on 18 December).

⁵ ADB. 2004. *Technical Assistance Performance Audit Report on Selected Technical Assistance for Fiscal Management and Tax Administration in India*. Manila. Available: <http://www.adb.org/Documents/TPARS/IND/tpar-ind-2004-05.pdf>. Appendix 4 of the TPAR includes an assessment of ADB. 1996. *Technical Assistance to India for Support for Gujarat Reform of Public Finances*. Manila (TA 2668-IND, for \$600,000, approved on 23 October 1996).

⁶ The (i) public expenditure ratio—the percentage of state income allocated to public expenditure, (ii) social allocation ratio—percentage of total expenditure allocated to social services, (iii) social priority ratio—percentage of social expenditure allocated 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 previous three ratios). The Gujarat Human Development Report 2004 calculates these ratios based on data from FY1980 to FY2001, which the OEM updated to FY2004.

assessment report submitted to the Government in early 2002.⁷ The program completion report (PCR), prepared in December 2004,⁸ rated the program successful noting its contribution to the development of fiscal prudence, tax reform, budgetary controls particularly in treasury automation, and state-owned enterprise (SOE) reform. The PCR notes the negative impact of exogenous factors, including national Government policy changes, market factors, and a devastating earthquake, on achieving and sustaining fiscal reform targets. The OEM to India was conducted during October–November 2006 with consultants experienced in public finance and public enterprise reform in India.

B. Expected Results

3. The GPSRMP's impact (goal) was expected to be improved public sector resource mobilization and allocations efficiently used to promote industrialization for the benefit of the Gujarat population. Four indicators were identified (i) reduction in deficit and improved domestic resource mobilization, (ii) reorientation of public expenditures to high priority productive sectors, (iii) creation of an enabling environment to promote private investment, and (iv) higher savings and investment raising the state domestic product (SDP) projected to grow by more than 6% annually. The impact would be achieved through three outcomes (objectives): (i) strengthened state finances and their prudent management, as measured by the state's fiscal deficit being reduced to 2% of SDP by fiscal year (FY) 1999 by increasing current revenues by about 0.4% of SDP and proportionately decreasing the current expenditure to SDP ratio annually; (ii) reformed SOEs contributing to the state economy, measured by the adoption of the Public Sector Restructuring Program including divestment and restructuring of 23 of Gujarat's 54 SOEs; and (iii) private sector participation in infrastructure development in the state, as measured by the introduction of policy, regulatory, and institutional frameworks for power, ports, and roads. The design and monitoring framework (DMF) is detailed in Appendix 1 (Table A1.1) along with an analysis of the DMF, policy matrix, and description of the Program in the relevant sections of the RRP (Table A1.2).

4. The fiscal consolidation outcome had three outputs:⁹ (i) medium-term fiscal policy framework (MTFPF) implemented with strengthened fiscal policy management, (ii) improved revenue generation, and (iii) prioritized and rationalized expenditure. Outputs to achieve the public enterprise reform outcome included (i) institutional mechanisms in place to implement the Public Sector Restructuring Program, (ii) selected SOEs privatized, (iii) selected SOEs restructured, (iv) selected SOEs closed, and (v) affected SOE employees provided a social safety net (SSN). To create an enabling environment for private sector participation, outputs included (i) an enabling policy and regulatory framework and institutional mechanisms; and (ii) power, port, and road sector reforms.

⁷ ADB. 2002. *Gujarat Public Sector Resource Management Program: An Assessment*. Manila. The National Council of Applied Economic Research was engaged to conduct the assessment, which is referred to as the postprogram assessment elsewhere in this report.

⁸ ADB. 2004. *Program Completion Report on the Gujarat Public Sector Resource Management Program in India*. Manila.

⁹ The DMF does not contain outputs. Rather it specifies six program components and a series of activities. The OEM has reconstructed these outputs from the DMF, RRP, and policy matrix (Appendix 1, Table A1.3) for the purposes of this program evaluation report.

II. DESIGN AND IMPLEMENTATION

A. Formulation

5. The 1996 the country operational strategy study for India marked a significant shift in ADB's support to the Government's economic reform agenda by focusing on the need to (i) address unsustainable national and state government fiscal deficits through fiscal consolidation; (ii) reform trade and finance sectors; (iii) address infrastructure policy, and regulatory and institutional gaps; (iv) reform (corporatize or divest) public enterprises to reduce the drain on the budget; and (v) create a legislative and regulatory enabling environment for restructuring industries, promoting competition, and increasing private sector participation. This translated into a recasting of ADB's overall strategic objective to promote efficiency and higher sustainable growth to improve employment opportunities, while reducing poverty. The national and state governments had concurrent responsibility for fiscal and structural (including policy, legislative, and institutional) reforms; progress in the states had been slow.

6. In 1994 ADB undertook a mission¹⁰ to identify potential states for ADB support based on four criteria: (i) demonstrated commitment to reform; (ii) need in terms of population and infrastructure; (iii) satisfactory record of project and policy implementation; and (iv) financial capacity, ability, and willingness to accept ordinary capital resource loan terms and manage foreign exchange risks. The country operational strategy study outlined three foci of the proposed fiscal reform strategy: (i) supporting fiscal consolidation, (ii) restructuring SOEs, and (iii) providing an enabling policy, regulatory, and institutional environment for private sector participation in infrastructure sector reform. As a result ADB was to lead the way in directly supporting state fiscal adjustment and structural reforms to be complemented by support to sectors (energy, roads, railways, ports, and telecommunications) emphasizing structural reform and fostering public-private partnerships.

7. Gujarat was the first state selected; a decision influenced by the fact that in 1992 the Gujarat state government (GSG) constituted the Gujarat State Finance Commission (GSFC) to undertake a comprehensive review of state finances and provide recommendations on how to address its deteriorating fiscal condition. The GSFC report, released in April 1994, proposed substantial reduction in the growth of current expenditure with better planning of executive and investment outlays, extensive disinvestment in SOEs, and moving some government activities to the private sector.¹¹ Fiscal constraints undermined the state's ability to implement these recommendations. The state's political leadership and bureaucracy were fully committed to taking action if resources could be found to create the necessary fiscal space. The change in Government policy allowing states to enter into loan agreements with multilaterals, and the change in ADB's country strategy to support state reforms created the opportunity. The GPSRMP became the vehicle, providing international recognition of the reform process that enabled GSG to take sometimes difficult decisions with ADB support, much needed financial support to GSG to contribute to the adjustment costs, and technical advice on implementing reforms.

8. Being the first state public sector resource management loan, no subnational experience was available to draw on in India or other developing countries to design and manage the loan, including setting conditions and covenants, modifying them to take account of exogenous

¹⁰ A mission by staff of the then Programs West 2 Division visited four states—Maharashtra, Tamil Nadu, Punjab, and Gujarat—and chose Gujarat. In 1996 ADB decided to expand activities to one or two more states. Madhya Pradesh was the second state to be chosen, followed by Kerala in 2002, and Assam in 2004.

¹¹ Government of Gujarat. 1994. *Report of the Gujarat State Finance Commission*. Gandhinagar.

shocks, instituting a monitoring system, and providing capacity building TA. Two factors characterize the formulation of the GPSRMP. First, the Program was designed by ADB staff in conjunction with GSG officials drawing largely on the GSFC recommendations,¹² and second, it was completed over a relatively short time—9 months from reconnaissance to loan agreement.

9. The ADB Board in approving the GPSRMP recognized the potential demonstration effect beyond Gujarat, but expressed concern with the precedent of using the program lending modality at the subnational level, and as a precursor for future sector-specific lending. They were concerned that reform was a gradual process requiring skillful sequencing of interrelated aspects and some reforms would require a longer time frame than the 2-year loan, which raised sustainability issues. However they agreed to the precedent of a three-tranche approach. The importance of providing information to the public and closely monitoring the multiplicity of actions and conditionals was emphasized given the risks, including whether the necessary political will and technical skills existed to reform public finances, and restructure half of Gujarat's SOEs while ensuring monopolies were not created after privatization. The inclusion of an SSN mechanism was a positive element to mitigate risks posed for those adversely affected. However, the Board questioned the effectiveness of the proposed management by committee arrangements.

B. Rationale

10. The rationale for the GPSRMP was sound and well timed to assist GSG implement its own reform program. After three and a half decades of low gross domestic product (GDP) growth at 3.5% per year, the Indian economy accelerated to over 5% in the latter half of the 1980s. While the initial impetus to growth acceleration came from economic liberalization, this is mainly attributed to an expansionist fiscal stance of the national Government, partly contributed to by a hike in public sector wages in FY1987. The gross fiscal deficit of the national and state governments steadily increased from 5.9% of GDP in FY1982 to 9.4% in FY1990, and outstanding liabilities relative to GDP rose from 46.4% in FY1980 to 61.4% in FY1990. However, this fiscal expansion-led growth was inherently unsustainable, with the fiscal imbalance spilling over into balance of payments, combined with the sharp increase in oil prices caused by the Gulf crisis, triggering an economic crisis.

11. The stabilization and structural adjustment reforms initiated in 1991 required containment of fiscal deficits by the national and state governments. For the states, in addition to containing deficits, reforms had to address the issue of enhancing allocation and technical efficiency in public spending and creating an enabling environment for private sector participation to accelerate economic growth. Economic liberalization required creation of a competitive environment for domestic manufacturers. The hardening central finances reduced resource transfers to states; one mitigation measure adopted was to allow reform-oriented states to negotiate loans from multilateral institutions. Given that fiscal reform was an inherent part of the loan negotiations, allowing the states to borrow from multilateral institutions could achieve the objectives of (i) improving their finances, augmenting outlay on social and physical infrastructure; (ii) restructuring public enterprises; and (iii) creating an enabling environment for private sector functioning. GSG's weak fiscal position in the mid-1990s had eroded the effectiveness and efficiency of public service provision and public investment, preventing GSG from realistically financing infrastructure that would foster the sort of economic activities that would allow the state to realize its potential growth. To mitigate the effects of these two factors,

¹² Although one small-scale and three advisory TA projects were approved in 1996, prior to loan approval, they did not provide substantial input to the loan design.

GSG decided to open all key infrastructure sectors to private sector participation. The key elements of the consequently adopted operating strategy were to (i) reduce the state's fiscal deficit, (ii) reform and restructure public sector enterprises to improve their operating efficiency, and (iii) support reforms in key infrastructure sectors to attract private investment.

12. ADB's choice of Gujarat as the first state to work with was appropriate. Gujarat was a progressive and reform-oriented state, known for its market-oriented culture, presence of significant private entrepreneurship, and political leadership with a tradition of good administration and governance. The state had a proactive reform agenda with the GSFC report waiting to be implemented. By adopting many of the GSFC recommendations as policy actions (either conditions or covenants), GSG had complete ownership of GPSRMP-supported reforms. This strategy also helped the general public accept the reforms. Thus, even with several changes of state government and chief minister,¹³ GPSRMP-supported reforms never appeared to be in danger as all parties were equally committed to their implementation.

C. Cost, Financing, and Executing Arrangements

13. The adjustment costs resulting from reforms were estimated at about \$740 million, spread over the 2 years of implementation. These included \$302 million in revenue foregone due to tax rationalization and reforms, \$413 million in SOE debt settlements, and about \$130 million for liabilities and payment to retrenched SOE employees under the voluntary retirement scheme (VRS) funded by the State Renewal Fund. The balance was for budgetary support to operationalize the Gujarat Infrastructure Development Board (GIDB), and finance project development and feasibility studies for key infrastructure sectors. At \$250 million, the program loan provided 40% of the estimated adjustment costs. The adjustment costs were expected to be offset by revenue gains resulting from enhanced tax compliance resulting from lower tax rates and a wider tax base, reduced subsidies for SOEs, and proceeds from SOE divestment including sales of assets. The 2002 postprogram review found that actual adjustment costs appeared to be consistent with and remarkably close to the design estimates (footnote 7, p. 47). The national Government transferred the loan funds to GSG on a 70:30 loan:grant ratio, with the loan carrying 11.8% interest and 15 years maturity. The Government assumed the foreign exchange risk with the transfers treated as additional to annual center-state fiscal transfers.

14. Overall, implementation arrangements were satisfactory. GSG's Finance Department, the Executing Agency provided leadership in all aspects of the reform effort. Several new committees and institutions were established to supervise and monitor program implementation including (i) a policy level expenditure prioritization committee (chaired by the chief minister) to review and approve the core investment plan prioritizing social and physical infrastructure; (ii) GIDB (also chaired by the chief minister) to promote privatization of key infrastructure sectors; (iii) State Public Finance Reform Committee (SPFRC)¹⁴ to provide advice on fiscal reforms, solicit private sector views, and create public awareness of tax reforms; (iv) three working groups to support the SPFRC on tax reform, expenditure management and control, and computerization and training; (v) a cabinet subcommittee on SOE reform (chaired by the chief minister with ministers of finance and industry as members) responsible to review and approve details of modality, scope of divestment, pricing, and structuring of SOEs; and (vi) a technical secretariat within the Finance Department to service the SOE reform committee.

¹³ Between 1995 and 2001 the ruling party changed four times, and the chief minister changed nine times, including two periods of central Government-imposed Governor's rule (in 1996 and 1997–1998). Since 2001 both the ruling party and chief minister have been unchanged.

¹⁴ Although a Government resolution was promulgated on 28 November 1996 to establish the SPFRC it wasn't implemented until September 1998, with its first meeting held in January 1999.

D. Scheduling and Design Changes

15. The Program was designed to be implemented during 2 years, from December 1996 to December 1998, with the loan disbursed through three tranches; the first tranche of \$100 million being released on loan effectiveness, 20 December 1996. Each release was triggered by compliance with specified policy conditions. Although a number of covenants followed in sequence with certain conditions, their attainment was not bound to the respective tranche release. The \$50 million incentive subtranche of the second tranche was due to be released in June 1997, however a combination of (i) the impact of the national Government's salary revision for civil servants negatively affecting the fiscal deficit, (ii) adverse market reaction to SOE reforms depressing bid offers and delaying the attainment of divestment conditions, and (iii) changes in GSG delayed the release by 2 years to July 1999. The \$100 million final subtranche of the second tranche, program completion, and loan closing dates were then rescheduled to December 1999. However, this too would be delayed for another 12 months.

16. In a report¹⁵ submitted to ADB in December 1999, GSG presented the case that "the program loan should be treated as successfully completed as on 31 December 1999," with 3 months extension to March 2000 to close the Program and release the final tranche. ADB did not concur with this assessment, believing 12 months would be required to meet the conditions necessary to release the final tranche. In January 2000, the first of four missions from ADB headquarters in the year,¹⁶ proposed a set of minimum policy actions required for release of the final tranche: (i) initiation of the phasing out of power tariff subsidies and determination of appropriate tariff by the Gujarat Electricity Regulatory Commission (GERC), increase in irrigation rates as a means of restoring the state's fiscal balance, and preparation of a medium-term fiscal consolidation program; and (ii) fulfillment of policy actions not met under the incentive tranche but postponed to the second tranche as approved by the ADB Board, including restructuring of Gujarat Industrial Investment Corporation (GIIC). GSG maintained its position that sufficient progress had been achieved to release the final tranche, and that further delay would only increase costs with little meaningful benefit.¹⁷ Although GSG took actions to meet sufficient compliance, mission reports and correspondence throughout 2000 reflect its frustration with ADB's apparent lack of flexibility in interpreting conditions within a broader reform context. Thus, the 2-year anticipated implementation became 4 years. Design changes were not affected during implementation, but the four final tranche conditions were amended to enable its release and program closure.

E. Results

17. The Program's achievements are described for the three outcomes following the OEM's reconstruction of the DMF outputs (para. 4). A detailed analysis of the status of conditions and covenants at the time of the OEM is provided in Appendix 2.

¹⁵ Finance Department, Government of Gujarat. 1999. *Gujarat Public Sector Resources Management Program Loan Self Assessment Report*. Gandhinagar.

¹⁶ Significant effort was expended by all parties—GOG, ADB (headquarters and resident mission), and the national Government during the year to ensure that sufficient compliance was achieved to justify release of the final tranche.

¹⁷ GOG strongly urged ADB to fund the proposed Gujarat infrastructure facility, and expressed their displeasure of ADB's decision not to provide funding to the March 2000 mission.

1. Strengthened Public Finances and their Prudent Management

18. This outcome was to be achieved by implementing an MTFPF, improving revenue generation, and prioritizing expenditure. GSG was expected to reduce the fiscal deficit to 3.5% of SDP in FY1997 and to 2.7% in FY1998,¹⁸ by raising revenues annually by about 0.5% SDP and proportionately reducing the expenditure to SDP ratio. However, exogenous factors resulted in neither nominal target being attained. Consequently, adjustments were made to account for these exogenous factors so that the actual fiscal deficit in FY1998 of 4.2% of SDP was adjusted to 2.8%, and the FY1999 actual fiscal deficit of 7.3% adjusted to 2.5%. By FY2005 the actual fiscal deficit had been contained at 3.5% of SDP, and the revenue deficit reduced to 0.2% of SDP. (Appendix 3 provides an overview of the political economy of fiscal reform in India including an analysis of the state's fiscal performance over time).

19. **MTFPF Implemented with Strengthened Fiscal Policy Management.** The MTFPF was formulated in FY1997 and thereafter its progress was assessed with projections revised in line with base-year data. The SPFRC prepared a medium-term fiscal consolidation plan in December 2000 for adoption starting FY2002. However, the MTFPF was not linked to the budget and did not provide a hard budget constraint in a program budgeting sense. The MTFPF was submitted to the Cabinet for adoption starting FY2002. A draft memorandum of understanding between GSG and the national Government as per Fiscal Responsibility Act requirements included an MTFPF based on this plan. The SPFRC was established along with three working groups on expenditure management and control, tax reforms, and computerization and training. Reform proposals for value-added tax (VAT), property tax, *octroi*,¹⁹ and improvements in expenditure management and control were submitted to the state in October 1998. Further studies were undertaken on more strategic management of public resources and improved containment of the fiscal deficit. A fiscal consolidation plan was submitted to the state Cabinet. This was used to prepare the draft memorandum of understanding between GSG and the national Government for the state to avail of the states' fiscal reforms facility, approved by the Government in 2004.

20. **Revenue Generation Improved.** To facilitate VAT introduction, the sales tax rate structure was consolidated to six categories with four special rates, the turnover tax was merged with the sales tax, the number of items reduced from 63 to 24, and assessment systems were simplified by introducing a single-tier system. However, the VAT system was not launched until 1 April 2006 conforming to the structure agreed by the empowered committee of state finance ministers. During this short time, the VAT has already significantly improved revenue productivity, with the first 5 months of collections showing a growth of more than 30% over the corresponding period in the previous year. The stamp duty and professional tax rate schedules were adjusted with rates for some items reduced or converted to ad valorem rates, and automatic reckoning mechanisms for valuation of immovable properties were updated. The rate schedules of tax on goods, passengers, and motor vehicles (motor vehicle tax) changed in accordance with program conditions leading to a single rate of 4%. GSG further restructured the motor vehicle tax structure and rates to mobilize tax revenue. Tax rates for omnibuses were increased in FY2001, stamp duty exemptions for tractors used for agriculture purposes were withdrawn in FY2003, and sleeper bus coaches were subjected to motor vehicle tax starting in FY2004. The focus on key municipal taxes included reforming property tax and abolishing *octroi* in all local bodies except in municipal corporations due to inability to find a viable alternative.

¹⁸ The tranche condition for FY1999 was at variance with the DMF indicator, which stated 2% of SDP and increasing current revenues to 0.4% of SDP in FY1999.

¹⁹ *Octroi* taxes are levied on goods crossing (entering or leaving) municipal authority boundaries, and date back to Roman times.

GSG established the Directorate of Taxation. The Sales Tax Department, operation and the budget divisions of the Finance Department, and Office of Directorate of Accounts and Treasuries were fully computerized and interconnected.

21. Increasing user charges to improve cost recovery focused on increasing (an effectiveness condition), and later revising (a final tranche condition) power tariffs to maintain a 3% rate of return on the fixed assets of Gujarat Electricity Board (GEB), and increasing irrigation charges by 50%. The latter, a final tranche condition, was met with higher irrigation charges starting February 2001.²⁰ Further, the OEM was informed that GSG is considering establishing a water regulatory authority once irrigation water from the Narmada Dam is fully flowing.

22. The political sensitivity of increasing power tariffs constrained action on the GEB condition and became the subject of intense discussion between GSG and ADB throughout 2000,²¹ eventually resulting in an amendment to enable the release of the final tranche. The GSG self-assessment report (footnote 16) recognized the problem created by power sector subsidies. In FY1998 they accounted for 1.5% of SDP, and the delay in restructuring the power sector was a contributing factor to a higher than expected fiscal deficit. The report restated GSG's commitment to reform the sector, but stated that reducing subsidies "has to be a gradual and smooth process so as not to create social upheaval and bitter public perception. [Both bureaucrats and politicians were aware of the need to contain subsidies, but] it will probably take some more time before the target of eliminating subsidies is fully achieved" (footnote 16. p. 20). The report proposed that ADB review this condition as GERC was considering a tariff increase, and concluded with a proposal to defer the objectives of power sector reform and reduction in subsidies to the power sector restructuring loan, which was then being negotiated with ADB. ADB did not agree. The effectiveness condition had not been met, and the proposal to do away with the condition completely would be extremely problematic for both the GPSRMP and the proposed power sector loan, particularly as a number of ADB Board members had commented on the importance of power sector reform at the time of GPSRMP approval. A resolution was found (para. 16), with GSG taking a decision to cap power sector subsidies at Rs11,000 million in the FY2000 state budget. After 6 months of public hearings, GERC increased electricity tariffs including a substantial upward revision of agriculture tariffs in October 2000, after completion of local government elections. But even then the revisions did not enable GEB to attain 3% returns on fixed assets.

23. **Expenditure Prioritized and Rationalized.** This was supposed to be achieved with the introduction of an annual rolling core investment plan, which was to insulate expenditures with high social rate of return and therefore considered as priority from ad hoc expenditure cuts. However, the core investment plan was not implemented seriously and largely remained a paper exercise. The GPSRMP also required increasing the ratio of capital expenditure to net SDP (NSDP) from 2.1% in FY1996 to 2.6% in FY1998. This was met with capital expenditure rising to 3.2% of NSDP in FY1999 and was 3.1% in FY2000. The expenditure continues to be adequately protected with capital expenditure estimated at 3.4% of NSDP in FY2005.

2. Reformed SOEs Contribute to the State Economy

24. This outcome was to be achieved by establishing the required institutional mechanisms to implement the reform plan, privatizing, restructuring, or closing selected SOEs, and providing

²⁰ Irrigation charge increases were by crop, with rice increasing by 300%, sugarcane by 250%, and other crops by 200%.

²¹ In the 4 August 2000 Project Implementation Review Meeting between ADB and the national Government's Department of Economic Affairs, this was the only issue recorded as requiring action by the department.

an SSN for affected employees. Appendix 4 details SOE reform achievements of which merger and full privatization were the most successful. Although the complexities of SOE closure were not fully appreciated, operating closure was attained. The SSN was limited to provision of severance payment to all affected employees.

25. Institutional Mechanisms in Place to Implement the Public Sector Restructuring Program. Two bodies were established to implement and monitor SOE reforms. A policy level cabinet subcommittee chaired by the chief minister with the ministers of finance and industries and the chief secretary was mandated to review and approve the (i) extent of shareholding to be divested in enterprises identified for divestment, (ii) acceptance of a successful bidder's offer, (iii) price at which shares would be offered to the public, (iv) restructuring plans to be adopted for enterprises, and (v) enterprises to be closed. A technical secretariat for privatization headed by a full time ex-chief secretary with four technical staff was established with logistic and technical support from Gujarat State Investment Company, the apex holding company for all GSG equity investments in SOEs. The secretariat, which was administratively responsible to the Finance Department, was mandated to advise the department and line ministries with administrative control of SOEs, develop proposals for SOE reforms, prepare valuations of SOEs, and provide negotiation and contracting support during the privatization process. External consultants with specialized SOE reform and privatization skills were engaged to support the secretariat.

26. Selected SOEs Privatized. This involved two approaches (i) fully privatize three SOEs (Gujarat Tractors Corporation Limited (GTCL), Gujarat Communication and Electronics Limited (GCEL), and Gujarat State Export Corporation Limited (GSEC); and (ii) divest 51% of GSG's shareholding in two SOEs, GIIC and Gujarat Mineral Development Corporation Limited (GMDC). A 60% equity stake in GTCL was transferred to Mahindra and Mahindra Ltd. The remaining GSG stake in GTCL, to be transferred to Mahindra and Mahindra Ltd. in line with the sale-and-shareholder agreements, has not yet been transferred. In September 2004, the company was referred to the Board of Industrial and Financial Reconstruction, which declared GTCL a "sick" company, its net worth having been completely eroded due to accumulated losses. After two failed attempts to privatize GCEL, GSG decided to close it with all but 16 employees opting for VRS and retrenched by December 2000.²² GCEL's operations were suspended from February 2001 and an official liquidator was appointed in February 2002, with the process of disposal of fixed assets of the company in progress. Secured creditors including banks and financial institutions have initiated legal steps to recover their dues. These have yet to be settled. With a 57% equity stake in GSEC, GSG successfully tendered for a strategic partner. After protracted negotiations, including offering a third of GSEC's employees a VRS package to make the deal more attractive, GSG transferred management control by offloading its entire equity stake in February 2004.

27. GSG, which held 100% equity stake in GIIC and GMDC, proposed to divest management control by initially offering 26% to the public by mid-1997, and an additional 25% by June 1998. Both these enterprises were expected to concurrently seek technical collaboration with private sector companies with relevant expertise and experience, while implementing organizational restructuring to improve their performance. While national laws precluded GSG divesting management control in an SOE in the mineral subsector, it did succeed in divesting a 26% stake in GMDC through a public offer of shares in October 1997. However, it has not been able to offload any of its shareholding in GIIC.

²² However, 11 of the 16 remaining employees approached the courts for alternative employment with some of these cases still pending at the time of the OEM.

28. **Selected SOEs Restructured.** The three approaches included (i) partially divest between 26% and 74% of GSG's stake and restructure GSFC, Gujarat Industrial Development Corporation (GIDC), and Gujarat Agro Industries Corporation Limited (GAIC); (ii) merge selected SOEs; and (iii) lease selected services of one SOE. While GSG succeeded in reducing its stake in GSFC to 49.9% following a public offering, it has been unable to offload its shareholding in GIDC and GAIC. Given the strategic nature of GIDC operations in ensuring industrial development in the state, GSG decided not to proceed with divestment. The unbundling of GIDC operations was delayed because of employee resistance coupled with limited interest shown by private sector investors in operating industrial estates. GSG decided not to divest GAIC as it implements GSG's agriculture sector subsidy programs, which have a social and development objective. Restructuring measures were implemented with all manufacturing units being closed with GAIC retaining only its fertilizer distribution activities. All 202 employees belonging to the closed units received VRS.

29. The merger of Gujarat Industries Marketing Corporation Ltd. and Gujarat Leather Industries Corporation Ltd., which were both involved in marketing leather and footwear goods produced by rural artisans, was effective by January 2001. The merger of Gujarat State Handloom Development Corporation Ltd. with Gujarat State Handicrafts Development Corporation Ltd. to form Gujarat State Handloom and Handicrafts Development Corporation Ltd. to develop the handicraft and handloom sector by providing marketing support to the artisans and weavers was effective in FY2002; 68 employees received VRS as part of the restructuring process. The proposal to restructure Gujarat Slum Clearance Board (GSCB) by transferring its functions of constructing low-income housing, including assets and liabilities to Gujarat Housing Board, and slum clearance activities to nongovernment organizations and local bodies was refined. Given GSCB's huge bad loan portfolio due to nonrecovery of loans from its low-cost houses, the decision to transfer GSCB's assets and liabilities to Gujarat Housing Board could not be implemented. However, all GSCB operations have been discontinued and its employees redeployed to an independent cell of Gujarat Housing Board responsible for recovering GSCB overdue loans. These redeployed employees have been appointed on contract; their current remuneration is 50% of that received as GSCB employees. The amount recovered by the cell will be deposited in an escrow account after meeting the administrative expenses of the cell, and will be used to settle the outstanding GSG loans received by GSCB. Local bodies have taken on slum clearance activities. Nongovernment organizations have been less active than planned. GSG's proposal to sell or lease a number of assets of Tourism Corporation of Gujarat Ltd. could not be concluded due to litigation arising from inadequate drafting of the lease agreements. The report of the Comptroller and Auditor General of India for FY2004 resulted in a decision to close all unviable Tourism Corporation of Gujarat units with 52 employees being offered VRS. GSG provided Rs9.5 million as subsidies to the corporation during FY2004.

30. **Selected SOEs Closed.** Although closure was not defined in the design, it was inferred that at least operating closure would be achieved and steps toward financial closure would be initiated. Gujarat State Textile Corporation Ltd. mills have been closed; however around Rs6.34 billion of GSG investments in equity and loans remained blocked in the corporation as of FY2004. Gujarat Dairy Development Corporation Ltd. was closed with the plant and machinery disposed of, but its land has not yet been finally transferred to GSG. Around Rs1.1 billion of GSG investments in equity and loans remained blocked in the corporation as of FY2004. Gujarat Fisheries Development Corporation Ltd. was closed with all assets and liabilities transferred to Gujarat Fisheries Corporation Association. All employees were given VRS and subsequently redeployed in Gujarat Fisheries Corporation Association. About Rs40 million of GSG investment in equity and loans were blocked in Gujarat Fisheries Development

Corporation as of FY2004. Gujarat State Construction Corporation Ltd. was closed with all but 14 employees given VRS. Around Rs110 million of GSG investments in terms of equity and loans given remained blocked in the corporation as of FY2004. In all cases the unblocking of GSG investments will only be possible after each SOE's liabilities and dues are settled. This was still unresolved at the time of the OEM.

31. **Affected SOE Employees Provided an SSN.** The SSN program was not implemented as GSG believed that the VRS package for displaced employees was designed to ensure that the returns from the investment of VRS compensation would protect the entire remuneration being earned by the employees prior to their retrenchment. However, the OEM learned that the VRS compensation together with the earnings from alternative employment in the informal sector is estimated to have protected around 65% of the earnings of displaced employees.²³

3. Private Sector Participation in Infrastructure Development

32. This outcome would be achieved by creating the policy and regulatory framework for private sector participation in key infrastructure sectors along with the necessary institutional mechanisms to facilitate participation; and by initiating key reforms in power, ports, and road sectors. The private sector responded positively to the policy and regulatory developments under the Program and the specific reforms in the three targeted sectors prepared the foundation for further ADB financing.

33. **Policy and Regulatory Framework, and Institutional Mechanisms.** GIDB was established under the GPSRMP in June 1995 as a nodal agency for infrastructure development in the state to formulate policy, identify and evaluate priority infrastructure projects including conducting feasibility studies, attract private investment, and coordinate with concerned government departments. GIDB was chaired by the chief minister, with ministers of relevant infrastructure and industrial development departments as members. In 1998, GIDB launched a development strategy for the state entitled Vision 2010 outlining more than 380 priority infrastructure and industrial development projects totaling Rs1,170 billion. In 1999, GIDB was given statutory status with the passing of the Gujarat Infrastructure Development Act, formalizing its mandate as the preeminent infrastructure development agency in the state, establishing a legal framework for private sector participation in infrastructure development, and outlining the competitive bidding processes for various modalities including build-operate-transfer.²⁴ In 2004, GIDB reviewed Vision 2010 and produced the Blueprint for Infrastructure in Gujarat 2020 where "Gujarat shall enter into an exciting era of accelerated economic growth and cohesive social development creating benchmarks for the rest of the country."²⁵ The document outlines a 5-year schedule of projects across eight sectors requiring total investment of Rs1,700 billion of which 85% are in the energy, water and irrigation, and transport sectors. GSG's projected funding is Rs368 billion, with the national Government providing Rs5.5 billion (mostly in railways) and private sector Rs583 billion, leaving a funding gap of Rs693 billion.

34. **Power, Port, and Road Sector Reforms.** GERC was established in November 1998, created as an autonomous commission to regulate the power sector including setting tariffs. However the political implications of increasing power tariffs constrained action until late 2000 when the state budget included a decision to cap power sector subsidies and substantially

²³ Discussions with SSN experts associated with the closure of GSTC and similar programs in other states.

²⁴ Gujarat was the first state to provide a legal framework for modalities such as build-own-operate-transfer, build-own-operate-maintain, build-lease-maintain-transfer, and rehabilitate-own-transfer. The act established procedures for international competitive bidding and direct negotiation with limited competition.

²⁵ Gujarat Infrastructure Development Board. 2004. *Blueprint for Infrastructure in Gujarat 2020*. Gandhinagar.

increase agriculture tariffs. However, this delay undermined the aim of improving the financial viability of GEB, including the condition that GEB make 3% returns on its fixed assets. This condition was subject to intense discussion between GSG and ADB throughout 2000, and was eventually amended to enable the release of the final tranche of the GSPRMP. The promulgation of the Gujarat Electricity Industry Reorganization and Regulation Act in October 2000 led to initial steps in restructuring GEB with the creation of two power distribution circles. Power sector investment planning was addressed through the GIDB Vision 2010 and the updated Blueprint for Infrastructure in Gujarat 2020. Since the late 1990s, 10 independent power producers have entered the sector with a total investment of \$2.85 billion, increasing generation capacity by approximately 3,000 megawatts. The power sector reforms were politically sensitive and directly affected rich and poor rural constituents, as evidenced by the substantial time for the autonomous GERC to increase tariffs. However, once done and with the encouragement to private sector participation through legal and regulatory changes under the GSPRMP, additional support was provided by both the national Government and ADB to continue reforms in the sector.²⁶

35. With more than 1,600 kilometers of coastline providing 30% of India's minor and intermediate ports, a significant volume of goods pass through Gujarat's 13 main ports, all but one being managed by Gujarat Maritime Board.²⁷ The GSPRMP conditions and covenants to increase port changes, develop an appropriate regulatory framework for public-private port development, restructure Gujarat Maritime Board, and establish an independent port services development corporation to handle dredging and related port services were achieved. Revised port charges enabled GSG to repay a loan from 1982 Gujarat Maritime Board capital assets. The regulatory changes along with the Infrastructure Development Act attracted more than \$2 billion in private investment in port infrastructure including development of four greenfield sites with associated transport (rail and road), power, and industrial development.

36. The 1996 state roads policy emphasized the need for private sector investment. A private sector cell was established in the Roads and Bridges Department to process road projects. A positive response resulted in seven major roads and bridges being constructed with a total investment of about \$250 million by 2002.

F. Consultants

37. For the TA projects attached to the GSPRMP loan as well as the stand-alone TA, 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). The TA, Support for Gujarat Reform of Public Finances²⁸ encountered problems with the selection of consultants. Only two domestic firms expressed interest, and the selected firm was found to be largely inadequate, with changes in the team and production of poor quality outputs (footnote 5).

²⁶ On 13 December 2000 at the same ADB Board meeting that approved the release of the final tranche of the GSPRMP, the Board approved a \$200 million project loan, and a \$150 million program loan supporting power sector reform in Gujarat. ADB. 2000. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to India for the Gujarat Power Sector Development Project*. Manila (Loan 1804-IND, for \$200,000, approved on 13 December). ADB. 2000. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to India for the Gujarat Power Sector Development Program*. Manila (Loan 1803-IND, for \$150,000, approved on 13 December). GEB also received an incentive grant of Rs5,360 million under the national Government's Accelerated Power Development and Reforms Program scheme.

²⁷ The largest port at Kandla is administered by the national Government's Ministry of Shipping and Ports. Gujarat Maritime Board administers the other commercial ports along with 40 minor fishing ports.

²⁸ ADB. 1996. *Technical Assistance to India for Support for Gujarat's Reform of Public Finances*. Manila (TA 2668-IND, for \$600,000, approved on 23 October).

In July 1996 an international firm was selected for the TA to restructure SOEs;²⁹ it fielded consultants in November 1996. Their performance was generally satisfactory showing a high degree of professionalism, working well with senior government officials, and producing high quality reports with recommendations generally well accepted by GSG (Appendix 6). An international firm was selected for the TA to enhance the capacity of GIIC;³⁰ it fielded consultants in February 1997. Although GSG rated their performance generally satisfactory, ADB rated their performance lower (Appendix 7).³¹ An international firm was selected for the TA to provide institutional strengthening for GIDB in May 1997;³² it fielded consultants in June 1997. Both GSG and ADB found the performance of consultants as generally satisfactory, building a very productive working relationship and producing high quality outputs. However, numerous contract variations were required and the team leader was replaced, delaying project implementation by 17 months (Appendix 8).

G. Loan Covenants

38. The Program was scheduled to be implemented over 2 years, from December 1996 to December 1998, with the loan disbursed through three tranches to be released on compliance with specified policy conditions. The GPSRMP had a total of 104 policy actions, of which 42 were satisfied to trigger the release of the first tranche of \$100 million upon loan effectiveness as of 20 December 1996. Of the remaining 62 policy actions, 28 were conditions for tranche releases—11 for the incentive tranche of the second tranche and 17 for the final tranche of the second tranche; and 34 were covenants, sequenced with but not linked to tranche conditions—seven with the incentive tranche and 27 with the final tranche (Appendix 2 includes an assessment of the status of loan covenants).

39. The specificity of some tranche conditions and covenants created difficulties, particularly when external factors or political expediency conspired to hinder their achievement. For example, detailing the divestment strategy for specific SOEs as tranche conditions undermined GSG's negotiating position and contributed to delay in achieving conditions. In approving the incentive tranche the ADB Board acknowledged GSG's efforts, and deferred the achievement of the two outstanding SOE reform incentive tranche conditions to the final tranche.³³

40. The final tranche progress report noted that further progress on the two deferred conditions had not been achieved and proposed to waive the condition relating to divestment of GSEC, however just prior to the Board meeting GSG informed ADB that agreement had been reached on the sale price for more than 30% of GSG's equity in GSEC and the proposed waiver was withdrawn. The Board did approve two amendments: (i) the condition to fully privatize

²⁹ ADB. 1996. *Technical Assistance to India for Restructuring State-Owned Enterprises of Gujarat*. Manila (TA 2552-IND, for \$600,000, approved on 2 April).

³⁰ ADB. 1996. *Technical Assistance to India for Capacity Enhancement of Gujarat Industrial Investment Corporation*. Manila (TA 2579-IND, for \$500,000, approved on 30 May).

³¹ This was due to the consultant's initial draft manuals creating considerable confusion about some terms and conditions of a proposed ADB investment loan facility, when ADB had not committed to make any loans, nor had it identified potential terms and conditions at that time.

³² ADB. 1996. *Technical Assistance to India for Institutional Strengthening of the Gujarat Infrastructure Development Board*. Manila (TA 2716-IND, for \$930,000, approved on 18 December).

³³ Board members who either abstained or voted against approval raised at least two commonly held key concerns. First, the request for approval of tranche release (July 1999) coincided with the sanctions imposed on the Government of India (and Pakistan) for nuclear tests by the Group of 7 and other nations. Some argued that the tranche represented new lending and therefore was subject to sanction. The second was the fact that the Board was being requested to approve a tranche release when 2 of 11 conditions had not been met. This was reported to be a common occurrence with fast-disbursing policy-based lending with members arguing that approval to waive or defer brings ADB's credibility into question.

GCEL was amended to seek approval of the closure of GCEL, and (ii) the condition to reduce GSG's shareholding in GIIC to not more than 49% was amended to GSG "will undertake the operational and financial restructuring of GIIC prior to privatization."

41. Finally the political implications of taking actions necessary to increase power tariffs to meet the relevant tranche condition were deemed to be too difficult at the time and arguments were made that tariff setting had been depoliticized through the establishment of an independent electricity regulation commission under the Program. GSG despite its best efforts has not able to meet this condition. Consequently the condition to revise power tariffs to maintain a 3% rate of return on GEB's fixed assets was amended to "establish a process to enhance the level of costs recovery in the power sector." Immediately following the Board's discussion and approval of the final tranche release, it discussed and approved the first sector loan to Gujarat, a \$350 million power sector loan and associated TA that included actions to address GEB's financial viability and build on the regulatory initiatives under the GPSRMP.³⁴ These amendments led one ADB Board member to ask if ADB has mechanisms to monitor and implement the amended conditions after program closure, then the amendments are to ensure the release of a \$100 million tranche rather than to meet program objectives.

H. Policy Framework

42. An important unforeseen exogenous policy change that adversely affected Gujarat's finances was the sharp increase in public sector wages following implementation of the Fifth Pay Commission's recommendations in FY1997. Indeed, in FY1998 the finances of all state governments sharply deteriorated following these pay increases. Stagnant tax revenues and a decline in national Government transfers relative to the SDP aggravated the situation. This was compounded by increasing deficits and debt, and rising interest rates, contributing to a sharp deterioration in the fiscal health of the state requiring the deficit target to be revised. After GPSRMP closure, following the recommendation of the Eleventh Finance Commission, the Ministry of Finance designed a medium-term fiscal reform program requiring the states to reduce the ratio of revenue deficits to their total revenues by 5 percentage points every year to gain eligibility for receiving a portion of grants. Because of problems in the design of this performance-linked grants program,³⁵ 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 fiscal responsibility act entitling them to restructure and consolidate market loans and loans from the national 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 of its revenue deficit.

³⁴ ADB. 1999. *Report and Recommendation of the President to the Board of Directors on Proposed Loans and Technical Assistance Grants to India for the Gujarat Power Sector Development Program*. Manila (Loans 1803/1804-IND, for \$350 million and three TA projects totaling \$1.1 million, approved on 13 December).

³⁵ Rao. M. G. 2004. Linking Central Transfers to Fiscal Performance of States. *Economic and Political Weekly* 1 May: 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 as it fails to address the causes of deteriorating state fiscal performance.

III. PERFORMANCE ASSESSMENT

A. Overall Assessment

43. The OEM rates the GPSRMP overall as successful.³⁶ By closure, the Program's outcomes had by and large been achieved. The GPSRMP provided the stimulus to reform, enabling Gujarat by 2006 to achieve the fiscal deficit targets set by the TFC for FY2008, with an expected substantial revenue surplus from FY2006. SOE reforms were beginning to show dividends and private sector investors were responding positively to opportunities created by legal and regulatory changes in key infrastructure sectors. The Program's financial and human resources had been efficiently utilized and many of the reform measures were being sustained. The expectation that the Program would be replicated in other states was also achieved.³⁷ The OEM overall rating matches that of the PCR.

B. Relevance

44. The GPSRMP is rated as relevant (footnote 36). The GPSRMP supported the national Government's overall economic reform agenda with the states, and was consistent with the Ninth Five-Year Plan (1995–2000), other national policies, and agreement for multilateral funding agencies such as ADB to provide support directly to state governments. The Program built on the recommendations of GSG's own analysis of solutions for its fiscal condition as embodied in the 1994 GSFC report. This resulted in strong state ownership of the reform program supported by the GPSRMP; ownership that was to survive three changes of ruling party and nine changes of chief minister from 1995 to 2001. The Program was consistent with ADB's institutional development objectives of supporting economic growth and the India country strategy, in particular on reducing infrastructure constraints by supporting the development of an effective policy, regulatory, and institutional environment, and improving infrastructure availability and quality of service.

45. The GPSRMP was designed over a very short period, and the overall program logic was sound with respect to the three components—fiscal reform, SOE reform, and creation of an enabling environment—but the logical framework was not well constructed. Little documentary evidence is available on consideration of alternative fiscal policy options, particularly on the expenditure side (for example, addressing subsidies, state pension liabilities, or instituting expenditure performance measurement and reporting systems). A 2-year time frame was overly ambitious given the scope of the reform process, in particular the time required to effectively implement SOE restructuring and closure. As this was the first state policy-based loan supporting fiscal reform, India had little experience to draw on. However, considerable international experience with SOE reform³⁸ was available internationally, but was not referred to in the design. Despite that, a range of SOE reform options were assessed and implemented,

³⁶ 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 $2.7 \leq S \leq 1.6$, partly successful $1.6 < PS \leq 0.8$, and unsuccessful < 0.8. ADB. 2006. *Guidelines for Preparing Program Performance Evaluation Reports for Public Sector Operations*. Manila.

³⁷ As outlined in Appendix 5, the World Bank supported reforms in Uttar Pradesh (2000), Karnataka (2001), and Andhra Pradesh (2002). ADB supported programs in Madhya Pradesh (1999), Kerala (2003), and Assam (2004). Revisions to the eleventh and twelfth finance commission awards and the Fiscal Responsibility Act drew on GPSRMP experiences.

³⁸ For example, the 1989 issue of *World Development* 17 (5) was entitled Privatization and included eight articles on public enterprise reform focusing primarily on issues relating to privatization in the developing world. Although the experiences being discussed were for national SOEs, many of the lessons were equally applicable to state SOEs.

consistent with some of the key lessons from that experience. Institutional limitations were recognized, and the TA³⁹ that proposed to build capacity was relevant.

C. Effectiveness

46. The GPSRMP is rated as effective.⁴⁰ The nominal fiscal deficit targets were negatively affected by exogenous political economy and natural disaster factors—pay commission awards, decreased national Government transfers, an earthquake, and communal disturbances. After adjustments for these factors, the deficit figures were achieved. However, as recognized by ADB staff in their presentation to the ADB Board for the final tranche release, perhaps specifying targets in this manner was not wise. It was not the only measure for achievement of the outcome of strengthening the state's public finances and their prudent management, but it received the most attention. The effect of reforms is not merely direct and immediate, but may strengthen over time and these estimates do not capture the indirect and long-term effects. In Gujarat, the reform process helped the state to gear up to the requirements of the national Government's fiscal adjustment plan, based on the recommendations of the eleventh and twelfth finance commissions. Compared to the situation immediately after the earthquake and communal disturbances in 2001 and 2002, the situation of both revenue collections and expenditures improved so that compared to the situation before the pay revision in FY1997, in FY2005 the ratio of revenue to NSDP was higher by 0.7 points and the expenditure ratio lower by 0.9 points.

47. GSG largely succeeded in implementing SOE reform, particularly for the enterprises identified for full divestment and merger. With regard to SOEs identified for closure, operating closure was achieved, with financial and legal closure awaiting completion of the liquidation process. This is to be expected given the time required. GSG was relatively less successful in carrying out reforms of enterprises identified for partial divestment, in part because the naming of SOEs in tranche release conditions made GSG's negotiations for a reasonable price difficult when investors knew that the pressure of time was on their side. A broad political consensus remains on the need for SOE reforms to more effectively utilize resources and make the public sector more responsive. Phase II of SOE reforms continues with an independent expert committee making recommendations to GSG.

48. Promulgation of the Gujarat Infrastructure Development Act, formalizing GIDB's mandate as the preeminent infrastructure development agency in the state, and establishing a legal framework for private sector participation in infrastructure development, was a significant achievement in creating an enabling environment. Developing port, road, and power policies; establishing an electricity regulatory authority; and unbundling Gujarat Maritime Board all led to increased investment in their respective sectors.

49. In a study of the counterfactual, the econometric analysis of structural adjustment loans on individual states, after controlling for other exogenous factors, found in the short term the loans did not lead to any significant improvement in the overall fiscal situation in any of the six states receiving them (Appendix 5).⁴¹ The study notes the response to fiscal stress is influenced

³⁹ ADB. 1996. *Technical Assistance to India for Capacity Building of Public Sector Restructuring*. Manila (TA 2530-IND, for \$100,000, approved on 6 February).

⁴⁰ Based on a four-point scale, from 0 to 3, as follows: ineffective (0), less effective (1), effective (2), and highly effective (3).

⁴¹ 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, which did not receive such state multilateral loan support.

by the structure of incentives faced by states and political economy factors. The analysis of revenue and fiscal deficits shows significant interstate variations with the fiscal deficit consistently deteriorating when off-budget deficits due to power sector losses are correctly included. However, the study did not find a significant relationship between the amount of development expenditure and the size of state revenue or fiscal deficits. In Gujarat, an attempt at expenditure compression was not significant. Tax performance did not show any significant improvement, and the reforms did not result in enhancing nontax revenues from user charges and returns from state enterprises. However, as the period of analysis for the study was limited, the results could change over the medium term when the reform measures impact fully on the state's revenues and expenditures.

D. Efficiency

50. The Program is rated as efficient.⁴² The loan was provided to help GSG finance the adjustment costs of reform—lost tax revenue, SOE reform liabilities, cost of VRS and SSN for retrenched employees, and budget support for GIDB—estimated to be \$740 million. Although GSG and the national Government requested \$300 million, ADB agreed to \$250 million. The actual adjustment costs were covered by GSG, and were close to the ex ante estimates (footnote 7, p. 49). Tax revenues began to increase in FY2000, even though the VAT was not implemented until 2006. SOE reform saved GSG more than \$110 million in SOE employee wages. However, some \$173 million in outstanding GSG investments in equity and loans remain blocked in the four SOEs undergoing closure. More than 22,000 employees received VRS costing around \$116 million with VRS valued at between Rs100,000 and Rs590,000 per employee (\$2,272–\$13,409). Contrary to GPSRMP design, the SSN to retrain and counsel retrenched employees did not proceed as GSG considered the VRS package sufficient to enable employees to adopt alternative employment. With one TA rated as highly successful (footnote 32), two as successful (footnotes 29 and 39), one as partly successful (footnote 28), and one as unsuccessful (footnote 30), overall these resources were efficiently used (paras. 67–71). In terms of process efficiency, the Finance Department and respective policy and technical committees provided appropriate oversight.

E. Sustainability

51. The Program is rated as sustainable.⁴³ Gujarat stands out among Indian states for its strong reform attitude. All political parties in the state are agreed on the broad thrust of reforms, and the national Government continues to maintain a policy environment encouraging state fiscal responsibility. Gujarat historically had a greater promarket orientation than other states, and many of the reform initiatives under the Program were formulated by the state, underpinning commitment for their continuation. The cyclone, earthquake, and communal disturbances through FY2000–2002 distracted the state from the reform process. However, from FY2003 the reform process was put back on track. In FY2001, Gujarat, at 7% of NSDP, had the highest revenue deficit and, at 8.9% of NSDP had the highest fiscal deficit among the states. By FY2005, the revenue deficit was phased out, and fiscal deficit was reduced to 3.5% in conformity with the target recommended by the SPFRC. The finances of all states in India have shown significant improvement with more than 57% of improvement due to higher transfers and implementation of the TFC debt-restructuring plan, and 43% due to states' own efforts. In Gujarat the situation is similar with more than 50% of the improvement due to higher central

⁴² Based on a four-point scale, from 0 to 3, as follows: inefficient (0), less efficient (1), efficient (2), and highly efficient (3).

⁴³ 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).

transfers and debt-restructuring benefits contributing another 11%. Thus, almost two thirds of the improvement in the state finances since FY2003 was due to TFC recommendations, and only one third improvement was due to the state's own effort. Capacity building to introduce the VAT is likely to significantly enhance revenue productivity of the tax system. The effort will be particularly rewarding if the state takes up the challenge of building a systematic management information system from the VAT returns. Although this improvement took place after GPSRMP completion, the Program gave a boost to a reform culture, which has been sustained.

52. All political parties in Gujarat agree that state enterprises should exist only in cases of market failure ensuring that adequate safeguards against state failure are in place, and that state ownership is not a substitute for regulation. GSG has initiated a second phase of SOE reform under the guidance of a body of independent experts. The responsibility to provide an SSN, at least in terms of adequate severance pay to start a new livelihood, has been successfully handed over to the SOEs, and the confidence their adherence to this system creates to those potentially affected is expected to assist in furthering these reforms.

53. The third component of reform—creation of an enabling environment for the participation of the private sector in infrastructure provision—has gone beyond that envisaged in the Program. GIDB has worked with zeal to create an enabling environment. With limited follow-on assistance from the World Bank, the capacity of GIDB to develop legal, regulatory, and implementation frameworks was strengthened. The progress in attracting private capital across a range of sectors including water supply, gas transmission and distribution, information technology, power, ports, and roads has been impressive (paras. 32–34).

IV. OTHER ASSESSMENTS

A. Impact

1. Impact on Institutions

54. The Program helped to create institutional capacity to undertake fiscal reforms. For example, the SPFRC was established in 1996 to advise the Finance Department on fiscal reform implementation. In addition to its interim recommendations in October 1998 on matters relating to introduction of the VAT, property tax, and octroi, the SPFRC deliberated on prudent expenditure management and strengthening the control process. It submitted its final report in December 2000, reworking the sustainable level of the fiscal deficit to 3% of GSDP or 3.5% of NSDP. To achieve the task by FY2005, the SPFRC developed the medium-term fiscal framework, which is updated annually. Thus the medium-term fiscal plan was initiated in Gujarat much before other states, but limited progress has been made in introducing the medium-term fiscal plan at the department level. The Finance Department faces a challenge to turn this exercise from a mechanical and revenue and fiscal deficit reduction focus, to one of output-focused performance budgeting effectively prioritizing expenditures. This is linked to building capacity in budget formulation, implementation, monitoring and control systems, and institutions; and strengthening treasury management. The Program had a positive impact on Finance Department capacity to manage tax reforms, particularly for SOE restructuring, and preparing for the recent introduction of the VAT.

55. In November 1998, GSG appointed a senior review committee for employment restructuring. The committee undertook the review of all departments, boards, corporations, and grants-in-aid institutions to identify surplus and redundant positions. The review of the actual implementation showed that only about 50% of the positions identified as surplus were

abolished. Similarly, another committee appointed in 1999 to identify schemes that have outlived their utility submitted its report in March 2000; the SPFRC endorsed its recommendations. However, little progress has been made in abolishing such schemes.

56. A cabinet subcommittee to restructure SOEs chaired by the chief minister and assisted by an independent secretariat was established along with the State Renewal Fund and VRS to provide an SSN for employees in SOEs undergoing privatization. These have helped create policy and institutional frameworks for public sector restructuring. In the second phase of SOE restructuring, the subcommittee is assisted by an independent expert committee chaired by a respected entrepreneur that recommends restructuring options for the remaining 30 SOEs in the state.

57. GIDB continues to play an important role in maintaining an enabling environment for private sector participation in infrastructure development, providing strategic advice as well as effectively forging public-private partnerships in infrastructure projects. Gujarat continues to lead other Indian states in this area and GIDB has played an important role in this. In the power sector, the establishment of an autonomous regulating authority, GERC, was a significant step in a long and politically fraught reform process, which by the mid-2000s was beginning to show positive results.

2. Socioeconomic Impact

58. Poverty reduction was not an explicit objective of the Program. However, successful fiscal consolidation measures were expected to generate fiscal space for improved allocation for social services. While the fiscal deficit projections were not met during the program period, social services expenditure was not sacrificed to meet deficit shortfalls (Appendix 3 includes an assessment of the impact of fiscal reforms on key human development ratios). The incidence of poverty in Gujarat is lower than the national average with the percentage of Gujarat's population living below the poverty line reduced during the 1990s from 22% to 13% in rural areas, and 28% to 16% in urban areas.⁴⁴ Approximately 4.2 million rural and 1.5 million urban poor are estimated to have moved above the poverty line during the same period. The high economic growth and relatively strong employment figures have contributed to the relatively low incidence of poverty in the state. Migration is a major coping strategy of people living in environmentally degraded regions with poor nonfarm employment opportunities. With Gujarat's growth strategy, it has become a magnet for migration from tribal regions, poor agricultural and fishing areas, as well as small urban centers. This migration seems to enable migrant households to survive in the lean season, which has helped reduce the incidence of poverty in the state.

59. The GPSRMP-supported fiscal management reform explicitly focused on the compression of fiscal deficits and ignored the reprioritization of expenditures to achieve human development goals. Although separate program components dealt with tax and expenditure reforms, and to some extent capital expenditures, the Program did not have any provision to protect spending on social sectors when expenditure compression had to be made. Social expenditures are easy to reduce when expenditure compression as a part of fiscal adjustment is implemented.

60. The public expenditure ratio, measuring the percentage of state income that goes into public expenditure, increased over the long term with a marked increase during FY1996–2000

⁴⁴ Datta, K. L. and S. Sharma. 2000. *Level of Living in India*. Planning Commission. New Delhi. GOG's Blueprint for Infrastructure in Gujarat 2020 cites a state-wide figure of 14% living below the poverty line in 2003.

from 19.6% to 33%, although the FY2000 and FY2001 figures were boosted by the response to the early 2001 earthquake. Since FY1999, this figure has been maintained around the UNDP norm of 25%. The social sector ratio measuring the percentage of total expenditure allocated to social services is marginally higher in FY2004 than in FY1991, but has remained between 5 and 8 points below the UNDP norm of 40%. However, it showed slight upward movement during the first 3 years of the Program and of course in FY2000 and FY2001. Of some concern though is the trend of the social priority ratio, which measures the percentage of social expenditure devoted to human priority concerns (education, health, water, and sanitation). Although well above the UNDP norm of 50% since FY1991, being around the mid-70% range until FY1996, it fluctuated through the program period dropping 10% over 4 years as a result of a succession of natural disasters, and a further 18% in FY2001 as a result of the large-scale communal disturbances in early 2002, before settling at around 60% after FY2002. The human development ratio, the product of these three ratios, measuring the percentage of state income devoted to human priority concerns, has shown long-term improvement with a rapid rise during the program period.

61. The socioeconomic impact of SOE reforms was mitigated by VRS measures, in particular the provision of severance pay to retrenched employees. Although included in the design, activities such as retraining and counseling were not implemented. All employees were left to their own devices to deal with the experience of being retrenched and finding alternative employment. The financial effect of the closure of a number of SOEs on the people and small business owners living and working close to these SOEs was not addressed. Again although planned in the Program, a study was not undertaken to assess the socioeconomic impact of SOE reforms on employees.

62. As part of the preparation of policy-based program loans, ADB introduced a poverty impact assessment (PIA) tool in 1995 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 GPSRMP was one of the first loans to include a PIA as a supplementary appendix. Its PIA was constructed as a final step in the formulation process, rather than as a design tool linked directly to the DMF. The PIA notes that with the exception of SOE divestment, and revision of power and water tariffs, most policy actions will have a neutral short-term effect on the poor, with all having positive medium- to long-term effects. The State Renewal Fund-funded SSN will mitigate the negative divestment effects. The PIA argues that the Program's targeting of increased outlays for social and economic services will contribute to poverty reduction by providing a basis for sustained economic growth and development. The GSPRMP focused on economic growth in productive sectors; improvement of public resource allocations to social sectors was not mentioned as an indicator in the DMF (para. 58). At best, the allocation to social services was not cut as a result of reform measures (para. 59 and Appendix 5).

3. Impact on the Environment

63. The Program, categorized as environmental category B, had no direct environmental impact. While this is strictly correct, as a result of successfully creating an enabling environment for public-private partnerships in developing the state's infrastructure and industrial base, a number of large projects have been implemented. Today Gujarat does not have an environment or a resettlement policy to govern these aspects of the state's development.

4. Impact on Anticorruption

64. 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,⁴⁵ approved in 1995, recognized that corruption needed to be addressed through a governance framework. ADB's anticorruption policy was not approved until 1998.⁴⁶ Although the GPSRMP did not specifically identify how policy actions might support GSG's anticorruption endeavors, in retrospect the Program included a number of measures that would contribute to reducing the incidence of corrupt practice by government officials. Some examples include (i) implementing a range of measures to simplify the taxation system and computerize its administration; (ii) upgrading budget policy formulation, planning, management, and control systems; and computerizing the various revenue, expenditure, treasury, and debt accounts; (iii) introducing contentious measures to raise electricity tariffs, and creating an independent regulatory authority to address subsidy abuse; and (iv) closing loss-making SOEs and improving corporate governance aspects of those remaining in operation.

B. Asian Development Bank Performance

65. ADB's performance is rated as satisfactory.⁴⁷ After the commendable effort from ADB staff and GSG counterparts to design the Program, without the assistance of preparatory TA, ADB's monitoring through headquarter missions was variable over the first 3 years of implementation. The first review mission fielded after loan approval in December 1996 was in May 1997, followed by a second in September 1997, a third in September 1998, and another in March 1999. This was a time of political change in the state, and the role of India Resident Mission staff in monitoring throughout the Program was essential. However, in 2000 the intensity of ADB monitoring missions increased significantly to reach agreement on what constituted sufficient compliance for the final tranche release. This was partly in response to GSG's assessment of progress in a report submitted to ADB in December 1999 with a request to extend the loan closing date by 3 months to March 2000. GSG proposed that the necessary conditions had been satisfied, and where this was not the case proposed amendments to conditions to avoid the significant additional costs full compliance would entail. Agreement was eventually reached that the loan closing date would be extended to 31 December 2000 with a minimum set of conditions to meet ADB Board requirements. During this period ADB Board members undertook a mission to India, including a visit to Gujarat, during which Board members emphasized the importance of meeting agreed conditions. Once conditions were met, disbursements were made in a timely fashion.

C. Borrower Performance

66. The performance of GSG, including the Finance Department as Executing Agency, was rated as satisfactory (footnote 47). The Finance Department met loan administration requirements. The various institutional mechanisms were established and performed their functions, although the delay in establishing the SPFRC was considerable. The decision for GIDB, rather than its administrative department, to be the Executing Agency for TA to strengthen GIDB (footnote 34), was unusual. Government officials were proactive, supportive of the program reforms, and available for discussion, including with the OEM some 5 years after

⁴⁵ ADB. 1995. *Governance: Sound Development Management*. Manila.

⁴⁶ ADB. 1998. *Anticorruption Policy*. Manila.

⁴⁷ Based on a four-point scale of unsatisfactory, less than satisfactory, satisfactory, or highly satisfactory.

program closure. In late 1999, GSG submitted a detailed progress report outlining the reform achievements. After program completion, at the national Government's request, ADB conducted an independent review of the GPSRMP in 2001 to provide lessons for other states (footnote 7). This was a sound initiative, and reportedly informed reform options being considered by the Government at the time.

D. Technical Assistance

67. ADB provided \$2.73 million for four stand-alone TA projects and an attached TA to the loan designed to build institutional capacity to implement the reforms. All four stand-alone TA projects were approved in 1996 in relatively quick succession prior to loan approval. After the first small-scale TA, the following three were advisory rather than project preparatory, providing limited input to the program design. The OEM conducted in-depth analysis of the three TA projects supporting SOE reform (Appendixes 6, 7, and 8), and an earlier TA performance evaluation report analyzed the TA supporting finance reforms (footnote 5). This section includes a summary of the five TA projects approved to support the GPSRMP drawing on these assessments.

68. **Capacity Building of Public Sector Restructuring** (footnote 39). This small-scale TA was to develop the capacity of GSG officials in designing and implementing the SOE reforms exposing policy makers, implementers, and other concerned groups to institutional frameworks for privatization. Two senior officials attended a 10-day course on options, techniques, and financing of privatization, at the Asian Center for Development Studies in Malaysia; and another attended a 1-month course on privatization and regulatory reforms at Harvard University. A 3-day workshop on SOE restructuring and privatization for 40 mid-level officials was conducted by the Indian Institute of Management in Gujarat. This small-scale TA was rated as successful in exposing key officials to issues pertaining to SOE reforms. While most officials were involved in the reform process during the Program, they have since been transferred or left government service.

69. **Restructuring of State-Owned Enterprises of Gujarat** (footnote 29). This TA was to strengthen the Technical Secretariat responsible for managing SOE reforms. The OEM rates the TA overall as successful. It was consistent with the GSG Public Sector Restructuring Program and ADB's India country strategy. A successful mix of experienced international and national consultants and the use of appropriate training methods enabled GSG to implement SOE reforms. Manuals and training materials prepared under the TA continue to be updated and used in the subsequent phases of SOE reform (Appendix 6).

70. **Capacity Enhancement of the Gujarat Industrial Investment Corporation** (footnote 30). The TA aimed to enhance GIIC's capacity to develop and finance infrastructure projects in Gujarat. Although the TCR rated the TA generally successful,⁴⁸ the OEM rated it as unsuccessful. Ensuring that audits of SOEs' finances were up-to-date was not conducted systematically under the Program. In the case of GIIC, this was particularly unfortunate. When the TA was completed, GIIC was found to be in dire financial straits. As a consequence, all lending was suspended, staffing was reduced, and the focus was on debt recovery. The TA consultants conducted training, and prepared manuals and procedures for GIIC's prior role. However, given the shift in focus, these were unused. Although GIIC has been able to reduce its debt burden over the past 5 years, the GSG phase II SOE reform task force has recommended the corporation be closed. No action had been taken at the time of the OEM (Appendix 7).

⁴⁸ This is the equivalent of "successful" on the current 4-point scale.

71. **Support of Gujarat Public Finance Reforms** (footnote 28). The TA aimed to build institutional capacity of the Finance Department; improve budget policy, planning, management, and control systems; and modernize and computerize the tax and expenditure divisions. The TA, rated generally successful in the TCR, delivered important inputs to GSG's effort to reform revenue and expenditure management. The TCR indicates that the TA reports and workshops provided important inputs to Gujarat's public finance reform process, although they came late, due to implementation delays and lack of government support—the 2.5-year delay in operationalizing the SPFRC meant the TA consultants did not have an appropriate counterpart to receive feedback on policy recommendations.⁴⁹ The postprogram assessment (footnote 7) indicates that the TA enhanced the technical capacity of Finance Department officers to deal with the complexities of budget management; however it notes that ADB overlooked the large sales tax exemptions given by GSG as an incentive to investors during the program period, the impact of which weakened overall fiscal performance. The TA performance evaluation report rated the TA as partly successful, recognizing it delivered a few good although not particularly innovative outputs, but as the consultants operated in isolation from GSG, the TA failed to significantly build capacity within the Finance Department.

72. **Capacity Building of GIDB** (footnote 32). This TA was attached to the loan to build GIDB capacity to play a strategic and nodal agency role in formulating infrastructure policies and promote private sector participation in infrastructure development. The OEM rated the TA as highly successful. GSG prioritized the establishment of a sound policy and regulatory framework, and administrative mechanisms to stimulate private sector investment in public infrastructure. The TA was consistent with ADB's India strategy and in particular the GPSRMP outcome. GIDB was able to utilize the experience and lessons identified during the TA to put in place a legal framework for public-private partnerships. Sector policies, procedures, and manuals contributed to ensuring order, transparency, and equal access in developing such partnerships. A sound mix of consultant inputs and training methods ensured outputs were put to good use. GIDB continues to provide quality services leading infrastructure planning and development in the state (Appendix 8).

V. ISSUES, LESSONS, AND FOLLOW-UP ACTIONS

A. Issues

73. **Strategic Support to Reform.** As suggested by the ADB Board, the timing and sequencing of reforms are issues. The original 2-year time frame was extended to 4 years, and a number of reforms continue some 10 years after the design phase. While the duration of a specific intervention is an issue, and clearly a 2-year design frame is insufficient for such complex reforms, a broader strategic issue relates to ADB's support for reform. After completion of the GPSRMP, ADB did not provide any follow-up support.⁵⁰ The observation of one Board member was that the amendments to the final tranche conditions appeared to be to close the Program rather than meet reform objectives. This raises the question of whether ADB was more committed to the reform process or the Program that was supporting those processes. The lack of additional TA resources to respond to changing needs during implementation or after closure suggests that the commitment was to the latter. By the time the GPSRMP had closed, a similar program loan had been approved in a second state, and another was in the early stages of preparation in a third state. From a country partnership strategy perspective, ADB and the

⁴⁹ The consultants finished their fieldwork in January 1999 as the SPFRC held its first meeting.

⁵⁰ For example, the World Bank provided assistance to GIDB after conclusion of the ADB TA.

national and respective state governments should assess the degree to which ADB can be a strategic partner in public resource management reform over the long term, recognizing that the nature and scope of support will change over time.

74. **Design.** The logic of three outcomes—fiscal consolidation, SOE reform, and creation of an enabling environment for private sector participation—to contribute to the impact was sound. However, the descriptions of the GPSRMP in the RRP text, DMF, and policy matrix were inconsistent.⁵¹ The RRP text states one objective, three components, and three outputs; whereas the DMF details six component statements and no output statements, and the 57 activities are a mix of rephrased conditions and covenants. The GPSRMP was designed as ADB introduced the DMF as a mandatory requirement. 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 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.⁵² The policy actions, many of which become tranche conditions or covenants, were a mix of measurable outcomes, outputs, and processes. While some of the monitoring indicators are appropriate, a number are ‘activities’ and some are outside the control of GSG. Generic assumptions and risks are identified, but are not clearly distinguished to enable mitigation measures to be developed to address risks.

75. **Quantitative Fiscal Targets.** In designing a fiscal reform program, should fiscal targets with monitorable indicators be tranche conditions, or should conditions be limited to the reform processes to achieve fiscal consolidation? This question was raised in ADB’s postprogram assessment (footnote 7) and the PCR (footnote 8). In the GSMRP, both quantitative fiscal deficit targets and processes such as tax and expenditure reform and restructuring of public enterprises were tranche conditions. Indeed, a case can be made for including both the nominal outcomes and processes as conditions because the degree to which the reform processes are implemented determines the desired outcomes. However, recognizing that such outcomes can be influenced by a variety of factors that may be within or beyond the control of the states is important. In the case of Gujarat for example, the target variable was the fiscal deficit and the size of fiscal deficit can be varied by the state government by not paying out the subsidies or other dues to state enterprises including GEB, or collecting tax revenues in advance, or delaying contractors’ payments. Furthermore, insufficient provision was made in the design to take account of national Government policy shifts.

76. **Setting Fiscal Targets.** The targeted fiscal deficit of 3.5% of SDP in FY1998 and 2.7% in FY1999 appeared to be derived on the basis of a broad judgment rather than from the application of any model. It is also not clear that the targeted reforms in tax, expenditure, SOE, and other policies were sufficient conditions to enable the state to reduce its fiscal deficit to the targeted level. The target seems to be too restrictive and setting a restrictive target could constrain resources for public spending on investment in much-needed infrastructure. In fact, when no control is placed on the over-revenue deficit and only the fiscal deficit target is fixed,

⁵¹ Unfortunately based on OED evaluation findings and review of the draft RRP for proposed programs, this issue remains today. For example the *2005 Panel Report to Management on the Quality-at-Entry of ADB Projects and Country Strategies Approved 2004–2005* recently completed by OED, which finds “the criterion of development objectives, evaluability 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).

⁵² 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.

the constraint on infrastructure spending could be even more binding. The state could not comply with the target mainly due to exogenous shocks, and the SPFRC reworked the target based on its sustainability model at 3.5% for FY2005. Even the TFC's target was that the states taken together should phase out their revenue deficits and limit the fiscal deficit to 3% of GDP by FY2008.

77. **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 national 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 the states. However, based on the recommendation of the Eleventh Finance Commission, the Government initiated incentive-linked grants requiring each of the major states to reduce its ratio of revenue deficit to total revenues by 5% every year for the 5 years beginning FY1999. In Gujarat, the GPSRMP was seen as an additional target that had to be reworked, first to adjust for the effect of natural calamities, and later based on the recommendation of the SPFRC to conform to its sustainability conditions.

78. **SOE Reform.** The most difficult area of reforms for the Indian states is restructuring of SOEs. GSFC had done considerable work and identified the units for privatization, restructuring, or closure. However, the audited statement of accounts of SOEs were in arrears by an average of 8 years, so judgments on the most appropriate reform for each SOE were made in the absence of complete knowledge of financial status. Where closure was proposed, its meaning was not clearly defined. Within a 2-year program time frame, the best that could be achieved would be operating closure. Financial closure would be expected to take at least 3 years and legal closure 5 years. Operating closure was achieved with as expected financial and legal closure awaiting the completion of the liquidation process, which in some cases has yet to be settled.

79. **Naming of SOEs.** Identifying SOEs for privatization or partial divestment in tranche release conditions negatively affected GSG's negotiating position with investors submitting bid prices well below enterprise valuation in the knowledge that GSG was under pressure to come to an agreement for ADB to release a loan tranche. The adoption of a two-stage process of divestment with an interval of 1–2 years between each stage assumed that the second stage would produce higher value realization. However, the risks included GSG changing its position to divest the balance due to policy changes or the transfer of key officials, and change in the investor's interests due to internal policies or market forces. In the cases of GTCL and GMDC, these risks appeared to be realized, questioning the value of adopting this approach.

80. **Expenditure Reform.** Where the ultimate objective of fiscal reforms is to accelerate growth and reduce poverty in a sustainable manner, a balance between revenue and expenditure reforms is required. For example, sales tax exemption incentives estimated to aggregate to 50% of the fiscal deficit were overlooked, and addressing power sector subsidies, which rose sharply during the Program, were deemed to be too politically difficult to address. Subsidies have a significant impact on a state's fiscal condition but are politically difficult to address. Future programs need to look carefully at subsidies during design, and formulate a strategy including a proactive public awareness campaign. The Program's fiscal management reform focused unduly on the compression of fiscal deficits, and paid insufficient attention to reprioritization of expenditures to achieve human development goals. Preparing a medium-term fiscal plan that is not linked to the budget limits the ability to affect program budgeting and exert more control over expenditure compression interventions. The Program did not have any provision to protect spending on social sectors when expenditure compression had to be made.

Social expenditures are often the first to be reduced when expenditure compression is implemented as a part of fiscal adjustment. In Gujarat, the allocation to social priority areas decreased from FY1999 to FY2001, with the reduction being particularly severe in FY2001, partly due to the earthquake in January 2001, but more importantly due to large-scale communal disturbances in February 2002. Given the systems introduced under the Program to prioritize spending, considerable effort at restructuring expenditures is expected in the coming years.

81. **Continuing Reform.** The iterative nature of reform creates opportunities to deepen and broaden aspects of reform including: (i) continuing the reform of stamp duties and property taxes; (ii) finding an alternative to phasing out octroi; (iii) taking advantage of the opportunity to extend the medium-term fiscal plan to all departments, to prioritize expenditures, and more importantly insulate socially productive expenditures on human development and physical infrastructure from ad hoc expenditure compression measures; and (iv) implementing performance-based budgeting, making departments accountable for their expenditure against measurable outcomes.

82. **ADB Board.** A correlation exists between the lessons reported in the PCR, the postprogram assessment, this OEM, and some of the issues raised by the ADB Board in approving the GPSRMP. A review of the minutes of Board meetings discussing progress reports does not refer to concerns raised in the meeting approving the loan. This raises the question of how Management responds to ensuring that the Board's concerns are addressed during implementation, and how the Board monitors that its concerns are being addressed when progress reports are discussed.

B. Lessons

83. **Strategic Commitment to Reform.** Public sector reforms are an iterative process over 5–10 years. While the OEM rated the GPSRMP successful, the 2-year design provided insufficient time to achieve the reform agenda, and did not adequately anticipate the complexity of implementation or the impact of exogenous factors. This is equally applicable to SOE reforms, where neither the technical complexity nor the time required to implement different SOE reform options, was adequately recognized in the design. At the time of the OEM, about 10 years after the Program was designed, SOE reforms continued. Reforms require a long-term commitment combining loan and adequate grant resources in different configurations in response to the progress of reforms. Ideally, an indicative allocation of additional resources should be programmed at the design stage.

84. **Quantitative Targets** are important to focus reform and its inherent processes. However, if quantitative targets must be used as loan conditions or targets in national-state reform agreements, the assumptions and limitations of such targets, along with transparent mechanisms to address the impact of exogenous influences, need to be clearly defined in the design. This applies equally to process conditions focusing on developing systems and institutional capacity, where the magnitude, sequencing, and pace to achieve the outcome may also require renegotiation during implementation. Institutional mechanisms are required to adequately respond to changes during implementation that materially affect loan conditions. This may include Management having the flexibility to make adjustments to ensure achievement of outcomes without having to revert to the ADB Board. An alternative is to focus loan conditions at a broader level of balanced budget over the cycle and use quantitative targets as indicators over a longer period.

85. **Exogenous Factors.** Central Government policy change or natural calamities are exogenous factors that are not highly improbable risks, but rather events that are reasonably likely to occur in the medium term. Perhaps they should be treated more like assumptions than risks. Irrespective, policy actions, tranche conditions, and covenants should be individually assessed in terms of the effect exogenous factors could have on them and mitigation measures designed accordingly. However, as the impact of natural disasters is particularly difficult to estimate and mitigate, mechanisms to review conditions and covenants either negatively or positively impacted by such factors need to be clearly specified in the design.

86. **Align Reform Targets.** A state lending program by multilateral institutions, constitutionally must involve the national Government, which is the Borrower, onlending to the states. Mechanisms need to be in place to align reform targets between ADB, the state, and central Government. This also requires flexibility within ADB for Management to make adjustments required to achieve outcomes.

87. **Anticorruption.** Public resource management programs provide an opportunity to explicitly target revenue and expenditure reforms to support GSG's anticorruption agenda.

C. Follow-Up Actions

88. By the fourth quarter of 2007, in formulating the India 2007–2010 country partnership strategy, the OEM recommends that ADB's state support strategy as revised in the 2003–2006 country strategy and program⁵³ should be reviewed to assess opportunities to support priority aspects of ongoing state public resource management reforms, and the most appropriate funding modalities to achieve jointly agreed outcomes.

⁵³ ADB. 2003. *Country Strategy and Program (2003–2006): India*. Manila.

ANALYSIS OF THE PROGRAM AND POLICY FRAMEWORKS OF THE GUJARAT PUBLIC SECTOR RESOURCE MANAGEMENT PROGRAM

Table A1.1: Design and Monitoring Framework

| Design Summary | Measurable Indicators | Monitoring Mechanism | Assumptions or Risks |
|---|---|--|---|
| <p>1. Goal</p> <p>Improve public sector mobilization and allocation, and enhance efficiency of its use to promote industrialization.</p> | <p>Reduced deficit and improved domestic resource mobilization</p> <p>Public expenditures reoriented to high priority productive sectors</p> <p>Enabling environment created that promotes private investment</p> <p>Increased savings and investment to assist in raising the state domestic product (SDP), which is likely to grow by more than 6% annually</p> | <p>Finance Department to prepare reports on the Medium-Term Fiscal Policy Framework (MTFPF) and tax reforms that will mobilize additional resources</p> <p>Expenditure Priorities Committee will monitor reorientation of public expenditures</p> <p>Gujarat Infrastructure Development Board (GIDB) to coordinate with sector ministries to monitor development of policy environment</p> <p>Gujarat Bureau of Statistics generates statistics that will facilitate monitoring trends in investment, savings, fiscal accounts, SDP, and infrastructure indicators</p> | <p>Political acceptability of fiscal stringency and tax reforms being taken to mobilize domestic resources</p> <p>Sector ministries/constituencies acceptance of the reorientation of public expenditures</p> <p>Timely operation of GIDB and its ability to effectively coordinate rather than encroach upon domain of sector ministries</p> <p>Success of the MTFPF is contingent on stable political and external environment to allow for steady economic growth. Exogenous shocks such as adverse weather and national policies, which are outside the ambit of the state, could have an adverse impact on growth and fiscal stability and environment for the private sector.</p> |
| <p>2. Program Objectives</p> <p>Restore and sustain fiscal stability, and improve fiscal capabilities and management.</p> | <p>Gujarat's fiscal deficit to be reduced to 2.0% of SDP by 1999/2000 through increase in current revenues by about 0.4% of SDP and a proportionate decrease in current expenditure/SDP ratio annually</p> | <p>Finance Department to provide budget documents and undertake regular monitoring of the MTFPF to indicate compliance with the associated policy simulations</p> | <p>Achievement of desired reduction in fiscal deficit while undertaking key structural reforms of taxes and other areas that entail high adjustment costs that have to be financed by the budget</p> |

| Design Summary | Measurable Indicators | Monitoring Mechanism | Assumptions or Risks |
|---|---|--|---|
| <p>Reduce the size of the public sector in commercial activities, and introduce more competition and efficiency in state-owned enterprises (SOEs).</p> <p>Create a conducive environment to augment private sector participation in critical infrastructure projects.</p> | <p>Public Sector Restructuring Program (PSRP) adopted, which includes privatization or divestment and restructuring of 23 of the 54 SOEs</p> <p>Sector policy, and regulatory and institutional framework introduced for three key infrastructure subsectors, including power, ports, and roads</p> | <p>The Technical Secretariat for Privatization to oversee and advise on implementation of the PSRP and provide progress report on SOE reforms cabinet subcommittee to approve reform recommendations</p> <p>Each sector ministry/parastatal involved in development of power, roads and bridges, and ports to provide the respective sector policies and proposals to the Asian Development Bank (ADB), Finance Department, and GIDB</p> | <p>No political and labor resistance of SOE reforms and timely development of capabilities across concerned agencies to implement SOE reforms</p> <p>Conductive capital market conditions to allow for success of the SOE public issues at the scheduled timetable</p> <p>Development and resolution of national outstanding issues of the private sector policy framework that supports evolution and direction of the state policy</p> <p>Appropriate and timely capacity building at sector ministries and parastatals to allow for the development and implementation of policies</p> |
| <p>3. Program Components</p> <p>To achieve desired reduction in fiscal deficit, agree to</p> <p>(i) reform state and municipal taxes,</p> <p>(ii) enhance cost recovery, and</p> <p>(iii) reorient public expenditures.</p> <p>Develop capabilities for improving fiscal discipline and management:</p> <p>(i) budget formulation and implementation,</p> <p>(ii) restructuring taxes, and</p> <p>(iii) implementation of public expenditure</p> | <p>Finance Department to introduce tax reform proposals and tariffs for power and irrigation, agreed upon with ADB in 1997/98 budget, on expenditure side, Finance Department to adopt stringent controls on current expenditures to raise capital expenditures to 2.6% of SDP and protect these outlays by introducing a core investment program (CIP)</p> <p>Finance Department will strengthen budgetary policy simulation capabilities, and expenditure monitoring. A directorate of taxation will be established by consolidating tax wings under it. In addition, a state public finance reform committee (SPFRC) is set up to support the Finance Department to advise on and implement various components of public</p> | <p>Finance Department to provide finance bill with details on new tax measures and notification for tariff revisions, while Expenditure Wing to provide CIP report</p> <p>Working groups on tax, expenditure, and computerization of the Finance Department will provide reports on strengthening of budgetary practices and development of in-house capabilities</p> | <p>Weakness in fiscal management and delays in strengthening of expenditure and tax wings</p> <p>Revenue growth could be adversely affected by the loss of revenue stemming from tax reforms, and lower than envisaged industrial growth</p> <p>Difficulties in maneuvering expenditures in the short term because of pressures to implement the National Commission Pay award and other exogenous factors</p> <p>Sector ministries to resist reorientation of the development outlays and their lack of ability to prioritize development program</p> |

| Design Summary | Measurable Indicators | Monitoring Mechanism | Assumptions or Risks |
|--|---|--|---|
| <p>reforms.</p> <p>Undertake a substantial reform of SOEs, with the objective of opening these corporations to enhanced competition and improved corporate governance with better accountability.</p> <p>Focus on development of key infrastructure sectors:</p> <p>(i) power,</p> <p>(ii) ports, and</p> <p>(iii) roads.</p> <p>Develop regulatory and institutional mechanisms for private sector participation.</p> | <p>finance reforms</p> <p>Reforms of SOEs to include privatization of 7 SOEs, partial divestment/ restructuring of 3 SOEs, merger of 6 SOEs, and closure of 4 SOEs. The companies targeted for reform include strategic companies involved in diverse activities such as product/mineral development, industrial development, and financial institutions.</p> <p>Introduction of sector policies and development of legal regulatory guidelines and procedures to introduce equal opportunities for infrastructure projects</p> <p>Address pricing issues</p> <p>Introduction of appropriate build-own-operate (BOO)/ build-own-transfer (BOT) arrangements; subcontracting, privatization, and joint ventures; and regulatory framework/bodies for these sectors</p> | <p>The Technical, Secretariat, with support of Price Waterhouse (International Privatization group) will provide a progress report on the implementation of SOE reforms.</p> <p>Government of Gujarat (GOG) to announce power, roads, and ports sector policies and introduce legal and regulatory guidelines by specific sector ministries</p> <p>Upward adjustment in tariffs of these services</p> <p>BOO/BOT policy framework and action plan for regulatory framework</p> | <p>Political resistance to selling SOEs</p> <p>SOE management and labor resistance</p> <p>Inability to sell the SOE within the stipulated time frame because of weak trends in capital market</p> <p>Uncertainty regarding response of buyers to the price at which the government may be interested in selling</p> <p>Lack of public sector capability to undertake restructuring and privatization of SOEs</p> <p>Effective implementation of policy and regulatory frameworks</p> <p>Public acceptability of the increase in power tariffs, port charges, and tolls on roads</p> <p>Timely and effective adoption and development of capacities for implementing BOO/BOT associated regulatory framework</p> |
| <p>Initiate restructuring of two key public utilities, Gujarat Maritime Board (GMB), which handles development and provision of port and associated services and Gujarat Electricity Board (GEB), which oversees power.</p> | <p>Initial steps to restructure GEB involve transfer of GEB generation to new entity while improving GEB's distribution centers and developing an autonomous or separate regulatory authority. GMB is also to restructure itself by separating the port development and dredging functions from regulatory</p> | <p>Finance Department to coordinate with these agencies to provide adequate reports to ADB on restructuring of GEB and GMB, and status of new companies created</p> | <p>Acceptability of the unbundling GMB and GEB by its staff and timely operationalization of the new companies to provide continuity to development of services concerned</p> <p>Resistance of both management and labor of GEB and GMB to unbundling of these parastatals</p> |

| Design Summary | Measurable Indicators | Monitoring Mechanism | Assumptions or Risks |
|--|---|--|--|
| | functions. | | |
| <p>4. Activities</p> <p>Adopt and implement adherence to the MTFPF for 1997/98 to 1999/2000.</p> <p>Implement sales tax reforms.</p> <p>Reform other state taxes:</p> <p>(i) stamp duty,</p> <p>(ii) profession tax,</p> <p>(iii) tax on goods and passengers, and</p> <p>(iv) motor vehicle tax.</p> | <p>Fiscal deficit to be reduced to 3.5% of GDP in 1997/98 and to 2.7% by 1998/99, on the basis of the average increase in current revenue/GDP ratio annually of about 0.4 and a proportionate reduction in current expenditures/GDP ratio</p> <p>Sales tax rates reduced from 23% to 7% and the prohibited list from the current 63 to 20 items to increase items eligible for sales tax, adopt a single-tier system to simplify tax assessment, and merge turnover tax with the sales tax</p> <p>Sales tax administration upgraded and modernized staff trained in administration of value-added tax (VAT), and public information campaign introduced</p> <p>(i) Rate schedule rationalized and valuation system for stamp duty strengthened</p> <p>(ii) Rationalization of tax abolished by developing a new rate structure that exempts low-income groups while raising income from higher income groups</p> <p>(iii) Rate schedule simplified and consolidated</p> <p>(iv) Shift from the weight-based to a composite ad valorem tax</p> | <p>Finance Department to submit annual and year-end reviews to ADB of the MTFPF along the lines agreed upon. In addition, GOG to provide annual budget documents and other related tables to allow staff to assess and monitor the budget</p> <p>Tax policy division of Finance Department to provide new sales tax rates schedule and amended Sales Tax Act</p> <p>Consultants of ADB technical assistance (TA) to finalize and discuss action plan of the VAT</p> <p>Training of staff of sales tax administration (both local and international) to develop familiarity with the VAT and its implementation</p> <p>ADB will be provided with new rate schedule and amended legislation for this taxes</p> | <p>Reduction of fiscal deficit is attainable if no adverse exogenous developments such as natural disasters and need to implement the National Pay Commission award</p> <p>Minimum resistance from the business communities with regard to the sales tax reforms and the eventual move toward the VAT, which, will include withdrawal of industrial concessions and exemptions under sales tax reforms</p> <p>Inadequacy of funds to train the required number of staff</p> <p>Introduction of more stringent valuation system for property tax and stamp duty, and proper enforcement of tax administration</p> |

| Design Summary | Measurable Indicators | Monitoring Mechanism | Assumptions or Risks |
|---|--|---|---|
| <p>Reform key municipal taxes.</p> <p>Improve cost recovery.</p> <p>Rationalize and prioritize public expenditures.</p> <p>Upgrade fiscal policy and management capabilities.</p> <p>Develop reform plan for SOEs and associated institutional mechanism.</p> <p>Privatize SOEs by selling them to a strategic partner with management control.</p> | <p>Review of property of tax and octroi, GOG to hold consultations with local governments, which will adopt feasible recommendations of these studies</p> <p>Power tariffs and irrigation charges increased</p> <p>CIP introduced in 1997/98 budget in the context of the Ninth Five-Year Plan</p> <p>Capital expenditures increased from 2.1% of GDP in 1996/97 to 2.6% in 1998/99</p> <p>The SPFRC is set up</p> <p>Budget policy formulation, planning, management, and control systems, and expenditure administration upgraded and computerized</p> <p>State Cabinet's approval for divestment and restructuring of 23 SOEs, and setting up of a technical secretariat and Cabinet.</p> <p>Subcommittee to approve reforms for SOEs</p> <p>Sale of Gujarat Communications and Electronic Ltd. and Gujarat Tractor Corporation Ltd., two of Gujarat Agro Industries Corporation Ltd. (GAIC) subsidiaries, and Gujarat State Electricity Company Limited (GSECL).</p> <p>51% divestment of Gujarat Industrial Investment Corporation and Gujarat Mineral Development Corporation.</p> | <p>Reports on property tax and octroi reforms to be provided by ADB, and adoption of agreed upon recommendation</p> <p>ADB will be provided with CIP, and EPC will regularly monitor the implementation of CIP and other public expenditures</p> <p>SPFRC to submit a progress report on public finance reforms as submitted by the SPFRC</p> <p>Technical Secretariat, with assistance from the Price Warehouse consultants, to report progress on SOE reforms</p> <p>Technical Secretariat to provide bidding document, prequalification status</p> | <p>Municipalities resist adoption of more stringent assessment of properties and local governments' opposition of withdrawal of octroi</p> <p>Capabilities of sector ministries to develop sector CIPs, and their timely integration into an overall CIP</p> <p>Resistance of bureaucracy to adopt better fiscal management and computerization</p> <p>Political and labor union resistance against the privatization and restructuring of SOEs</p> <p>Appropriate management and administrative capabilities to undertake reforms of SOEs</p> <p>Availability/interest of suitable strategic partners that bid inline with authorities' expectations</p> |
| Partially divest of SOEs. | <p>(i) 51% investment of Gujarat State Financial Corporation</p> <p>(ii) 49% divestment of GAIC</p> | Technical Secretariat provides status report on transfer of these SOEs to strategic | |

| Design Summary | Measurable Indicators | Monitoring Mechanism | Assumptions or Risks |
|---|--|---|--|
| <p>Merge SOEs.</p> <p>Restructure SOEs.</p> <p>Close SOEs.</p> | <p>(iii) 26% divestment of Gujarat Industrial Development Corporation (GIDC)</p> <p>Gujarat State Leather Industry Development Corporation with Gujarat Rural Industries Marketing Corporation, and Gujarat State Handicraft Corporation with Gujarat Handloom Corporation</p> <p>Gujarat Housing Board and Gujarat Slum Clearance Board</p> <p>Lease or sell 30 properties of the Tourism Corporation of Gujarat Ltd.</p> <p>Board for Industrial and Financial Reconstruction (BIFR) approval for the closure of 11 mills of Gujarat State Textile Corporation</p> | <p>partner</p> <p>SOEs' regular reports to Technical Secretariat on progress made</p> <p>Company Law Board to approve merger proposals of these SOEs, and Technical Secretariat to provide ADB with report on the final execution of merger</p> <p>Technical Secretariat to provide a final report on restructuring of these SOEs.</p> <p>Tourism Corporation of Gujarat Ltd to provide a report to Technical Secretariat</p> <p>BIFR notification and settlement and dues of workers and auditor's report submitted to ADB along with plan with closure of these SOEs and BIFR approval for such closure if required</p> | <p>Bearish capital market conditions in India.</p> <p>(i) Timely acceptability of central Government and states to amended State Financial Corporation Act, 1951</p> <p>(ii) Divestment of GIDC depends on its corporatization and satisfactory resolution of its land acquisition powers</p> <p>Synergies from merger and adequate settlement of labor and debt in the process of merger</p> <p>Adequate settlement of losses of Gujarat Slum Clearance Board and its role in development of low-income housing</p> <p>Political and labor acceptability of closure of SOEs</p> |
| <p>Develop a social safety net mechanism.</p> <p>Develop a regulatory and institutional mechanism for key infrastructure sectors.</p> <p>Reform power sector.</p> | <p>State Renewal Fund (SRF) set up.</p> <p>ADB and GOG agree on roles and functions of GIDB.</p> <p>GIDB operating with adequate staffing and budgetary allocation for project development and feasibility studies for key infrastructure sectors. GIDB expertise developed in the above areas to build capacities of sector ministries</p> <p>Power sector policy introduced and a letter of intent encourages private</p> | <p>Notification for its budgetary operationalization and allocation for SRF</p> <p>Department of industries follow-up and progress report on GIDB, and ADB TA helps develop capacities of GIDB upon which sector ministries can draw</p> <p>Energy Department report to ADB on progress of power</p> | <p>Availability of budgetary resources</p> <p>Timely and effective operationalization of GIDB and development of its capacities to play a strategic and advisory role in infrastructure development without encroaching on domain of ministries</p> <p>Effective implementation of power sector policy</p> |

| Design Summary | Measurable Indicators | Monitoring Mechanism | Assumptions or Risks |
|----------------------|---|--|--|
| | <p>sector participation in the field of power generation, transmission, and distribution, and restructuring of GEB</p> <p>Power tariffs raised to achieve at least 3% rate of return on GEB's fixed assets</p> <p>Power System Master Plan for Gujarat developed</p> <p>GSECL created and about 135 megawatts transferred from GEB to GSECL</p> <p>Restructuring of power sector legislation and regulation reviewed</p> <p>A time-bound action plan for development of a regulatory framework for the power sector developed in consultation with ADB</p> <p>GEB to convert, on a pilot basis, two of its distribution districts/circles into independent profit centers</p> | <p>sector reforms</p> <p>GEB to provide notification for the new tariff schedule</p> <p>ADB will assist and oversee the development of this plan</p> <p>Notification provided to ADB for GSECL.</p> <p>ADB will assist and oversee the development of a regulatory framework</p> <p>ADB TA provided to support reforms of these distribution centers</p> | <p>Public and industry resistance to increased power tariffs</p> <p>Adequate capabilities to assist in developing the CIP</p> <p>Effective management of GSECL and its success in mobilizing resources to expand generation capacity</p> <p>Timely approvals of state and central sector ministries and legislation for setting up this regulatory board</p> |
| Reform ports sector. | <p>Port development policy introduced</p> <p>Tenders floated and awarded to 15 port locations to privatize incomplete works of wharf/jetty, and install modern mechanical handling equipment in the existing wharves/jetties for private investment</p> <p>A policy and regulatory framework for private sector development of ports and associated facilities announced</p> <p>GMB restructured to make it more efficient and provide a better public/private interface</p> | <p>GMB report on progress on port sector reforms</p> <p>GMB has engaged Credit Rating Information Services in India, Ltd. To develop BOT policy framework and assist in regulatory framework</p> <p>GMB report on the process of its restructuring</p> | <p>Lack of familiarity of GMB to promote and regulate private ports</p> <p>Resistance of both management and labor of GMB to change, in particular,</p> |

| Design Summary | Measurable Indicators | Monitoring Mechanism | Assumptions or Risks |
|-------------------------|--|--|---|
| Reform the road sector. | <p>in the port sector</p> <p>New Gujarat Port Development Company (GPDC) developed to handle the construction of intermediate ports and to assist GMB in marketing, shipping, and project financing</p> <p>Port service development corporation set up to handle dredging and other related port services</p> <p>Ports sector CIP</p> <p>State road sector policy announced</p> <p>Bombay motor vehicle tax introduced</p> | <p>GMB report to ADB on operationalization of GPDC</p> <p>Finance Department will integrate this sector CIP in overall state CIP</p> <p>Roads and Building Department (R&BD) prepared this policy and is soliciting private sector comments</p> <p>R&BD to provide notification of these new tolls</p> | <p>privatization of the ports if this is accompanied by permission to sponsors to recruit new labor</p> <p>Success of these new companies will be dependent on provision of managerial, administrative, and financial autonomy to adopt commercial practices</p> <p>Adequate capabilities in sector ministry and GMB to formulate CIP</p> |
| | <p>Tolls levied on at least two designated state roads and bridges project under construction</p> <p>Roads sector CIP</p> <p>Private sector projects cell established within R&BD and plan approved for mobilizing staff needed to manage the processing of BOT state roads projects scheduled for award of concession contracts during 1996–1998</p> <p>List of at least six state bridge and road projects targeted for processing on a BOT basis approved</p> | <p>Finance Department to integrate roads sector CIP in the overall state CIP</p> <p>R&BD to provide GIDB with a report on experience gained</p> | <p>Adequate capabilities in R&BD to formulate sector CIP</p> <p>Lack of national consensus for BOT framework</p> <p>Lack of experience of R&BD in handling and processing BOT and projects of their financing</p> <p>Lack of agreement with sponsors on the terms and conditions of BOT projects</p> |

| Design Summary | Measurable Indicators | Monitoring Mechanism | Assumptions or Risks |
|-----------------------|--|---|-----------------------------|
| | R&BD submits to GIDB recommendations for changes, if any, to policy and regulatory frameworks for roads development by the public and private sector | <p>from negotiations of at least two private sector roads/bridges projects targeted for processing on a BOT basis during 1997-1998</p> <p>GIDB to play an important role in finalizing the policy a regulatory framework for road development in private sector</p> | |

Table A1.2: Comparison of the Gujarat Public Sector Resource Management Program Structure in the Policy Framework, Logical Framework, Policy Matrix, and Loan Agreement

| Policy Framework (RRP Section IV.C.2) | Logical Framework (RRP Appendix 4) | | Policy Matrix (RRP Appendix 3) | Loan Agreement (Schedule 5) |
|---|--|---|--|--|
| | Goal/Objectives | Components | | |
| <p>The objective is to assist GOG in augmenting domestic resource mobilization, improving allocation and efficiency of the public sector, and reducing GOG's role in commercial activities while promoting market-oriented policies to enhance private sector participation in the commercial and infrastructure sectors. This objective will be achieved by the following:</p> | <p>The goal is to improve public sector resource mobilization and allocation, and enhance efficiency of its use to promote industrialization through three objectives:</p> | | | |
| <p>1. Strengthen the state's public finances and their prudent management.</p> | <p>1. Restore and sustain fiscal stability, and improve fiscal capabilities and management.</p> | <p>1. To achieve desired reduction in fiscal deficit, agree to (i) undertake state and municipal tax reforms, (ii) enhance cost recovery, and (iii) reorient public expenditures. 2. Develop capabilities for improving fiscal discipline and management for (i) budget formulation and implementation, (ii) restructuring taxes, and (iii) implementation of public expenditure reforms.</p> | <p>I. Strengthen the state's public finances and their prudent management.</p> | <p>A. Strengthen state public finances and their prudent management.</p> |

| Policy Framework (RRP Section IV.C.2) | Logical Framework (RRP Appendix 4) | | Policy Matrix (RRP Appendix 3) | Loan Agreement (Schedule 5) |
|--|--|---|--|---|
| | Goal/Objectives | Components | | |
| 2. Privatize or divest and restructure SOEs to reduce the financial burden they impose on the budget and economy, while allowing the private sector to take the lead in commercial activities. | 2. Reduce the size of the public sector in commercial activities, and introduce more competition and efficiency in SOEs. | 3. Undertake substantial reform of SOEs, with the objective of opening these corporations to enhanced competition and improved corporate governance with better accountability. | II. Launch public sector restructuring program to privatize or divest and restructure the SOEs with the objective of maximizing efficiency and reducing GOG's role in commercial activities. | B. Reform SOEs. |
| 3. Enable private sector participation by strengthening the policy, regulatory, and institutional frameworks in critical infrastructure sectors. | 3. Create a conducive environment to augment private sector participation in critical infrastructure projects. | 4. Focus on development of key infrastructure sectors: power, ports, and roads. 5. Develop regulatory and institutional mechanisms for private sector participation. 6. Initiate restructuring of two key public utilities, Gujarat Maritime Board and Gujarat Electricity Board, which handle development and provision of port and associated services and power. | III. Evolve an enabling environment for private sector involvement in infrastructure sectors. | C. Evolve an enabling environment for private sector involvement in infrastructure sectors. |

| Program Framework (RRP Appendix 1) | Policy Matrix (RRP Appendix 3) | |
|--|---|--|
| Components | Objectives | Policy Areas |
| <p>1. To achieve desired reduction in fiscal deficit, agree to undertake</p> <ul style="list-style-type: none"> (i) state and municipal tax reforms, (ii) enhanced cost recovery; and (iii) reoriented public expenditures. <p>2. Develop capabilities for improving fiscal discipline and management:</p> <ul style="list-style-type: none"> (i) budget formulation and implementation, (ii) restructuring taxes, and (iii) implementation of public expenditure reforms. | <p>I. Strengthen the state's public finances and their prudent management.</p> | <p>I.1. Formulate and implement the medium-term fiscal policy framework. I. 2. Raise user charges to improve cost recovery. I.3. Prioritize and rationalize expenditure. I.4. Develop fiscal policy management capabilities and strengthen tax administration.</p> |
| <p>3. Undertake a substantial reform of SOEs with the objective of opening these corporations to enhanced competition and improved corporate governance with better accountability.</p> | <p>II. Launch public sector restructuring program to privatize or divest and restructure the SOEs with the objective of maximizing efficiency and reducing GOG's role in commercial activities.</p> | <p>II. 1. Develop SOE reform plan and associated institutional mechanism. II. 2. Privatize and transfer controlling interest of three SOEs: GCEL, GTCL, and GSEC. II. 3. Privatize two SOEs: GIIC and GMDC by offering 51% of GOG's shareholding. II. 4. Partially divest and restructure three SOEs: GSFC, GIDC, GAIC. II. 5 Merge SOEs and lease selected services of one SOE. II.6. Close SOE. II.7. Develop social safety net for restructuring of SOEs.</p> |
| <p>4. Focus on development of key infrastructure sectors: power, ports, and roads. 5. Develop regulatory and institutional mechanisms for private sector participation. 6. Initiate restructuring of two key public utilities, Gujarat Maritime Board and Gujarat Electricity Board, which handle development and provision of port and associated services and power, respectively</p> | <p>III. Evolve and enabling environment for private sector involvement in infrastructure sectors</p> | <p>III.1. Develop overall supportive policy and regulatory and institutional mechanism for key infrastructure sectors III. 2. Take initial steps to start power sector reforms III. 3. Develop policy and regulatory framework for promoting private sector development of ports III. 4. Road sector reforms to attract private investment in road infrastructure</p> |

GAIC = Gujarat Agro Industries Corporation, GCEL = Gujarat Communication and Electric Limited, GIDC = Gujarat Industrial Development Corporation, GMDC = Gujarat Mineral Development Corporation, GOG = Government of Gujarat, GSEC = Gujarat State Export Corporation, GSFC = Gujarat State Finance Corporation, GTCL = Gujarat Tractor Corporation Limited, RRP = report and recommendation of the President, SOE = state-owned enterprise.

Source: Operations Evaluation Mission.

Table A1.3: Reconstruction of the Design and Monitoring Framework of the Gujarat Public Sector Resource Management Program

| Impact/Outcomes | Outputs |
|--|--|
| <p>Impact. Improved public sector resource mobilization and allocations efficiently promoting industrialization</p> | |
| <p>Outcome 1. The state's public finances and their prudent management strengthened</p> | <p>1.1 Medium-term fiscal policy framework implemented with strengthening of fiscal policy management 1.2 Improved revenue generation 1.3 Prioritized and rationalized expenditure</p> |
| <p>Outcome 2. Reformed state-owned enterprises (SOEs) contributing to the state economy</p> | <p>2.1 Institutional mechanisms in place to implement the public sector restructuring program 2.2 Selected SOEs privatized 2.3 Selected SOEs restructured 2.4 Selected SOEs closed 2.5 Affected SOE employees provided a social safety net</p> |
| <p>Outcome 3. Private sector participating in infrastructure development in the state</p> | <p>3.1 An enabling policy and regulatory framework and institutional mechanisms in place 3.2 Key power, port, and road sector reforms initiated</p> |

Note: The reconstruction was completed by the Operations Evaluation Mission.

Source: Operations Evaluation Mission.

STATUS OF PROGRAM COMPLIANCE WITH TRANCHE RELEASE CONDITIONS AND COVENANTS

Table A2.1: Tranche Release Conditions

| Condition | Status at Tranche Release | Status at PCR | Status at OEM |
|--|---|---|--|
| A. Strengthening of State Public Finances and its Prudent Management | | | |
| <p>IT: 1. Reduce the fiscal deficit to 3.5% of SDP in the state's budget for FY1997.</p> | <p>Fully met. The actual unadjusted indicator was 4.2% of the NSDP. Adjusted fiscal deficit to NSDP was 2.8% after exclusion of the fiscal cost of unforeseen expenditures on civil service wage increase resulting from the central Government's Fifth Pay Commission recommendations and natural calamities in the state.</p> | <p>The fiscal deficit to NSDP deteriorated after the 2001 earthquake. The actual unadjusted indicators were 7.3%, 8.6%, and 6.1% of NSDP for FY2000, FY2001, and FY2002. GOG, however, started launching the second phase of fiscal consolidation to contain the fiscal deficit. GOG recently submitted a draft MOU to the central Government under the states' fiscal reforms facility. The monitoring indicator used in the MOU is the revenue deficit as a percentage of revenue received.</p> | <p>Fiscal deficit was contained at 3.5% of NSDP. Similarly revenue deficit was reduced to 0.2% of NSDP. The state has already achieved the targets set by the Twelfth Finance Commission for 2008/09 for the fiscal deficit. It is expected to generate a substantial revenue surplus from 2006/07 onward.</p> |
| <p>FT: 1. Reduce the fiscal deficit to 2.7% in the FY1998 state budget. This is to be achieved by raising current revenues annually by about 0.5% of SDP and a proportionate reduction in the current expenditure to SDP ratio.</p> | <p>The condition was amended to establish a fiscal process based on a sound fiscal framework agreeable to ADB. Taking exogenous factors and slow progress in power sector reforms into consideration, the fiscal deficit would have been 2.5% of the NSDP, with the mandated wage bill increase accounting for 2.0%, recurring natural calamities for 0.2%, decreased central transfers for 0.4%, and high power subsidies due to delay in power sector reforms for 1.6%.</p> | <p>See I. A.1.</p> | |
| <p>IT: 2. Introduce the following tax reforms including the merger of turnover tax with</p> | <p>Fully met. (i) Rate structure of sales tax was consolidated to six categories with four special rates in 1997. (ii) Item numbers were reduced from</p> | <p>Status of (i), (iii), and (iv) remains the same as reported for the final tranche, which was released in December 2000. As for (ii), this has been further reduced and currently 16 items are on</p> | <p>The state switched to the VAT system from 1 April 2006. The structure of the tax conforms to that agreed to by the Empowered Committee of State Finance</p> |

| Condition | Status at Tranche Release | Status at PCR | Status at OEM |
|---|---|-----------------------------|---|
| <p>the sales tax:</p> <p>(i) Reduce the number of sales tax rates from 23 items to about a third thereof.</p> <p>(ii) Reduce the number of items on the prohibited list from 63 to about a third thereof.</p> <p>(iii) Introduce simplified tax assessment through a single tier system.</p> <p>(iv) Merge turnover tax with sales tax.</p> | <p>63 to 33 in the FY1998 budget and to 24 in the FY1999 budget.</p> <p>(iii) Assessment systems were simplified by introducing a single-tier system of assessment from April 1998.</p> <p>(iv) Turnover tax was merged with sales tax in April 1997.</p> | <p>the prohibited list.</p> | <p>Ministers. The switch to the VAT has led to significant improvement in revenue productivity and the first 5 months collections show more than 30% growth over the corresponding period in the previous year.</p> |
| <p>IT: 3. Introduce a rationalized stamp duty schedule based on ad valorem rates and initiate steps to improve the valuation system for the stamp duty.</p> | <p>Fully met. The rate schedule was adjusted. Rates for some items were reduced or converted to ad valorem rates. For improvement of the valuation system, the automatic reckoning mechanisms for valuation of immovable properties were updated in June 1998 and again in 1999 for the purpose of stamp duty assessment.</p> | | <p>No change.</p> |
| <p>IT: 4. Rationalize the profession tax.</p> | <p>Fully met. The rate schedule was adjusted. Rates for some items were reduced or converted to ad valorem rates. For improvement of the valuation system, the automatic reckoning mechanisms for valuation of immovable properties were updated in June 1998 and again in 1999 for the purpose of stamp duty assessment.</p> | | <p>No change.</p> |

| Condition | Status at Tranche Release | Status at PCR | Status at OEM |
|--|--|---|---|
| <p>IT: 5. Introduce a new rate schedule for tax on goods and passengers that reduces the number of rate categories from 15 to about a third thereof.</p> | <p>Fully met. The rate schedules of tax on goods and passengers and MVT were merged on goods and passenger vehicles to simplify the schedule from April 1997. The number of rate categories for goods vehicles was reduced from 15 to 7.</p> | | <p>No change.</p> |
| <p>IT: 6. Shift from the weight-based MVT to a composite ad valorem MVT. Also, replace the existing sales tax and lifetime tax on private cars with a single one-time composite and ad valorem tax.</p> | <p>Fully met. An ad valorem MVT on private cars was introduced from August 1998. The new rate structure was simplified carrying a single rate of 4%.</p> | <p>GOG further restructured the MVT structure and rates to mobilize tax revenue. Tax rates for omnibuses were increased in FY2001. Sleeper bus coaches were subjected to MVT starting in FY2004. Stamp duty exemptions for tractors used for agriculture purposes were withdrawn from 1 April 2003.</p> | <p>No change.</p> |
| <p>FT: 2. Revise power tariffs to maintain a 3% rate of return on GEB's fixed assets by FY1998.</p> | <p>In view of changed circumstances, the Government requested an amendment of this policy condition.</p> <p>GEB met the 3% rate of return on its net fixed assets with subsidies of \$214 million in FY1997, although GEB made a net loss of \$199 million. Delays in power sector restructuring increased GEB's net losses, and in FY1998 GOG was no longer able to subsidize power sector operations to the extent of meeting the 3% return. GEB's return on fixed assets fell to negative 5% with subsidies and negative 26% without subsidies in FY1998, and to negative 5% with subsidies and negative 38% without subsidies in FY1999.</p> | <p>Raising the agriculture sector tariff remains politically challenging. GOG informed the program completion review mission that it continues to be committed to raising power tariffs for farmers despite political pressure. GEB has also been implementing an intensive meter installation program to replace old meters with sealed, tamper-proof meters in the agriculture sector where the majority of users were unmetered. GOG also enacted the Gujarat Electricity and Regulation Act in 2003, which followed the central Government's enactment of the Electricity Act in 2003. A target tariff rate was set to be at least two thirds of total supply cost by 2006. The remaining one third will be financed by</p> | <p>Power sector reform remains a challenge and the finances of GEB continue to adversely impact the budget. Tariffs and structures have been adequate to sustain cash flow. The regulator granted increases in FY2000, including a 300% increase for agricultural consumers. The next increase was in June 2004, when rates rose by about 1%, and a further application is being processed. Overall a profit should be made across the group in FY2005.</p> |

| Condition | Status at Tranche Release | Status at PCR | Status at OEM |
|-----------|--|---|---------------|
| | <p>GOG established the Gujarat Electricity Regulatory Commission (GERC), an independent regulatory authority for awarding power tariffs, in November 1998, but GERC was unable to revise power tariffs due to political and social considerations. Its revision came on 10 October 2000. GERC reviewed all relevant operating data submitted by GEB and other independent power corporations and undertook public hearings during March to October 2000 on the revised electricity tariffs. The revisions including substantial upward revision for agricultural tariffs were announced and made effective immediately. This will reduce power sector subsidies to the capped level of Rs11 billion for FY2001.</p> <p>The revised power tariffs will not enable GEB to make 3% returns on its fixed assets for a few more years. This target must be met in combination with GEB's own efforts in undertaking rigorous financial and operational restructuring. The then-proposed Power Sector Development Program Loan scheduled to be discussed by ADB's Board in December 2000 was expected to address some of GEB's problems inherent to all state electricity boards in India in the context of comprehensive restructuring of the power sector industry in Gujarat.</p> | <p>a cross-subsidy from the industry to the agriculture sector.</p> <p>GEB's return on fixed assets deteriorated greatly in FY2000 to negative 24% and in FY2001 negative 25%, but improved in FY2002 to 6% and FY2003 to 4%.</p> <p>GEB continues to be a loss-making SOE despite the restructuring and reorganizing efforts. GEB was divided functionally into generation, transmission, and distribution companies. GEB transferred its generating units to its existing subsidiary company for generation. A transmission company (Gujarat Electricity Company Ltd.) was also created to take over the transmission business. Four distribution companies were created to look after distribution functions in four regions of the state. GEB remains the holding entity to oversee the remaining functions such as bulk power purchase and bulk supply functions.</p> <p>GEB has implemented several measures to control cost and expenditure including reduction in fixed cost of independent power producers through renegotiation, optimization of fuel mix to reduce high-cost fuel consumption, renegotiation with creditors to restructure high-cost loans, and attrition with no replacement combined with 20% cut in staffing and other measures. These measures resulted in a substantial reduction in the cost of power purchase and net cash loss. GEB also received an incentive grant of Rs5,360 million under the central Government's</p> | |

| Condition | Status at Tranche Release | Status at PCR | Status at OEM |
|--|---|---|---|
| <p>IT: 3. Increase irrigation charges to levels agreed with ADB.</p> | <p>Fully met. During loan negotiations, a 50% increase in irrigation charge was agreed as the acceptable rate of increase. On 25 October 2000, Gujarat issued an order to raise irrigation charges from the existing rates by 3.0 times on rice, 2.5 times on sugarcane, and 2.0 times on other crops starting February 2001.</p> | <p>Accelerated Power Development and Reforms Program scheme. Condition satisfied.</p> | <p>No change, although GOG is reportedly considering establishing a water regulatory authority.</p> |
| <p>FT: 4. Introduce the CIP in the context of the Ninth Five-Year Plan and institute arrangements to institutionalize and roll over the CIP annually, while protecting it from ad hoc budgetary cuts.</p> | <p>Fully met. The CIP was introduced in the context of the Ninth Five-Year Plan from 1996 to 1997. A system that prioritizes sectors, projects, and schemes was institutionalized and implemented. The system was properly established and is updated by the state on an annual basis.</p> | <p>Condition satisfied.</p> | <p>To prioritize expenditures, GOG initiated the CIP in April 1998 along with institutional arrangements to roll over the CIP annually. The objective of the CIP is to insulate expenditures with high social rates of return and is therefore considered as a priority for ad hoc expenditure cuts. The program also envisaged raising the ratio of capital expenditure to NSDP from 2.1% in 1996/97 to 2.6% in 1998/99. However, this was not implemented seriously and the exercise largely remained on paper.</p> |
| <p>FT: 5. Raise capital expenditures from 2.1% of SDP in FY1997 to about 2.6% of SDP by FY1999 in line with the MTFPF.</p> | <p>Fully met. Capital expenditure rose to 3.2% of NSDP in FY1999 and was 3.1% in FY2000.</p> | <p>Capital expenditures were protected.</p> | <p>Capital expenditure is estimated at 3.4% of NSDP in 2005/06. The expenditure continues to be adequately protected.</p> |

| Condition | Status at Tranche Release | Status at PCR | Status at OEM |
|---|--|--|---|
| B. Reform of State-Owned Enterprises | | | |
| <p>IT: 7. Privatize GCEL and GTCL by selling off 51% of the state's shares in each, through a transparent procedure.</p> | <p>Partially complied with. GOG adopted a properly designed and transparent bidding procedure that was acceptable to all parties. GCEL: While GOG followed an identical bidding procedure for GTCL, it could not find a suitable buyer. A GOG cabinet subcommittee decided to reinstate bids while restructuring GCEL. GOG successfully reduced the workforce from 1,390 to 740 and retendered the sale offer in January 1999.</p> <p>GTCL: In August 1998, GOG and Mahindra & Mahindra Ltd., a leading tractor manufacturing company in India, agreed on all details including the settlement price, for Mahindra & Mahindra to acquire 51% of GOG's shares. However, Mahindra & Mahindra is reconsidering its offer.</p> | <p>GCEL: Upon the decision to close, GOG provided the voluntary retirement scheme (VRS) to all employees. On 18 February 2002, the Gujarat High Court passed the order to close the company and appoint an official liquidator.</p> <p>GTCL: No progress was made in privatizing GTCL.</p> | <p>GCEL was originally in the full privatization category of the policy matrix. It was moved to the closure list, with ADB concurrence. GOG offered VRS to all employees and the Gujarat High Court passed orders in February 2002 to wind up GCEL and appoint an official liquidator, marking the beginning of the liquidation process. The windup formalities are ongoing.</p> |
| <p>FT: 6. Fully privatize GCEL and GTCL by selling all of the state's shares in GCEL and GTCL.</p> | <p>Condition amended to fully privatize GTCL and approve closure of GCEL.</p> <p>GCEL: GOG has decided to close GCEL. GOG failed to reach an agreement with GCEL's final bidder on payment of wages in arrears resulting from the Fifth Pay Commission's wage increases. GOG discontinued its attempt to divest GCEL and decided to close the enterprise. On 9 October 2000, GCEL's closure was approved by a cabinet subcommittee.</p> <p>GTCL: GOG's 60% shareholding of GTCL was divested. GOG's 51%</p> | <p>See I.B.7.</p> | <p>GTCL: 51% of GOG's shares were transferred to Mahindra & Mahindra in December 1999 along with management control; another 9% was subsequently transferred. Share price achieved was Rs12 per share higher than the original offer, successfully negotiated by GOG in spite of pressure to achieve the condition to enable the release of the incentive tranche. The option to purchase the remaining 40% is yet to be exercised.</p> |

| Condition | Status at Tranche Release | Status at PCR | Status at OEM |
|---|--|-------------------|--|
| | <p>shareholding of GTCL was sold to Mahindra & Mahindra Ltd. on 18 December 1999. An additional 9% of GTCL was transferred to Mahindra & Mahindra Ltd. on 30 May 2000. Under the sale-and-shareholders agreement, Mahindra & Mahindra Ltd. has an irrevocable option to purchase the remaining 40% share at a predetermined price, binding the state to sell the remaining stake in GTCL on request by Mahindra & Mahindra Ltd.</p> | | |
| <p>IT: 8. Offer up to 25% of GSFC equity for public issue, as permissible under existing law.</p> | <p>Complied with. Public issue of Rs235 million of GSFC equity, which was equivalent to 25% of pro-forma shares, was floated in February 1997. The price of the issue was fixed at Rs20 per share (premium of Rs10). The issue was oversubscribed and over 60% was acquired at the retail level. The allotment of shares was completed in May 1997. Allowing for the Industrial Development Bank of India's shareholding, GOG's holdings in GSFC were reduced to about 49% (which is a condition of the second tranche). GSFC substantially reduced its nonperforming portfolio. Financial restructuring has also improved GSFC's capital adequacy ratio from 8.4% in March 1996 to about 13% in March 1997.</p> | | |
| <p>FT: 8. Reduce GOG's shareholding in GSFC to not more than 49% and implement financial and organizational restructuring of</p> | <p>Partially complied with. GOG selected ICICI, IL&FS, and HDFC for divesting 26% of its shareholding in GIIC and completed valuation of GIIC's assets through an independent consultant after finalizing the accounts for 1997/98. A cabinet subcommittee on SOE reforms approved the sale and</p> | <p>See I.B.9.</p> | <p>GOG equity stake brought down to 49%. Recommendations of the task force, appointed by GOG, waited before taking final decision on the GSFC.</p> |

| Condition | Status at Tranche Release | Status at PCR | Status at OEM |
|--|---|--|--|
| GSFC along with the plan for upgrading its information and technology. | constituted a committee to negotiate a purchase price for the issuance of fresh equity to buyers. However, the offered price by ICICI after their due diligence was not acceptable to GOG. GOG is seeking the possibility of entering into a technical collaboration agreement with IL&FS. Organizational restructuring has been implemented based on various studies by outside consultants. GOG took steps for financial restructuring. | | |
| <p>IT: 9. Reduce by 26% the state's shareholding in GIIC and GMDC and cause GIIC to (i) enter into an agreement with a technical collaborator for enhancing its capacity, and (ii) initiate implementation of its organizational and financial restructuring.</p> | <p>GIIC: Partially complied with. GOG selected ICICI, IL&FS, and HDFC for divesting 26% of its shareholding in GIIC and completed valuation of GIIC's assets through an independent consultant after finalizing the accounts for 1997/98. A cabinet subcommittee on SOE reforms approved the sale and constituted a committee to negotiate a purchase price for issue of fresh equity to the buyers. However, the offered price by ICICI after their due diligence was not acceptable to GOG. GOG is seeking the possibility of entering into a technical collaboration agreement with IL&FS. Organizational restructuring was implemented based on various studies by outside consultants. GOG took steps for financial restructuring.</p> <p>GMDC: Complied with. In October 1997, GOG successfully divested 26% of its equity in GMDC to the general public by offering for sale 8,268,000 shares of Rs10 each with a premium of Rs120 per share, totaling Rs1.07 billion. The offer has met with resounding success despite sluggish market conditions. The offer was</p> | GOG converted outstanding loans amounting to Rs992.2 million into equity capital during FY2001. GIIC has also mobilized Rs1,499.6 million through issuance of long-term bonds guaranteed by GOG. GIIC carried out internal restructuring during this period. | GIIC: All lending activities of GIIC have been discontinued and the focus has shifted to recovery of old dues. The final decision regarding the future of GIIC would depend on the recommendations of the task force appointed by GOG to recommend a strategy. |

| Condition | Status at Tranche Release | Status at PCR | Status at OEM |
|--|--|--|--|
| | oversubscribed by more than two times. | | |
| <p>FT: 9. Reduce GOG's shareholding in GMDC to not more than 49% and GMDC to enter into an agreement with a technical collaborator for enhancing capacity. GMDC to sell its inefficient and unprofitable units.</p> | <p>Complied with. In October 1997, GOG successfully divested 26% of its equity in GMDC to the general public by offering for sale 8,268,000 shares of Rs10 each with a premium of Rs120 per share, totaling Rs1.07 billion. The offer has met with resounding success despite sluggish market conditions. The offer was oversubscribed by more than 2 times.</p> | <p>Condition satisfied.</p> | <p>Legally GOG is not able to divest more than 49%; 26% has been divested; and a further 23% stake is proposed to be divested in phase II of SOE restructuring. Consultants recommended that outside experts be appointed to assist in further restructuring measures. This recommendation was confirmed by the Phase II Experts Committee</p> |
| <p>FT: 7. Reduce the state's 56% shareholding in GSEC to 26% or less by transferring the same along with management control to a strategic partner.</p> | <p>Partially met. Gujarat is reducing its 56.6% of GSEC shareholding to 11.0%. The divestment process was prolonged due to GSEC's possession of an air cargo complex, which required approval from the central Government for transfer of ownership at the time of divestment. Central Government approval was given. On 9 October 2000, a cabinet subcommittee confirmed the sale, for which final bids were received on 23 June 2000. The selected corporation's quote price was Rs1,500 per share, against the underwriter's estimated share price of Rs5,000. While the difference is substantial, the investment amount is not significant. Gujarat is confident that an agreement on the price will be reached since the number of shares is limited (6,840 shares) and the company is profitable. Furthermore, no labor disputes exist.</p> | <p>GOG now possesses 26% shareholding in GSEC. The bid from Ms Adani Exports Ltd. for acquiring 45.6% equity, thereby reducing GOG shareholding to 11% had not materialized.</p> | <p>The ADB Board approved a waiver of full compliance as the divestment was delayed by negotiations on the sale price and by the need to obtain central Government approval for transfer of GSEC's air cargo complex at Ahmedabad Airport. The entire GOG stake was transferred to Adani Co. Ltd., in February 2004.</p> |

| Condition | Status at Tranche Release | Status at PCR | Status at OEM |
|--|--|-----------------------------|---|
| <p>FT: 11. Adopt, as agreed with ADB, the recommendations of the study and (i) corporatize GIDC and divest 26% of GOG shareholding, (ii) offer leaseholders an option to convert leaseholds to freeholds in state-owned industrial estates if legally feasible, and (iii) strengthen the regulatory and planning framework for existing and new industrial estates.</p> | <p>Fully met. As recommended by ADB, GIDC will retain its regulatory, planning, and land acquisition functions; and divest those pertaining to estate management and estate development. GIDC, accepting ADB's recommendation, approved GIDC's restructuring plan on 12 June 2000. GOG has, however, opted not to corporatize and to retain its statutory position and to continue its regulatory role.</p> <p>To proceed with its restructuring plan, GIDC offered VRS to its staff members and 615 employees (22% of the total staff) were retrenched as of 28 February 2000. On its divestment of estate management, GIDC faced reluctance from industries to take over because of low returns from these estates. However, GIDC has transferred water supply schemes of 15 estates; and in accordance with GOG's decision, GIDC will transfer 21 estates that will be managed by an independent agency, and divest 51 estates situated in municipal limits to municipalities and local bodies.</p> <p>For all new investments, GIDC will put up 26% of the capital and the remaining 74% will be provided from the private sector. GIDC invited tender offers for two projects for the development of a residential township in Atali, Dahej, and Ankrleshwar on a build-own-maintain basis. Private sector interests, however, have not been encouraging. The proposals are currently being reviewed for restructuring to attract higher private sector interest.</p> | <p>Condition satisfied.</p> | <p>GIDC referred to the Expert Committee, which has made recommendations similar to those of the consultants during the program design phase.</p> |

| Condition | Status at Tranche Release | Status at PCR | Status at OEM |
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| <p>FT: 12. Divest 49% of GOG's shares in GAIC and close uneconomic units and/or divisions of GAIC.</p> | <p>Substantially met. GAIC sold its two subsidiaries and closed down all commercial activities, including uneconomic units and/or divisions, with the exception of pesticides and its distribution network. Voluntary retirement schemes will be offered to all employees of the closed units in accordance with GOG order of 12 April 1999.</p> <p>GOG will maintain GAIC's distribution network, used mainly to provide price-controlled fertilizer (urea) and offer agricultural inputs and technical advice to the remote areas of the state. The distribution network was streamlined by disengaging 400 independent members of the network out of 800 and adding 150 new members on the basis of a minimum performance target set by GAIC. However, due in part to the recurrent droughts, selling off the pesticide operation and distribution network was possible, as these operations remain commercially nonviable.</p> <p>The uneconomic units undergoing liquidation account for approximately 60% of GAIC's net fixed assets and 50% of employees. In view of the fact that private sector interest is likely to be low for servicing remote areas of the state, GOG opts to retain 100% of GAIC, and dedicate GAIC as a development and/or promotional agency for the state's agriculture.</p> | <p>Status remains. (See also Appendix 3.)</p> | <p>Only manufacturing units closed.</p> |

| Condition | Status at Tranche Release | Status at PCR | Status at OEM |
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| C. Evolve an Enabling Environment for Private Sector Involvement in Infrastructure Sectors | | | |
| 10. Announce a state roads sector policy. | Complied with. A road policy was announced in January 1997 to encourage private sector participation in construction and maintenance of roads. The roads sector policy aims to provide an efficient roads network across the state and includes specific guidelines for private sector participation in this sector. | Condition satisfied. | State roads policy being updated by PWD |
| 11. Announce a policy for private sector participation in the state's ports sector and associated facilities including the policy for creating a regulatory framework. | Complied with. GOG approved and announced its BOOT policy for the ports sector in July 1997, which includes a package of BOOT principles serving as a framework for the involvement of the private sector in the construction and operation of these new ports. The scope of BOOT policy guidelines includes issues such as the rights and responsibilities of developer and government regulatory control. | Condition satisfied. | Policy forms the basis for infrastructure development in the state through GIDB. The Gujarat Vision 2020 provides details of how public-private participation in all sectors including ports will be implemented. |
| FT: 13. Develop a time-bound action plan for the development of a regulatory framework for the power sector in consultation with ADB. | Fully met. A plan for developing a power sector regulatory framework was developed and substantially implemented. GERC was established in November 1998 under the Electricity Commission Act of 1998 as an independent organization empowered to determine the power tariffs for wholesale, bulk, grid, and retail electricity. Under the new regulation, GEB and other licensees are requested to submit their proposals for tariff revisions to GERC based on actual data of operation. Upon receipt of such proposals, GERC assesses the proposals together with the operating | GERC has continued to operate. It prepared the Gujarat Electricity and Regulatory Act, which was in harmony with the central Government's Electricity Act 2003. The Gujarat Electricity and Regulatory Act became effective in 2003 and set a target of two thirds of the supply cost to be financed by tariffs by 2006. | The support to develop a regulatory framework for the power sector was followed with ADB lending and technical assistance including preparation of a reorganization plan for GEB, consumer awareness and support to providing comprehensive incentives to implement a reform program. Ownership of reforms in the successor entities that have replaced GEB is now very high. |

| Condition | Status at Tranche Release | Status at PCR | Status at OEM |
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| | data and conducts public hearings, subsequently revising the power tariffs. The process may be undertaken on an annual basis if required. | | |
| FT: 14. Set tariff objectives based on economic and financial principles by September 1997. Following this, revise and raise the port charges based on specific objectives, including, in particular, the cost of services rendered. | Fully met. The Ports and Fisheries Department revised port charges based on economic and financial principles including costs incurred, pursuant to notifications issued on 12 May 1998. The new charges became effective as of 14 May 1998. | Condition satisfied. | |
| 15. Develop an implementation plan for a suitable regulatory framework for public and private ports development. | Fully met. GOG approved and announced BOOT policy for the ports sector in July 1997, which included a package of BOOT principles serving as a framework for involving the private sector for construction and operation of new ports. The scope of BOOT policy guidelines covered such matters as rights and responsibilities of developers and government regulatory control. | Condition satisfied. | |
| FT: 16. Levy tolls on at least two designated state road and bridge projects under construction that are sufficient to recover at least 50% of annualized | Fully met. Tolls determined on the basis of construction, maintenance, and financial costs were levied for Magdalla Bridge on Magdalla Ichhapor road from 1 September 1998 and Roads over Brides at Gujarat Narmada Valley Fertilizer Company Ltd. on Bharuch bypass joining Bharuch and Dehej State Highway to National | In addition, two toll roads were completed in 2003 (Ahmedabad-Rajkot) and 2004 (Bagodra-Vasad). Four tolled bridges were also built and operated, namely Mahi, Watrak, Narmada, and Mahi bypass. | |

| Condition | Status at Tranche Release | Status at PCR | Status at OEM |
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| construction, maintenance, and financial costs. | Highway No. 8 from 7 February 1999. | | |
| FT: 17. Cause R&BD to provide GIDB with a report on experience gained from negotiations of at least two private sector roads or bridge projects, together with recommendations for changes, if any, to the policy and regulatory framework for private sector road development. | Fully met. R&BD submitted to GIDB its report based on experience in handling build-operate-transfer (BOT) projects, although relatively small in size, and the same was provided to ADB on 24 December 1999. Subsequent to completion of a large-scale BOT project in November 1999, a report containing recommendations for changes in policy and the regulatory framework for road development by private sector was provided. | Condition satisfied. | |

ADB, Asian Development Bank, BOOT = build-own-operate-transfer, CIP = core investment program, FY = fiscal year, GCEL = Gujarat Communications and Electronic Ltd., GEB = Gujarat Electricity Board, GERC = Gujarat Electricity Regulatory Commission, GIDB = Gujarat Infrastructure Development Board, GIDC = Gujarat Industrial Development Corporation, GIIC = Gujarat Industrial Investment Corporation, GMDC = Gujarat Mineral Development Corporation, GOG = government of Gujarat, GSFC = Gujarat State Financial Corporation, GTCL = Gujarat Tractor Corporation Ltd., HDFC = Housing Development Finance Corporation, ICICC = Industrial Credit and Investment Corporation Ltd., IL&FS = Infrastructure Leasing and Financial Services, MOU = memorandum of understanding, MTFPF = medium-term fiscal policy framework, MVT = motor vehicle tax, NSDP = net state domestic product, OEM = operations evaluation mission, PCR = project completion report, PWD = Public Works Department, R&BD = Roads and Bridges Department, SDP = state domestic product, SOE = state-owned enterprise, VAT = value added tax, VRS = voluntary retirement scheme.

Source: Operations Evaluation Mission.

Table A2.2: Approval of Release Covenants Unrelated to the Tranche

| Covenant | Status at Tranche Release | Status at PCR | Status at OEM |
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| A. Covenants to be Achieved by the Release of the Incentive Tranche | | | |
| 1. Provide a report on the review of property tax and <i>octroi</i> to ADB. | <p>Complied with.</p> <p>Property Tax: The analysis of the various aspects of an area-based assessment and rationalization of property tax rates was entrusted to experts. The expert team carried out a study and submitted detailed reports to GOG for all six municipalities of the state. The reports were submitted in October 1998 to ADB. GOG initiated action to extend a new system.</p> <p>Octroi Tax: GOG established a committee chaired by the principal secretary of the Urban Development Department to examine measures to rationalize structural reform and procedural rationalization. GOG constituted a high-level committee chaired by the finance minister comprising representatives from all fields to study octroi alternatives.</p> | Condition satisfied. | <p>Property tax reform has been carried out.</p> <p>Octroi in all local bodies except municipal corporations has been abolished. Abolition of the tax in municipal corporations was not carried out due to inability to find a viable alternative.</p> |
| 2. Initiate implementation of the CIP. | Complied with. Expenditure prioritization was implemented under the system of earmarking selected sectors, projects, and schemes. This system was established in the state and GOG is regularly and successfully following it. | Condition satisfied. | CIP not institutionalized beyond the program life. |
| 3. Initiate steps to (i) design and implement tax and expenditure restructuring; (ii) upgrade budget policy formulation, planning, management, and control systems; (iii) computerize | <p>Complied with.</p> <p>(i) GOG established and made operational the SPFRC as well as appointed a renowned economist as head of the SPFRC.</p> <p>(ii) Three working groups on expenditure management and control, tax reforms, and</p> | Condition satisfied. | No change. |

| Covenant | Status at Tranche Release | Status at PCR | Status at OEM |
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| the various revenue, expenditure, treasury, and debt accounts; and (iv) improve tax administration for enhancing tax compliance and enforcement. | computerization and training were constituted based on the resolution of July 1998. (iii) GOG made funds available for computerization of the Sales Tax Department. | | |
| 4. Reorganize and establish a full-fledged directorate of taxation with separate wings for major taxes, and strengthen the research and analytical capability of this directorate. | Complied with. GOG established the directorate in April 1998. The directorate's functions were under overall supervision of the additional chief secretary (finance). A joint secretary (tax) was appointed as director of taxation. Suitable personnel are being identified for strengthening research and analytical capabilities. | Condition satisfied. | No change. |
| 5. The Technical Secretariat is to submit a progress report for SOEs divested or restructured. | Complied with. | Condition satisfied. | |
| 6. Make appropriate allocation for the SRF in the FY1998 state budget. | Complied with. The necessary budgetary allocation was made. Rs150 million was asked as a budgetary allocation for the SRF in FY1999 in addition to the remaining balance of Rs101 million. The SRF has therefore sufficient balance to meet the expenditure likely to be incurred for the VRS by the SOEs. | Condition satisfied. | |
| 7. Make GIDB operational with adequate staffing and budgetary allocation for project development and feasibility studies for key infrastructure sectors, and develop its technical expertise in these areas to build capacities of sector ministries. | Complied with. GIDB was made operational through a form of society in July 1997, and a full-time chief executive officer and sector specialists and professionals were appointed for day-to-day administration. All policy decisions to be taken in respect of objectives of the board are handled by the Executive Committee and full meetings of the board. Budgetary allocation was made for identification and feasibility of infrastructure projects. | Condition satisfied. | |

| Covenant | Status at Tranche Release | Status at PCR | Status at OEM |
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| B. Covenants to be Achieved by the Release of the Final Tranche | | | |
| <p>1. Implement the MTFPF, regularly assess its progress, and prepare projections annually in line with revised base-year data starting from FY1998.</p> | <p>Fully met. An MTFPF was formulated in FY1997 and thereafter its progress has been assessed regularly and projections revised in line with base-year data. The SPFRC prepared a medium-term fiscal consolidation plan in December 2000 for adoption starting FY2002.</p> | <p>The MTFPF was submitted to the Cabinet for adoption starting FY2002. A draft MOU between GOG and the central Government for the MTFPF was prepared based on this plan. The SPFRC was dissolved after completion of medium-term fiscal consolidation plan.</p> | <p>The MTFPF is updated annually.</p> |
| <p>2. Finance Department to take into account the recommendations of ADB-financed technical assistance to</p> <ul style="list-style-type: none"> (i) develop a VAT blueprint plan, model legislation, and a credit system for input taxation; (ii) initiate upgrading and modernizing of sales tax administration and training of staff members in tax administration including VAT; (iii) launch a public information campaign; and (iv) examine options for eliminating industrial concessions and exemptions and tax relief for bankrupt industries in line with the recommendations of the Committee of State Finance Ministers along with the implementation of similar actions by neighboring | <p>Fully met. Gujarat adopted the blueprint prepared by the Committee of Chief Ministers for implementing the VAT nationwide by 1 April 2002. In preparation for the switch, a committee was appointed to design a VAT for Gujarat, based on the model VAT legislation prepared by the National Institute of Public Finance and Policy. The national model envisages gradual reduction in the central sales tax rate from 4% to 1% in 3 years and a three-tier VAT tariff structure effective from 1 April 2002.</p> <ul style="list-style-type: none"> (i) GOG is implementing a \$3.4 million computerization program to modernize sales tax administration, which was to be completed by 2002. (ii) GOG constituted a committee for supervising VAT implementation. The committee will launch a broad-based public information campaign once the scope of the VAT is finalized. (iv) GOG has implemented the recommendations of the Committee of State Finance Ministers to eliminate all sales tax incentives to the industry (exception to those already in the pipeline) from 1 January 2000, and agreed on uniform floor rates of sales taxation to avoid tax competition, effective 1 | <p>VAT preparation including legislation, computerization system, training and workshop, and public awareness campaign, was completed. The VAT bill was passed by the State Assembly and submitted to the central Government for approval. The Government still has not approved the submitted bill. Nationwide, the central Government decided to postpone the original plan of VAT introduction (1 April 2002) indefinitely. Note that the proposed three rates are 4%, 8%, and 12%.</p> <p>In 1999, about 13,000 companies had industrial exemptions for sales tax. Currently, about 3,000 companies enjoy such exemption. About 500 companies lose their exemptions each year. By 2009, no companies will enjoy</p> | <p>The VAT was implemented from 1 April 2006. The progress in revenue collections has been extremely good. Revenue increased by over 30% in the first 5 months in 2006/07 relative to the corresponding period in 2005/06.</p> |

| Covenant | Status at Tranche Release | Status at PCR | Status at OEM |
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| states. | January 2000. The floor rate regime is expected to bring additional revenue of Rs3 billion to Rs5 billion. Removal of incentives will increase tax buoyancy after 2 years and increase the tax revenue base by approximately 20% in 5–6 years. | any such privilege. | |
| 3. Improve the valuation system for stamp duty. | Fully met. To strengthen the valuation system, tax tables were updated in June 1998. In consultation with the Revenue Department, regular updating of tax tables is being institutionalized. | Another survey was carried out in 1999. A survey will be carried out to revise the valuation of land by zone. The revision should be completed in 2 years. | No further development. |
| 4. The SPFRC, with ADB technical assistance support, is to prepare proposals for improvement in tax administration of a profession tax, tax on goods and passengers, and MVT, to support effective implementation of state tax reforms. | Fully met. Based on recommendations of the Support for Gujarat Public Finance Reforms technical assistance, the profession tax, tax on goods and passengers, and MVT structures were improved, effective April 1997. | GOG continues to improve tax administration for effective and efficient tax administration of profession tax, and other small taxes. GOG is reviewing consolidation of profession and entertainment taxes. | Reforms in implementation continue. |
| 5. Develop, in consultation with the municipal corporations and municipalities, a time-bound action plan for property tax reforms, including a tax table (as an automatic reckoning mechanism) for valuation of properties to support tax assessment. | Fully met. GOG is implementing an action plan for property tax reform while the study for reforms in valuation systems was completed and the tax table prepared. | GOG continues implementing the reforms in valuation systems. | Reforms in implementation continue. |
| 6. Implement, in consultation with the municipal corporations and municipalities, recommendations of study | Substantially met. The Bombay Municipal Corporation Act was amended to permit levy of property tax under the new matrix-based system in six municipal corporations in Gujarat. Ahmedabad City took the initiative to introduce | No further progress. | No change. |

| Covenant | Status at Tranche Release | Status at PCR | Status at OEM |
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| <p>on the property tax, including introduction of a criteria-based valuation system for property tax.</p> | <p>the system and has surveyed three of four zones in the city to collect information on tax base (area of properties, number, and characteristics) to design revenue neutral tax rates for implementation from FY2002. GOG conducted workshops to educate other municipal corporations and smaller municipalities on the system and GOG plans to amend the Gujarat Municipal Act to facilitate introduction of the new system of property tax in all municipal areas.</p> | | |
| <p>7. Implement, in consultation with municipal corporations and municipalities, recommendations of studies on <i>octroi</i> designed to develop uniformity in the octroi system across these bodies, and to streamline octroi administration and procedures.</p> | <p>Substantially met. The decision to abolish octroi was taken by the state. A draft entry tax law was prepared to replace octroi and sent to the central Government for approval. The law will be enacted and implemented upon receiving federal approval. GOG recommended that local bodies rationalize octroi, and take measures, including implementation of uniform rates. Local bodies expressed concerns that the new impost, which will be collected by GOG and passed on to them, may not be as buoyant and liquid as octroi. GOG incorporated safeguards in the draft legislation to ensure high buoyancy and automatic transfer of revenues to local bodies.</p> | <p>The decision to abolish octroi was reversed. Seven municipal corporations are exempted from the octroi abolition. Revenue from octroi is buoyant and liquid in these seven exempted local bodies.</p> | <p>Search for a viable alternative revenue source continues.</p> |
| <p>8. Finance Department is to take into account the recommendations of ADB-financed technical assistance for enhancing cost recovery for key socioeconomic services, such as those for the transport and social sectors.</p> | <p>Continued progress. The SPFRC formulated overall guidelines for cost recovery for key socioeconomic services and made specific recommendations. GOG has accepted several SPFRC recommendations and took action to increase cost recovery in transport, technical education, and irrigation. GOG considers enhancing cost recovery as an ongoing process and is focusing on its improvement as part of the medium-term fiscal consolidation framework.</p> | <p>GOG implemented several measures to increase nontax revenue and reduce subsidy expenditure. In January 2004, water charges were increased. The fee in secondary and higher secondary schools, colleges, and technical institutes were revised in June 2003. The electricity charges for the agriculture sector were also increased.</p> | <p>No change.</p> |

| Covenant | Status at Tranche Release | Status at PCR | Status at OEM |
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| <p>9. Introduce improvements in budget plan, management, and control systems; and computerize tax and expenditure systems, as well as treasury and debt management systems.</p> | <p>Fully met. The entire Finance Department operation and the budget divisions of various departments were computerized. The office of Directorate of Accounts and Treasuries was also fully computerized. Software was developed for compiling the state's budget and is currently being tested. Budgetary management was substantially computerized. Software was being developed for the sales tax.</p> | <p>GOG commissioned the National Informatics Center to establish the Gujarat wide area network, which connects all departments. By FY2006, all departments will be computerized. At the moment, the Treasury Department has its own computerized system that is used to monitor and manage cash on a daily basis. However, the system used has not yet been linked with other units within the Finance Department.</p> | <p>No change.</p> |
| <p>10. Submit to the SPFRC a progress report on public finance reforms for review by GOG and ADB by December 1997. This report, among others, includes reform proposals for (i) VAT, property tax, and octroi; and (ii) improvements in expenditure management and control. The recommendations of the SPFRC report, as agreed by ADB and GOG, will be adopted by April 1998.</p> | <p>Fully met. The SPFRC was formed in November 1996 and submitted proposals for reform for VAT, property tax, and octroi; and improvements in expenditure management and control to the state in October 1998. It undertook additional studies on improving strategic management of public resources and containment of the fiscal deficit. A fiscal consolidation plan is to be completed in December 2000. The relevant state departments are deliberating on the implementation procedures.</p> | <p>The fiscal consolidated plan, completed in December 2000, was submitted to the state Cabinet. Data and analysis in the plan was used as a foundation for preparing the draft MOU between GOG and the central Government for the state to avail of the States Fiscal Reforms Facility. The draft MOU was submitted to the central Government on 20 November 2003 for approval.</p> | <p>No change.</p> |

| Covenant | Status at Tranche Release | Status at PCR | Status at OEM |
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| 11. The Technical Secretariat is to submit a progress report for SOEs that have been divested or restructured, and prepare strategies for restructuring eight other SOEs. | Fully met. The progress report on the status of SOE divestment and restructuring together with strategies for restructuring eight SOEs was submitted to ADB in September 1999. | GOG through the Technical Secretariat carried forward the SOE restructuring agenda in the second phase of the Public Sector Resource Management Program, initiated by GOG. GOG is contemplating a new target of SOE restructuring for FY2005. However, no specific time-bound and targeted restructure plan was adopted. | |
| 12. Approve the proposed reform of eight SOEs. | Fully met. Approval for restructuring eight SOEs was given by the Cabinet subcommittee. | | |
| 13. Finalize the study on technical and restructuring options for GIDC. | Fully met. The study was finalized on 10 November 1997. The study proposed to restructure GIDC by unbundling its operations. Estate development, estate management, and lease and/or financing would be divested while maintaining planning and regulation, land acquisition, and land ownership under GIDC. | Condition satisfied. | GIDC referred to the Expert Committee, which has made recommendations similar to those of the consultants during the program design phase. |
| 14. Merge (i) Gujarat State Leather Industry Development Corporation with Gujarat Rural Industries Marketing Corporation, and (ii) Gujarat State Handicraft Corporation with Gujarat State Handloom Corporation. | (i) Substantially met. The Company Law Board, of the national Department of Company Affairs, approved the merger, and an announcement of the merger was made on 22 January 2000. No objections on the merger were received, and the formal notification of the merger was published in the official gazette. (ii) Substantially met. The Company Law Board, Department of Company Affairs, Government of India, approved the merger. Objections were received from the employee union and cooperative bodies. Negotiations with the objecting parties are ongoing and settlement was expected by the end of | The necessary procedure for registering the merger with the Registrar of Companies has been completed and the merger became effective from 9 January 2001. Settlement has still not reached a conclusion. GOG assigned the Institute of Rural Management, Anand, to study the proposed merger, and examine the human resource, financial, and operating terms of the merged corporation. A | (i) All formalities for merger of Gujarat State Leather Industry Development Corporation with Gujarat Rural Industries Marketing Corporation are complete. (ii) The merger of Gujarat State Handloom Development Corporation Ltd. with Gujarat State Handicraft Development Corporation Ltd. was operationalized, with a single development corporation being established. The |

| Covenant | Status at Tranche Release | Status at PCR | Status at OEM |
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| | December 2000. | preliminary report was submitted and examined by the department. | corporation discharges the functions of a social development organization for purchase of handicraft and handloom products from artisans and weavers, with commercial considerations not being in focus. |
| 15. Lease or sell another 20 properties of Tourism Corporation of Gujarat Ltd. | Partially met. Of the 20 properties, 10 properties were leased or sold. For 7 leased properties, litigations were filed and court judgments from the High Court of Gujarat are pending. Problems arose due mainly to the inadequately prepared lease deeds. Having learned from this lesson, consultants were hired to assess the lease value and prepare the lease deeds for the remaining 10 properties. These properties will be either leased or sold. | The leasing or selling processes were held up, due to litigation. | Sale/lease of remaining properties is still in abeyance due to legal issues arising from inadequately prepared lease deeds. |
| 16. Restructure GHB and GSCB by transferring all construction of low-income housing from GSCB and rationalizing GSCB activities. | Fully met. A cabinet subcommittee suspended the activities of GSCB by transferring slum clearance activities to local bodies and/or nongovernment organizations and the assets to Gujarat Housing Board. GSBC employees will be offered VRS. The closure of GSCB is being implemented by the Urban Development Department. | <p>The Urban Development and Urban and Housing Development Department initiated action according to the cabinet subcommittee's decision. Activities of GSCB were closed down. Almost all employees were paid through VRS.</p> <p>The Urban Development and Urban and Housing Development Department has not yet initiated actions to restructure GHB.</p> | All operations of GSCB have been discontinued. For administrative convenience, GSCB's employees were offered VRS and then redeployed in a separate cell of Gujarat Housing Board, with their focus only on recovery of old dues. During the next 3–4 years the collection of all recoverable dues is expected to be completed; the funds are to be deposited in an escrow account to be made available for GOG use. |
| 17. Report on settlement of creditors' dues from the | Fully met. A report on settlement of creditors' dues was submitted in October 2000. GSTC | Condition satisfied. The liquidation process is | All 17 mills of the company remain closed. |

| Covenant | Status at Tranche Release | Status at PCR | Status at OEM |
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| closed textile mills in cases where closure was approved by the relevant statutory authorities, and downsize GSTC. | was ordered to be liquidated by the Gujarat High Court on 6 February 1998 and the High Court appointed an official liquidator in accordance with the provision of the Company Act. A sales committee consisting of commercial banks and GOG representatives was formed to facilitate the liquidation process. However, its completion is expected to take a few more years. The 17 textile mills under GSTC at the time of liquidation were valued and workers were given VRS. | ongoing. | |
| 18. Review, with ADB, the status of the preparation of closure of three SOEs. | Fully met. GOG approved closure of the three SOEs, namely Gujarat State Construction Corporation, GSTC, and Gujarat Film Development Corporation. | GOG closed five SOEs. Apart from the three identified SOEs, GOG closed two additional SOEs, namely Gujarat Small Industries Corporation (GSIC) and GDDC. | |
| 19. Take necessary steps for closure of three SOEs and where required seek Board for Industrial and Financial Reconstruction (BIFR) approval for such closure. | Fully met. Three SOEs, Gujarat State Fisheries Corporation, Gujarat Small Industries Corporation, and Gujarat State Construction Corporation were closed. The liquidation process is under way, and employees will be given VRS. | For the closure of GDDC, GOG sought BIFR approval. The BIFR case was registered. GOG directed the Agriculture Department to close GDDC activities. Almost all employees were given VRS. | The GDDC has been closed. Only land belonging to GDDC has not yet been sold but is likely to be transferred to GOG. VRS for the remaining five employees is to be paid from GDDC resources as per phase III of the VRS. |
| 20. The Technical Secretariat is to review implementation of the SRF and submit a progress report on the SRF to the state and ADB. | Fully met. The report was submitted to ADB in September 1999. According to the report, Personal Ledger Account of SRF, as part of the social safety net under the program of SOE restructuring, was made operational with disbursements totaling Rs2,770 million covering 17,143 SOE employees as of September 1999. | The SRF is still in operation and is under the purview of the Technical Secretariat that has a mandate for SOE restructuring. So far 17,800 employees have been given VRS at the cost of Rs3,280 million. When the latest VRS package for 3,040 employees becomes effective, a total of 20,840 employees will have been given VRS at a cost of | |

| Covenant | Status at Tranche Release | Status at PCR | Status at OEM |
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| | | Rs4,240 million. | |
| 21. Provide a report to ADB on progress made by GIDB in performing its role and function. | Fully met. The progress report was submitted to ADB in September 1999. The report outlines the progress achieved by GIDB, including the adoption of the Gujarat Infrastructure Development Act, 1999 (also called the Build-Operate-Transfer Act) and the preparation of Vision 2010, identifying off the shelf projects in each of the infrastructure sectors for this decade. | The road map, Vision 2010, was completed and is accessible through GIDB's website. The document incorporates 10 infrastructure sectors, including ports, roads, power, water, gas, urban infrastructure, and industrial parks. | On behalf of GOG, GIDB prepared Vision 2010, the updated Blueprint for Infrastructure in Gujarat 2020, as the statutory authority responsible for coordinating infrastructure development in the state. |
| 22. Prepare the CIP for the power sector for 1997–2012 on the basis of a least-cost expansion plan. | Fully met. The progress report was submitted to ADB in September 1999. The report forecasts the power demand of the state to 2010 under different scenarios. The line-up of projects to meet the demand was prioritized, in accordance with preestablished parameters. The CIP for the power sector on the basis of this report was included in the state's overall CIP. | Condition satisfied. | Vision 2010 prepared, including prioritized power sector plan, updated in the Vision 2020 |
| 23. GEB to convert, on a pilot basis, two of its distribution districts or circles into independent profit centers, to increase cost efficiencies of these circles through greater commercialization of their operations. | Fully met. The distribution circles of Rajkot and Kheda began operation as profit centers with the aim of increasing cost efficiencies and achieving greater commercialization of their operations. | Condition satisfied. | |
| 24. Provide a progress report to ADB on the restructuring of GMB and make GDPC operational. | Fully met. The progress report on GMB restructuring was provided to ADB in December 1999. Under the plan, GMB proposes to maintain its commercial operations while establishing a separate independent regulatory body for the ports sector and downsizing its workforce. | Condition satisfied. | The expert committee recommended the creation of GMA under the Maritime Authority Act, with GMA having regulatory responsibilities including tariffs, with port development |

| Covenant | Status at Tranche Release | Status at PCR | Status at OEM |
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| | GDPC is in operation as a joint venture with Adani Port Ltd., a private sector corporation and will be developing Mundar Port. | | activities retained by GMB. The draft legislation is being considered by a parliamentary committee, and is expected to be passed within a year. |
| 25. Finalize the proposed ports sector CIP for inclusion by GOG in the overall state CIP. | Fully met. The CIP was prepared in late 1998 and a report was provided to ADB in December 1998. The CIP for the subsector was included in the state's overall CIP. | GOG no longer prepares the CIP. The capital expenditure was planned under the state's 5-year plans. | GOG prepared Vision 2010 including prioritized port sector plan, updated in the BIG 2020. |
| 26. In the second phase, establish a port service development corporation to handle dredging and related port services. | Fully met. GMB outsourced loss-making operations such as dredging, rather than maintain them under a port service development corporation. | Condition satisfied. | No change. |
| 27. Finalize the proposed roads sector CIP based on the R&BD strategic options study for inclusion by GOG in the overall state CIP. | Fully met. The CIP was provided to ADB in December 1998. Of the roads examined under the strategic option study, which covered 3,000 kilometers of roads in Gujarat, a World Bank project supported a study of 2,000 kilometers. The CIP for the roads sector was finalized on the basis of this study and included in the state's CIP. | Condition satisfied. | GOG prepared Vision 2010 including prioritized road sector plan, updated in the Vision 2020. |

ADB = Asian Development Bank, BOOT = build-own-operate-transfer, BOT = build-operate-transfer, CIP = core investment program, GAIC = Gujarat Agro Industries Corporation Ltd., GCEL = Gujarat Communications and Electronic Ltd., GDDC = Gujarat Dairy Development Corporation, GDPC = Gujarat Port Development Company, GEB = Gujarat Electricity Board, GIDB = Gujarat Infrastructure Development Board, GIDC = Gujarat Industrial Development Corporation, GIIC = Gujarat Industrial Investment Corporation, GERC = Gujarat Electricity Regulatory Commission, GHB = Gujarat Housing Board, GMA = Gujarat Maritime Authority, GMB = Gujarat Maritime Board, GMDC = Gujarat Mineral Development Corporation, GOG = government of Gujarat, GSCB = Gujarat Slum Clearance Board, GSEC = Gujarat State Export Corporation, GSFC = Gujarat State Financial Corporation, GSTC = Gujarat State Textile Corporation, GTCL = Gujarat Tractor Corporation Ltd., HDFC = Housing Development Finance Corporation, ICICI = Industrial Credit and Investment Corporation Ltd., IL&FS = Infrastructure Leasing and Financial Services, MOU = memorandum of understanding, MTFPF = medium-term fiscal policy framework, MVT = motor vehicle tax, NSDP = net state domestic product, R&BD = Roads and Bridges Department, SDP = state domestic product, SOE = state-owned enterprise, SPFRC = State Public Finance Reforms Committee, SRF = State Renewal Fund, TFC = twelfth finance commission, VAT = value-added tax, VRS = voluntary retirement scheme.

Source: Operations Evaluation Mission data and ADB. 2004. *Program Completion Report on the Gujarat Public Sector Resource Management Program in India*. Manila.

OVERVIEW OF THE POLITICAL ECONOMY OF FISCAL REFORM IN GUJARAT

A. Background

1. The policy shift allowing the states to borrow from multilateral agencies came about in response to the severe fiscal imbalance and balance of payments problem. After three and a half decades of low gross domestic product (GDP) growth at 3.5% per year, the Indian economy accelerated to over 5% in the latter half of the 1980s. While the initial impetus to growth acceleration came from economic liberalization, this is mainly attributed to the expansionist fiscal stance of the central Government, partly contributed to by the increase in public sector wages in FY1987. The gross fiscal deficit of the central and state governments steadily increased from 5.9% in FY1982 to 9.4% in FY1990, and outstanding liabilities relative to GDP rose from 46.4% in FY1980 to 61.4% in FY1990. The fiscal expansion-led growth was inherently unsustainable. The fiscal imbalance spilled over into balance of payments and the sharp increase in oil prices caused by the Gulf crisis triggered economic crisis in the country.

2. The stabilization and structural adjustment reforms initiated in 1991 required containment of central and state fiscal deficits. State reforms also had to address the issue of enhancing allocative and technical efficiency in public spending, and creating an enabling environment for private sector participation in accelerating economic growth. Economic liberalization required creation of a competitive environment for domestic manufacturers. The hardening central finances reduced resource transfers to states; one measure adopted was to allow the reform-oriented states to negotiate loans from multilateral institutions. Given that fiscal reform was an inherent part of the loan negotiations, allowing the states to borrow from multilateral institutions could achieve the objectives of (i) improving their finances, (ii) augmenting outlay on social and physical infrastructure and restructure of public enterprises, and (iii) creating an enabling environment for private sector functioning.

3. Notably, until the mid-1990s, the states were not allowed to directly negotiate loans with multilateral agencies. Gujarat was the first state to avail of the liberalized regime. In 1996 the Asian Development Bank (ADB) revised its operating strategy to advance a portion of assistance to states in India. Although the loan agreement for ADB was with the central Government, which retained the repayment liability, negotiations were with the state government of Gujarat (GOG), which agreed to the ADB conditions. Prudent and efficient use of the resources provided under the loan, therefore, was as important for the central Government as it was to ADB. The fact that this was the first loan for public sector resource management, no precedence and experience was available to assist with designing and managing the loan, including setting specific conditions and covenants, modifying them to take account of exogenous shocks, instituting a monitoring system, and providing technical assistance and building capacity.

4. The choice of Gujarat state by ADB was appropriate. Gujarat has been a progressive and reform-oriented state. Of all the states, Gujarat has had a culture of market orientation, and has significant private entrepreneurship and political leadership with a tradition of good administration and governance. The state has had a proactive reform agenda and already had the report of the Gujarat State Finance Commission (GSFC) ready to be implemented. Taking the GSFC recommendations as conditions resulted in GOG having complete ownership of the reforms. The strategy also helped with the acceptance of reforms by the general public. Thus, even with several changes in governments and chief ministers in office during the period, the reforms adopted in the ADB program never looked in danger and all the parties were equally committed to implementing them.

B. Key Developments and Constraints during Implementation

5. The loan to Gujarat for public sector resource management was followed by similar loans to Madhya Pradesh, Kerala, and Assam by ADB; and to Uttar Pradesh, Karnataka, and Andhra Pradesh by the World Bank. Over time, considerable experience has been gained in designing and implementing such loans and in monitoring them to ensure compliance with the conditions and overall achievement of the objectives. A major lesson from the Gujarat program has been the need to accommodate exigencies arising from unforeseen factors while specifying the loan conditions.

6. An important unforeseen factor that adversely affected Gujarat state finances was the sharp increase in public sector wages following implementation of the Fifth Pay Commission's national recommendations in FY1997. As in other states, this contributed to the sharp deterioration in the fiscal health of Gujarat and required revising the deficit target. In addition, unforeseen factors such as the severe drought in FY1999, cyclone in FY2000, and massive earthquake in January 2001 completely destabilized Gujarat's finances. The loan conditions had to be revised to take account of the adverse impacts. The communal violence in February 2002 took a significant toll on economic activity and with it, the fiscal consolidation program.

7. Because the original design did not account for the influence of exogenous factors on the set targets, the fiscal deficit targets had to be revised from time to time. Thus, the fiscal deficit target was originally set to be reduced from 4% of NSDP in FY1996 to 2% in FY1999, but the actual deficit in the year was 8.9% due to the cumulative effect of the drought, cyclone, and earthquake. The State Public Finance Reform Committee (SPFRC), at the behest of the state finance minister, reworked the sustainable level of fiscal deficit to 3.5% of gross state domestic product (GSDP) in FY2005.

8. Indeed, the finances of all state governments sharply deteriorated following the pay increases in FY1998. Stagnancy in tax revenues and decline in the central transfers relative to the state domestic product (SDP) aggravated the situation. The problem was compounded by increasing deficits and debt, and rising interest rates. Following the recommendation of the Eleventh Finance Commission, the Ministry of Finance designed the medium-term fiscal reforms program requiring the states to reduce the ratio of revenue deficits to total revenues by 5 percentage points every year to gain eligibility for grants. The design of this performance-linked grants program had problems.¹ 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 fiscal responsibility act. This would entitle them to get the benefit of restructuring and consolidation of market loans, and loans from the central Government with a substantially reduced rate of interest. 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.

9. Whether or not the incentive system fiscal performance to loan waiver designed by the TFC is effective, the fiscal management monitoring system has come a long way from what existed in FY1996 when the Gujarat Public Sector Resource Management Program (GPSRMP) was designed. Indeed, the Program and those that followed it in other states, initiated by ADB and the World Bank, have helped to evolve design, implementation, and monitoring of the conditions to improve states' fiscal performances. Although considerable work remains, future programs should ensure harmony between the fiscal performance

¹ For a critique of the recommendations of the Eleventh Finance Commission and Medium-term Fiscal Reform Committee see Rao. M.D. 2004. Linking Central Transfers to Fiscal Performance of States. *Economic and Political Weekly*. XXXIX (18):1820–1825.

targets set by the central Government and those designed by ADB as conditions for loans to states.

C. Current Trends in State Finances

10. The aggregate fiscal trends for the states show significant improvement since FY2003. The aggregate revenue and fiscal deficits of the states have declined significantly. The revised estimate of revenue deficit in FY2005 is about 0.5% of GDP; this is about 2 percentage points lower than in FY2001 (Table A3.1 and Figure A3.1) and only 0.5 percentage point more than the restructuring target set by the TFC for FY2008. Similarly, the revised estimate of fiscal deficit for FY2005 at 3.2% of GDP is marginally higher than the adjustment target set for FY2008. Even if the final figures of revenue and fiscal deficits for the year turn out to be marginally higher, the trend indicates that the states' fiscal health has clearly shown a significant improvement.

11. The analysis of the sources of improvements in state finances shows a 2.1 percentage point improvement, increase in revenues contributed to 1.5 points or 72% and the remaining 0.6 point or 28% was due to compression of expenditures. Within the former, the bulk of the contribution, about 1 percentage point, was due to increased devolution recommended by the TFC, higher buoyancy central taxes since FY2002, and increased grants for various central schemes. Similarly, for expenditures, reduced interest payments following the debt swap scheme and later due to the adoption of the TFC's scheme of debt restructuring and write-off contributed to 0.24 point improvement in the revenue deficit.

Table A3.1: Fiscal Trends in All Indian States 2001–2007
(Percent of GDP)

| Description | FY2001 | FY2002 | FY2003 | FY2004 | FY2005 | FY2006 |
|---|--------|--------|--------|--------|--------|--------|
| Revenue Deficit | 2.59 | 2.25 | 2.22 | 1.17 | 0.49 | 0.05 |
| Gross Fiscal Deficit | 4.21 | 4.17 | 4.46 | 3.50 | 3.20 | 2.71 |
| Primary Deficit | 1.47 | 1.31 | 1.50 | 0.68 | 0.70 | 0.16 |
| Revenue Receipts | 11.21 | 11.44 | 11.47 | 11.92 | 12.74 | 13.12 |
| Current Transfers | 4.18 | 4.18 | 4.29 | 4.34 | 5.13 | 5.31 |
| Revenue Expenditure | 13.80 | 13.69 | 13.68 | 13.09 | 13.22 | 13.16 |
| Interest Payments | 2.74 | 2.86 | 2.96 | 2.82 | 2.50 | 2.54 |
| Capital Outlay | 1.41 | 1.49 | 1.90 | 1.97 | 2.39 | 2.43 |
| Development Expenditure ^a | 9.50 | 9.32 | 10.15 | 9.40 | 10.16 | 9.81 |
| Nondevelopment Expenditure ^a | 6.05 | 6.20 | 6.12 | 6.03 | 5.70 | 5.83 |
| Social Sector Expenditure ^a | 5.78 | 5.60 | 5.42 | 5.39 | 5.95 | 5.82 |
| Social Services ^a | 5.13 | 5.00 | 4.82 | 4.71 | 5.19 | 5.13 |
| of which | | | | | | |
| (i) Education, Sports, Art, and Culture | 2.66 | 2.57 | 2.40 | 2.31 | 2.33 | 2.91 |
| (ii) Medical, Public Health, and Family Welfare | 0.73 | 0.70 | 0.66 | 0.63 | 0.72 | 0.73 |

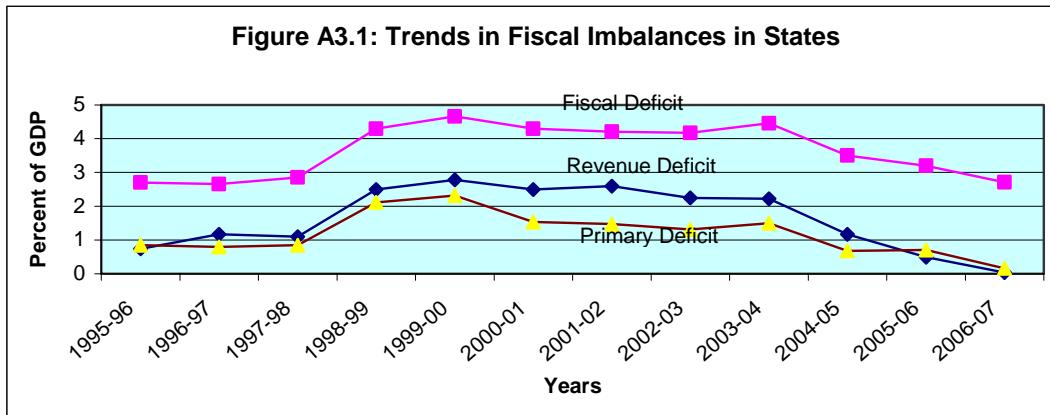
FY = fiscal year, GDP = gross domestic product.

^a Indicates GDP for 2006/07 was estimated from Budget at a Glance 2006/07.

Source: Reserve Bank of India.

12. In keeping with the general trend in state finances, the finances of Gujarat state have shown appreciable improvement. Both revenue and fiscal deficit have improved significantly since FY2000 (Table A3.2, Figure A3.2). The revenue deficit, which was high at 7% of NSDP in FY2001, is estimated to have been virtually phased out in FY2005. Similarly, the fiscal deficit was reduced from 8.9% of NSDP in FY2000 and to 3.5% in FY2005. In other words,

the state has achieved the medium-term target set for FY2005 by the SPFRC. In fact, it has already achieved the fiscal restructuring target set by the TFC for FY2008.

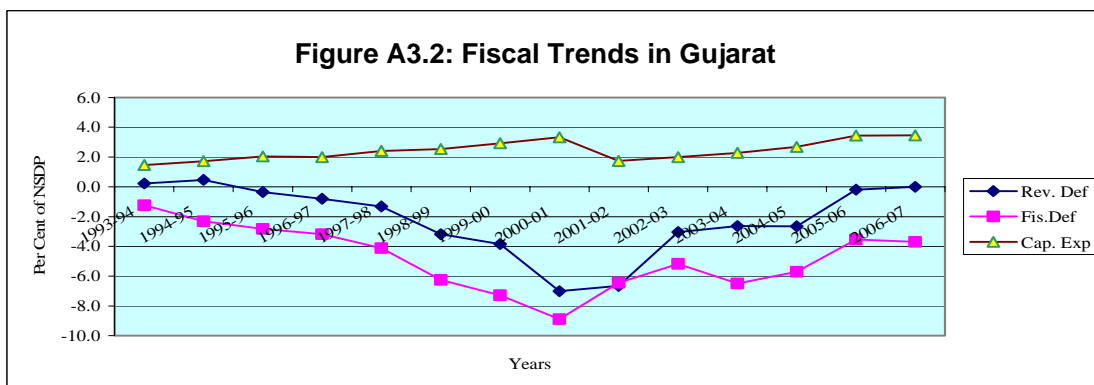


GDP = gross domestic product.
Source: Reserve Bank of India.

Table A3.2: Fiscal Trends in Gujarat

| Financial Year | Revenue Deficit | Fiscal Deficit | Capital Expenditure | Development Expenditure |
|----------------|-----------------|----------------|---------------------|-------------------------|
| 1995/96 | (0.4) | (2.8) | 2.0 | 11.9 |
| 1996/97 | (0.8) | (3.2) | 2.0 | 11.3 |
| 1997/98 | (1.3) | (4.1) | 2.4 | 13.3 |
| 1998/99 | (3.2) | (6.3) | 2.5 | 14.5 |
| 1999/2000 | (3.8) | (7.3) | 2.9 | 15.6 |
| 2000/01 | (7.0) | (8.9) | 3.3 | 20.9 |
| 2001/02 | (6.7) | (6.4) | 1.7 | 17.0 |
| 2002/03 | (3.0) | (5.2) | 2.0 | 13.1 |
| 2003/04 | (2.6) | (6.5) | 2.3 | 11.2 |
| 2004/05 | (2.6) | (5.7) | 2.7 | 11.9 |
| 2005/06 | (0.2) | (3.5) | 3.4 | 11.6 |

Note: Figures in parenthesis are negative.
Source: Government of Gujarat Annual Budget Papers.



Source: Government of Gujarat annual budget papers.

D. Human Development Progress in Gujarat

13. The GPSRMP-supported fiscal management reform explicitly focused on the compression of fiscal deficits and ignored the reprioritization of expenditures to achieve human development goals. Although separate components of the Program dealt with tax and expenditure reforms, and to some extent capital expenditures, the GPSRMP did not have any provision to protect spending on social sectors when expenditure compression had to be made. Social expenditures are easy to reduce when expenditure compression as a part of fiscal adjustment is implemented. While successive natural calamities in 1999, 2000, and 2001, and a human-made tragedy in 2002 caused sharp increases in expenditures, the GPSRMP actually provided some cushion to social sector spending. As illustrated in Table A3.3, within the social sector, however, the allocation of social priority areas actually suffered in these years and the reduction in the allocation was particularly severe in 2001/02, partly due to the earthquake in January 2001 and more importantly due to large-scale communal disturbances in February 2002.

14. The public expenditure ratio, measuring the percentage of state income that goes into public expenditure, is increasing over the long term with a marked increase over the years FY1996–FY2000 from 19.6% to 33%, although the FY2000 and FY2001 figures were boosted by the response to the early 2001 earthquake. Since FY1999, this figure has been maintained around the norm of the United Nations Development Programme (UNDP) of 25%. The social sector ratio measuring the percentage of total expenditure allocated to social services was marginally higher in FY2004 than in FY1991, but has remained between 5 and 8 points below the UNDP norm of 40%. However, it showed slight upward movement during the first 3 years of the GPSRMP and of course in FY2000 and FY2001. Of some concern though is the trend of the social priority ratio, which measures the percentage of social expenditure devoted to human priority concerns (education, health, water, and sanitation). Although well above the UNDP norm of 50% since FY1991, being around the mid-70% range until FY1996, it fluctuates through the program period dropping 10% over 4 years as a result of a succession of natural disasters, and a further 18% in FY2001 as a result of the large-scale communal disturbances in early 2002, before settling at around 60% after FY2002. The human development ratio, the product of the above three ratios, measuring the percentage of state income devoted to human priority concerns, has shown a long-term improvement with a rapid rise during the program period.

Table A3.3: Human Development Ratios in Gujarat

| Financial Year | Public Expenditure Ratio | Social Sector Ratio | Social Priority Ratio | Human Development Ratio |
|----------------|--------------------------|---------------------|-----------------------|-------------------------|
| 1991/92 | 15.9 | 32.2 | 74.3 | 3.8 |
| 1992/93 | 14.0 | 30.2 | 75.8 | 3.2 |
| 1993/94 | 15.4 | 32.8 | 74.5 | 3.7 |
| 1994/95 | 14.7 | 33.3 | 74.2 | 3.6 |
| 1995/96 | 16.4 | 32.2 | 72.3 | 3.8 |
| 1996/97 | 16.8 | 30.4 | 73.4 | 3.7 |
| 1997/98 | 19.6 | 31.8 | 70.0 | 4.4 |
| 1998/99 | 23.4 | 32.9 | 73.6 | 5.7 |
| 1999/2000 | 26.1 | 33.9 | 66.5 | 5.9 |
| 2000/01 | 33.0 | 35.0 | 61.9 | 7.1 |
| 2001/02 | 29.9 | 35.1 | 43.1 | 4.5 |
| 2002/03 | 26.4 | 31.8 | 61.0 | 5.1 |
| 2003/04 | 24.2 | 32.7 | 60.2 | 4.8 |

2004/05

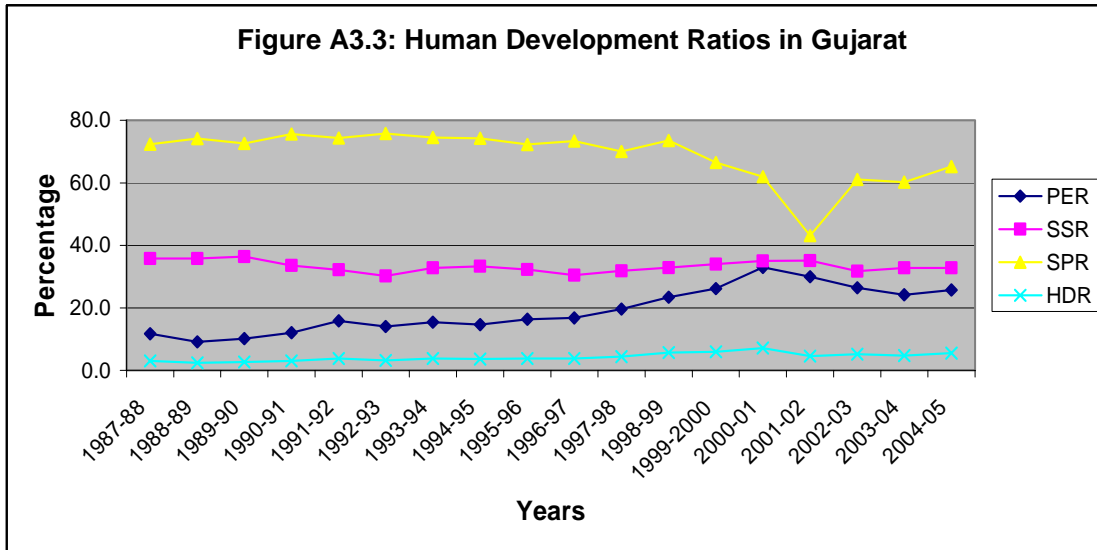
25.7

32.7

65.2

5.5

Source: Government of Gujarat annual budget papers.



HDR = human development ratio, PER = public expenditure ratio, SAR = social allocation ratio, SPR = social priority ration.

Source: Government of Gujarat Annual Budget Papers.

STATE-OWNED ENTERPRISE REFORM IN GUJARAT

A. Background

1. India's states have replicated the central Government's model of using state-owned enterprises (SOEs) to spur industrial and socioeconomic development. Currently, state SOEs contribute around 5% of gross domestic product (GDP) in terms of aggregate revenues, as compared to 10% in the case of central SOEs. The total investment in state SOEs is estimated to have been Rs360,058 crore¹ in 2003. Among the states, Andhra Pradesh had the largest investment in SOEs, accounting for 8% of the country's total investment, followed by Jammu and Kashmir (7%), and Delhi and Maharashtra (5% each).

2. Most state governments emulated the central Government in setting up manufacturing enterprises to increase industrialization in their respective states. State SOEs have also been used to achieve objectives ranging from employment creation to supply of subsidized services like power and transport. Of 1,068 state SOEs, more than 50% were engaged in manufacturing activities. Other categories in which state SOEs operate include promotional and development activities (16% of all state SOEs), 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 SOEs at 109, with 77 engaged in manufacturing. Uttar Pradesh with 104 SOEs had the second largest concentration, but accounts for the largest number of enterprises engaged in promotional and welfare activities. In FY2003, the total revenues earned by all state SOEs was Rs86,284 crore with net losses of Rs6,997 crore recorded. Most state SOEs continue to depend on annual budgetary support from their respective state governments. Given the budgetary constraints being faced by most states, many initiated SOE reforms to reduce the recurring budgetary support required to sustain the SOEs and allocate additional resources to infrastructure, health, and education.

4. States like Gujarat, Andhra Pradesh, and Karnataka have been the pioneers in SOE reform in India. Gujarat's total investments in 54 SOEs were estimated at Rs13,000 crore in FY1994. These enterprises employed 160,000 people, accounting for around 10% of the state's workforce in the organized sector. Like other states, Gujarat too had to provide recurring budgetary support to sustain its underperforming SOEs. In FY1994, the year in which the SOE reform program was initiated, SOEs received budgetary support of more than Rs1,900 crore in the form of equity infusion, grants, loans, and subsidies.

5. In 1992, the first attempt to reform Gujarat's SOEs was made when a review undertaken by the State Finance Commission (SFC) recommended closure of 11 SOEs and divestment in another 21, with only enterprises engaged in socially relevant activities in the state being retained under government ownership. SFC proposed establishment of a senior committee under the chief minister for pursuing divestment in a transparent and professional manner. However, in the absence of political will and an effective institutional and policy framework for implementing these measures, SFC's recommendations could not be adopted. Moreover, SOE reforms were hampered by the prevalent restrictive land and labor legislation, which acted as barriers to restructuring.

¹ 1 Crore is equal to 10 million Rs.

6. The Bureau of Public Enterprises was established in 1979 under administrative control of the Finance Department, to serve as a central coordinating agency for state SOEs. Its mandate was to monitor performance and provide broad guidelines for efficient performance of enterprises owned by the government of Gujarat (GOG) including² (i) being involved in matters relating to wage policies and service conditions of SOEs; (ii) undertaking financial analyses and evaluation of feasibility studies and investment proposals; (iii) carrying out periodic performance appraisals of functioning of SOEs; (iv) preparing annual reports on the performance of state SOEs; (v) promoting management training in critical areas such as financial control, accounts and audit, material management, personnel, industrial relations, and marketing; (vi) serving as a repository of information on various aspects of management and performance in the public sector; and (vii) providing consulting services to line departments in establishing new enterprises, and offering legal assistance in respect of statutory corporations. However, GOG did not give the Bureau of Public Enterprises the mandate to implement SOE reforms, a task assigned to the high-level cabinet committee.

B. Program Design

1. Rationale for the SOE Component of the Program

7. The long-term development strategy of GOG, as detailed in its Eighth Five-Year Plan (1992–1997), was to reduce poverty and unemployment. This was to be achieved by ensuring universal literacy, developing villages, improving reproductive and child health, developing small-scale industry, and providing skills training. The state set specific social targets to be achieved by 2001, including maternal and prenatal care, with a reduction of the birth and infant mortality rates to 21 per 1,000 and 60 per 1,000, expansion of immunization, safe drinking water to all villages, and provision of *pucca* roads in 2,403 villages. While GOG had ambitious development plans, like other states at the time, resource constraints led to severe cuts in public investments. Given its fiscal constraints, the state was expected to realize investment outlays of around Rs105 billion during the plan, but had a shortfall of Rs10 billion.

8. To achieve higher economic growth, GOG announced a new industrial policy in 1995 to (i) promote private domestic and foreign direct investment in infrastructure development and technology, (ii) accelerate employment generation and development of less developed regions, and (iii) divest and restructure SOEs. By March 1995, GOG's total investment in SOEs (including loans and equity capital) was Rs130 billion, almost at the same level as the state's Eighth Five-Year Plan. With profit after taxes from SOEs at less than Rs0.9 billion and dividends of around Rs0.5 billion, compared to an annual subsidy to SOEs of Rs10 billion, the drain on the state's budget was unsustainable. However, SOEs employed more than 160,000 workers and accounted for around 10% of the formal employment in the state, which had potentially difficult political implications. GOG recognized that the adverse impact of SOEs on government finances needed to be reduced to free up resources for investment in infrastructure and social sectors, and to encourage the private sector to participate in infrastructure development. It also acknowledged the need for divestment of its stake in selected SOEs to reduce its role in commercial activities, as per the 1995 industrial policy.

9. The Gujarat Public Sector Resource Management Program (GPSRMP) was designed to support these reforms by (i) strengthening state public finances and their prudent management; (ii) divesting and restructuring SOEs; and (iii) strengthening the policy, regulatory, legal, and institutional frameworks for private sector participation in critical infrastructure sectors like power,

² Annual Report on Public Sector Enterprises of GOG compiled by BPE.

ports, and roads. The Program targeted 23 SOEs having a work force of 75,000 (47% of total SOE employment in the state) and outstanding debt liabilities of Rs76 billion or 80% of total outstanding SOE debt.

C. Policy Measures for SOE Reforms under the GPSRMP

10. **Framework to Categorize SOEs.** Based on the SFC report recommendations, four reform strategies were adopted for the 23 SOEs under the Program:

- (i) **Full divestment.** SOEs whose operations could be made sustainable by handing over management control to a private sector partner selected by competitive bidding were to be privatized. Privatization was to be done in 2 stages; first 51% of GOG's shares were to be sold to the selected private sector partner, followed by the balance of shares to be sold after 1 year.
- (ii) **Partial divestment.** Two approaches were proposed. (a) SOEs such as the state financial intermediary and the mineral development agency requiring additional capital to meet emerging requirements in the industry were to be partially divested, with GOG retaining only a 49% stake postdivestment. The partial divestment was to be made through an offer of GOG shareholding to the public. (b) For the other four enterprises, which were involved in export promotion, extending loans, planning, developing, and regulating industrial estates, and distribution of agricultural inputs, GOG proposed divesting part of its shareholding ranging between 26% and 74%.
- (iii) **Merger.** SOEs fulfilling GOG's socioeconomic development responsibilities were to be restructured through merger with like enterprises to ensure operating efficiencies with associated personnel and financial restructuring.
- (iv) **Closure.** SOEs consistently reporting losses and whose net worth had been eroded due to unviable operations were to be closed down through a process of liquidation after offering the voluntary retirement scheme (VRS) to all employees.
- (v) **Restructuring through sale/lease of assets or unbundling of activities.** Sale/lease of properties was proposed for the Tourism Corporation as part of the overall focus on reducing GOG participation in commercial activities, where adequate private sector activity was already prevalent. With respect to the Gujarat Electricity Board, functional restructuring involving, among other measures, the conversion of two of its distribution circles into an independent profit center was proposed. The unbundling of diverse activities was also intended to be undertaken by the Gujarat Maritime Board to improve sustainability of its operations.

11. **Institutional Framework to Support SOE Reforms.** Two bodies were responsible for implementing, reviewing, and monitoring the SOE reform process. A policy-level cabinet subcommittee, chaired by the chief minister with the ministers of finance and industries and the chief secretary, was established to review and approve the (i) extent of shareholding to be divested in enterprises identified for divestment, (ii) acceptance of a successful bidder's offer, (iii) price at which shares would be offered to the public, (iv) restructuring plans to be adopted for enterprises, and (v) enterprises to be closed.

12. A technical secretariat for privatization headed by a full time ex-chief secretary with four technical staff was established with logistic and technical support from Gujarat State Investment Company, which is the apex holding company for all GOG equity investments in SOEs. The secretariat, which was administratively responsible to the Finance Department, was mandated as an advisory body to the Finance Department and the line ministries having administrative control of SOEs, to develop proposals for SOE reforms, value SOEs, and provide negotiation and contracting support during the privatization process. External consultants with specialized SOE reform and privatization skills were engaged to support the Technical Secretariat.

13. **State Renewal Fund for Voluntary Retirement Scheme and Social Safety Net for Displaced Workers.** GOG instituted a VRS policy in 1997, as part of the GPSRMP, covering displaced employees of SOEs identified for restructuring, closure, and privatization. In line with the Program, in September 1996 the State Renewal Fund (SRF) was established under the administrative control of the Finance Department to finance VRS payments, cost of redeployment of surplus human resources, financial restructuring plans of SOEs, and other associated activities. The SRF was to be financed through (i) contributions from GOG, (ii) the central Government's National Renewal Fund, (iii) proceeds from the sale of GOG shareholding in SOEs, and (iv) sale of assets of closed SOEs. A social safety net (SSN) scheme was intended to provide training to reskill displaced employees enabling them to seek alternate employment opportunities.

14. The following institutional mechanism was adopted for VRS disbursement from the SRF to employees displaced during SOE restructuring:

- (i) Open a personal ledger account under the SRF for each SOE identified for human resource reform.
- (ii) Formulate clearly defined rules and regulations for bringing the SRF into operation, including provisions relating to sanctioning of VRS proposals to be funded by the SRF as well as proper accounting and audit of all disbursements from the SRF.
- (iii) Constitute a high-level committee to administer the SRF, chaired by the chief secretary, with the principal secretaries of the departments of finance, industries, and labor and employment as members, in addition to representation of the additional secretary (institutional finance and Bureau of Public Enterprises) as the member secretary.
- (iv) Move funds through the state's budget to the personal ledger account under the SRF, based on requirements, to facilitate speedy disbursal of VRS compensation to displaced employees of SOEs identified for restructuring.

15. The VRS compensation for individual employees was computed based on the lower of 1.5 months salary for every completed year of service or the total salary expected to be earned by the employee for the remaining period of service, whichever is lower, and 35 days salary for every completed year of service plus 25 days salary for the remaining years of service.³

³ Interview with social safety net program expert.

D. Assessment of Policy Measures

16. The proposed policy measures were based on two key risks identified during the design: (i) political and labor union resistance to the retrenchment of SOE employees proposed to be undertaken under the Program, and (ii) lack of experience of GOG and the respective enterprises with SOE reforms. While the first risk was proposed to be addressed through regular consultations with key stakeholders together with a liberal VRS package funded by the SRF, or alternative employment to displaced employees; the second risk was intended to be mitigated by leveraging the expertise of the Technical Secretariat, supported by external consultants.

17. Given the fast pace of reforms undertaken as part of the Program, the process of managing political and trade union expectations was quite effective. While around 18,000 employees of identified SOEs were offered the VRS aggregating Rs364.5 crore, financed by the SRF, no instances of labor resistance to the human resource restructuring undertaken as part of the SOE reforms are recorded, reflecting the relative success of the VRS policy. The Technical Secretariat was also fairly successful in guiding individual departments and SOEs in the reform process. However, slight fine-tuning of the program design for a few areas may have increased its effectiveness:

- (i) While the categorization of SOEs covered by the Program appears to have been based on an analysis of the respective mandates for individual SOEs, the reform and restructuring strategy for each category could be improved. For example, offering a majority stake (with management control) to prospective private partners for enterprises with limited socioeconomic obligations like Gujarat Agro Industries Corporation Ltd. (GAIC) may have increased chances of successful divestment.
- (ii) As indicated in the program completion report, selling or leasing properties of Tourism Corporation of Gujarat Ltd. (TCGL) was held up on account of litigation. It may have been possible to avoid some of these complications by availing of expert external advice at the time of implementing the divestment exercise, a practice that was subsequently adopted.
- (iii) Some SOEs, having specific divestment targets as tranche conditions, were reportedly adversely impacted by the implementation exercise in terms of bidders quoting abnormally low prices, as potential buyers were aware of the Government's constraints on this front.
- (iv) The SSN scheme including counseling and retraining of displaced employees was not implemented due to the perceived high support costs and the view that the VRS was sufficient to enable displaced workers to proactively adopt alternative livelihoods.

E. Effectiveness of SOE Reforms

18. The relevant loan conditions, covenants, and the current status of the individual enterprises identified for reform are presented in Appendix 1.

1. SOE Restructuring—Full Divestment

19. Initially four SOEs were to be fully divested. Divestment of two subsidiaries of GAIC—Agrocel Pesticides Ltd., and Gujarat Insecticides Ltd.—was completed even before the release of the first tranche of the Asian Development Bank (ADB) loan in December 2006. Of the other two enterprises, a 60% equity stake in Gujarat Tractors Corporation Ltd. was transferred to Mahindra and Mahindra Ltd. After two failed attempts at privatizing Gujarat Communication and Electronics Ltd. (GCEL), GOG decided to close the company.

20. **Gujarat Tractors Corporation Ltd. (GTCL).** Four bidders were determined to be eligible for bidding, however only one, Mahindra and Mahindra Ltd., placed a financial bid at only 60% of the reserve price fixed for divestment. Following negotiations, GOG transferred 60% of its shareholding in two tranches (51% initially and then 9%) to the bidder at the reserve price, with the first tranche being transferred in December 1999 and the second in May 2000. The remaining GOG stake in GTCL, to be transferred to Mahindra and Mahindra Ltd. in line with the sale and shareholder agreements, has not yet been transferred. In September 2004, the company was referred to the Board of Industrial and Financial Reconstruction (BIFR), which declared GTCL a “sick” company, its net worth having been completely eroded due to accumulated losses.⁴

21. **Gujarat Communication and Electronics Ltd.** The first attempt at privatization was made in late 1996; two technical bids were received by October 1997. However, the consultants to the divestment recommended that the bidders be asked to resubmit after being provided details of the VRS scheme proposed by GOG; a new deadline of February 1998 was fixed. Only one bid was submitted within the stipulated time. A new government then assumed power and decided to retender after personnel restructuring, with a revised deadline of March 1999 being fixed for receipt of bids. Two bids were received, both after the deadline. The cabinet subcommittee decided to stop the privatization process and asked the GCEL board to initiate suitable measures to cease business activities. The board approached the labor commissioner for approval to close. All but 16 employees opted for the VRS and were relieved by December 2000, with 11 of the 16 approaching courts for alternative employment. Some of these cases are still pending with the court. GCEL’s operations were suspended from February 2001. An official liquidator was appointed in February 2002, with the process of disposal of fixed assets of the company in progress. Secured creditors including banks and financial institutions have initiated legal steps to recover their dues. These have yet to be settled.

2. SOE Restructuring—Partial Divestment (51% stake)

22. GOG proposed divestment of management control of Gujarat Industrial Investment Corporation Ltd. (GIIC) and Gujarat Mineral Development Corporation Ltd. (GMDC). GOG, which held 100% equity stake in both these enterprises, proposed to initially offer 26% to the public by mid-1997, followed by an additional 25% by June 1998. These enterprises were expected to concurrently seek technical collaboration with private sector companies with relevant expertise and experience, while implementing organizational restructuring to improve their performance. While national laws precluded GOG divesting management control in an SOE in the mineral sector, it did succeed in divesting a 26% stake in GMDC through a public offer of shares in October 1997. However, GOG has not been able to offload its shareholding in GIIC.

⁴ *The Hindu Business Line*, 2 September 2004.

23. **Gujarat Industrial Investment Corporation Ltd.** Valuation of GIIC's assets was undertaken through an independent consultant during 1997–1998. However, the divestment of 26% stake in favor of a consortium of Industrial Credit and Investment Corporation Ltd., Infrastructure Leasing and Financial Services, and Housing Development Finance Corporation, proposed in August 1998, did not materialize as the share price offered by Industrial Credit and Investment Corporation Ltd. was not acceptable to GOG. Specific restructuring measures including conversion of outstanding GOG loans of Rs99 crore to equity, infusion of additional equity of around Rs89 crore, and extending government guarantees for long-term bonds of Rs1.5 billion floated by GIIC have been implemented. Two VRS schemes, covering 180 of the 324 employees, were implemented.

24. **Gujarat Mineral Development Corporation Ltd.** GOG divested its 26% stake in GMDC in October 1997 through an offer to the public at a premium of Rs120 per share, realizing Rs107 crores in the process. However, it has not made any additional divestments, with the prevalent Mining Regulation Act confining mining activities to the government sector and the expected legislation allowing private sector participation in coal mining not materializing during the Program's tenure. Though the company entered into a memorandum of understanding with Rheinbraun Engineering Germany in 2000, a full-fledged collaboration for streamlining GMDC's lignite projects did not materialize, as the company perceived limited value in the arrangement. Limited progress has been made in improving operating efficiencies by divesting an underperforming cement plant acquired earlier through BIFR or outsourcing bauxite-mining operations. In FY2003, 297 of a total of 2,766 employees availed of the VRS.

25. Highlights of the financial performance of both the enterprises pre- and postrestructuring are presented in Table A4.1. As is observed, GIIC's operating performance has deteriorated significantly with the enterprise posting a net loss of Rs67.02 crore during FY2003, compared to a profit of Rs44.26 crore in FY1998. The primary reason for this downturn in performance was an increase in nonperforming assets coupled with cessation of lending activities. Despite conversion of Rs99 crore of GOG loans to equity together with an infusion of additional equity of Rs89 crore, GIIC's debt equity was 2.05:1 as of 31 March 2004. Much of the additional borrowing was guaranteed by GOG, resulting in outstanding government guarantees increasing by Rs137 crore during the period. For GMDC, while the stock market performance of the enterprise has been encouraging (market capitalization of Rs1,100 crore as against net worth of Rs682 crore as of 31 March 2003), the enterprise has availed of GOG guarantees of Rs600 crore postrestructuring to raise external borrowings for its new initiatives.

Table A4.1: Financial Performance of Enterprises Identified for Partial Divestment (51% stake)

| State Department (in Rs Crore) | Govt investment - pre reforms | | | Govt investment - post reforms | | | Performance before | | Performance after | |
|-----------------------------------|-------------------------------|--------|-----------|--------------------------------|--------|-----------|--------------------|------------------------------|-------------------|------------------------------|
| | Loans | Equity | Guarantee | Loans | Equity | Guarantee | PAT | Accumulated profit / loss | PAT | Accumulated profit / loss |
| GIIC | 353.36 | 69.16 | 23.54 | 25.00 | 256.98 | 160.10 | 44.26 | 61.41 | (67.02) | (178.82) |
| GMDC | | 23.53 | | | 23.53 | 600.00 | 141.39 | 21.41 | 120.46 | 650.77 |

GIIC = Gujarat Industrial Investment Corporation, GMDC = Gujarat Mineral and Development Corporation, Govt = Government, PAT = profit after tax.

Source: Reports of the Comptroller and Auditor General of India.

3. SOE Restructuring—Partial Divestment (26%–74% stake)

26. GOG proposed to divest between 26% and 74% of its stake in four SOEs. While it succeeded in divesting its entire equity stake in Gujarat State Export Corporation Ltd. (GSEC) to Adani Exports Ltd. by February 2004 and reducing its stake in Gujarat State Finance Corporation Ltd. (GSFC) to 49.9% following a public offer, it has been unable to offload its shareholding in Gujarat Industrial Development Corporation Ltd. (GIDC) and Gujarat Agro Industries Corporation Ltd. (GAIC).

27. **Gujarat State Export Corporation Ltd.** With a 57% equity stake in GSEC, GOG proposed to induct a strategic partner and transfer management control by reducing its shareholding to 26% or less by June 1998. The divestment process was delayed by the process of obtaining necessary central Government clearances to transfer ownership of an air cargo complex to GSEC. Following advertisements in January 1999 seeking expressions of interest for acquiring a 45.6% equity stake, only one investor responded within the deadline for submission. The investor was deemed to be qualified to proceed through the subsequent stages of the divestment process. However, the bid submitted was significantly lower than the reserve price. GOG offered to negotiate with the investor who initially expressed inability to offer a higher price. However, following 23 of GSEC's 71 employees availing of a VRS package, GOG successfully negotiated with the investor to sell the 30% stake in early 2001,⁵ and eventually succeeded in offloading its entire equity stake in February 2004.

28. **Gujarat State Finance Corporation Ltd.** GSFC was a statutory corporation, in which GOG proposed to reduce its equity stake from the 68% held prior to the Program. The reduction was intended to be achieved by means of a public offer for 25% of GSFC's equity (as per the threshold under the State Financial Corporation [SFC] Act, 1951) followed by the subsequent divestment of 26% shareholding by June 1998 so that the GOG equity stake in GSFC was reduced to not more than 49%. The subsequent divestment was subject to the central Government allowing an amendment to the SFC Act to increase the limit of private shareholding in a state finance corporation from the maximum limit of 25%. The public issue for a 25% equity stake floated in February 1997 was oversubscribed. After the public offer, GOG's stake was reduced to 49.9%, and the composition of the GSFC board changed with the chair being appointed by Small Industries Development Bank of India. However, GSFC's management continued to be governed by the provisions of the SFC Act. GSFC implemented restructuring measures strengthening its adherence to prudential and exposure norms, organizational restructuring with increased decentralization and empowerment of regional offices, and upgrading of its systems and processes through automation as per recommendations of the consultant engaged to assess its systems and processes. Of its 670 employees, 176 availed of the VRS during FY2004.

29. **Gujarat Industrial Development Corporation Ltd.** GIDC was to be corporatized under the Companies Act (1956) with GOG's equity stake reduced by 26% by June 1998. Existing leaseholders of GIDC industrial estates were required to be provided an option to convert their lease to freehold within this time frame with the objective of repositioning GIDC as a regulatory body to ensure systematic and planned growth of industrial estates in the state as compared to its role as a developer and manager of industrial estates. GIDC began implementing a restructuring plan in November 1997; segregating its estate development and management, financing, and leasing operations; and seeking private sector participation in these activities.

⁵ The conclusion of this deal was relayed to the ADB Board when it was considering release of the final tranche as a waiver of the condition relating to GSEC was being sought and this information made the waiver unnecessary.

This was to lead to GIDC focusing on regulatory, planning, and land acquisition activities. However, given the strategic nature of GIDC's operations in ensuring industrial development in the state, GOG decided not to proceed with divestment. The unbundling of operations was delayed because of employee resistance coupled with limited interest shown by private sector investors in operating industrial estates. Eventually, operation and maintenance of 16 estates was offered to private sector investors with another 19 estates considered for private sector participation. GOG has adopted a resolution giving in principal approval for conversion of leasehold land in industrial estates to freehold with the final orders for implementing the resolution yet to be issued. Of GIDC's employees, 710—about 20% of GIDC's employee strength—have availed of the VRS.

30. **Gujarat Agro Industries Corporation Ltd.** GOG, which held 51% equity stake, was first to acquire the central Government's 49% equity stake in the company and then restructure it, including closing uneconomic units/divisions. GOG would then divest a 49% equity stake in the company through a public offer by June 1998. Additionally, GAIC was to adopt commercial practices in marketing of fertilizers and pesticides, preparatory to divestiture. As GAIC's role in implementing agriculture sector government subsidy programs had a social and development objective, GOG decided not to divest. However, restructuring measures were implemented with all manufacturing units except Gondal being closed by April 2000. The Gondal unit was closed subsequently, with GAIC currently retaining only its fertilizer distribution activities. All 202 employees belonging to the closed units have availed of the VRS. Following measures adopted to strengthen the fertilizer distribution network another 239 employees were given the VRS with 150 technicians with requisite skills were appointed.

31. Highlights of the financial performance of these four enterprises pre- and post restructuring are presented in Table A4.2. GSFC's operating performance has deteriorated significantly with the enterprise posting a net loss of Rs158 crore during FY2003, as compared to a profit of Rs162 crore in FY1998. The primary reason for this downturn in performance has been an increase in nonperforming assets from 24% of FY1998 outstanding lending to 59% of FY2002 outstanding lending. This has resulted in an erosion of accumulated profits by Rs749 crore and resulted in its share prices being quoted at below face value—Rs8.70 against face value of Rs10 in December 2006. Annual support from GOG to GSFC increased by around Rs16 crore postreform. GIDC's operating performance after the restructuring has reduced significantly with profits decreasing by more than Rs30 crore resulting in GOG providing Rs35 crore in the form of subsidies to the enterprise. GAIC's operating performance has improved postrestructuring and consequently GOG's annual financial support to the enterprise has decreased.

**Table A4.2: Financial Performance of Enterprises Identified for Partial Divestment
(26%–74% stake)**

| State Department (in Rs Crore) | Govt investment - pre reforms | | | Govt investment - post reforms | | | Performance before | | Performance after | |
|---------------------------------------|-------------------------------|--------|-----------|--------------------------------|--------|-----------|--------------------|---------------------------|-------------------|---------------------------|
| | Loans | Equity | Guarantee | Loans | Equity | Guarantee | PAT | Accumulated profit / loss | PAT | Accumulated profit / loss |
| GSEC | | 0.08 | | | 1.65 | | 0.13 | 2.78 | 0.22 | 3.68 |
| GSFC | | 26.28 | 684.33 | 41.02 | 49.09 | 465.53 | 16.20 | 14.15 | (158.47) | (734.58) |
| GIDC | 5.29 | | 26.98 | 2.53 | | 14.22 | 31.59 | 43.86 | 1.01 | 144.12 |
| GAIC | | 6.99 | | 7.00 | 7.04 | | (0.73) | 10.50 | 0.69 | (16.26) |

GAIC = Gujarat Agro Industries Corporation Ltd, GIDC = Gujarat Industrial Development Corporation Ltd., Govt = Government, GSEC = Gujarat State Export Corporation Ltd., GSFC = Gujarat State Finance Corporation Ltd., PAT = profit after tax.

Source: Reports of the Comptroller and Auditor General of India.

4. SOE Restructuring—Merger

32. Six SOEs were identified for merger: Gujarat Industries Marketing Corporation Ltd., Gujarat Leather Industries Corporation Ltd., Gujarat State Handloom Development Corporation Ltd., Gujarat State Handicrafts Development Corporation Ltd., Gujarat Housing Board (GHB), and Gujarat Slum Clearance Board (GSCB). Given the synergies and overlapping operations of the enterprises, in September 1996 GOG submitted a merger scheme with the amalgamation/merger schemes to be completed by December 1997.

33. GOG proposed to amalgamate Gujarat Industries Marketing Corporation Ltd. and Gujarat Leather Industries Corporation Ltd., as both were involved in marketing leather and footwear goods produced by rural artisans. The approval for merger from the Company Law Board was received in January 2000 and the merger was effective by January 2001 on completion of registration with the Registrar of Companies.

34. GOG proposed to merge the Gujarat State Handloom Development Corporation Ltd. with Gujarat State Handicrafts Development Corporation Ltd. to form Gujarat State Handloom and Handicrafts Development Corporation Ltd. (GSHHDCL) to take advantage of the synergies of their marketing network and avoid overlapping functions and adverse competition between these two enterprises. The merger was based on a study by the Institute of Rural Management, Anand, commissioned by GOG, which recommended merger of the two corporations along with extensive operating, financial, and personnel restructuring measures. With GOG accepting the recommendation, necessary applications were submitted to the Company Law Board. After settling objections of employee unions and cooperative bodies, the merger came into effect in FY2002. GSHHDCL's current mandate includes development of the handicraft and handloom sector in the state by providing marketing support to the artisans and weavers. Sixty-eight employees availed of the VRS as part of the restructuring process.

35. GOG proposed to restructure GSCB by transferring its functions of constructing low-income housing to GHB. This activity was required to be completed by December 1997. The cabinet subcommittee initially proposed closing GSCB and transferring its assets and liabilities to GHB; nongovernment organizations and local bodies were to be given the responsibility of continuing GSCB's slum clearance activities. However, given GSCB's huge bad loan portfolio because of nonrecovery of loans from the low-cost houses constructed by it, the decision to transfer GSCB's assets and liabilities to GHB could not be implemented. All GSCB operations have been discontinued and all its employees discharged. The employees were redeployed to an independent cell of GHB with responsibility for recovering overdue GSCB loans. These redeployed employees have been appointed on contract with remuneration at 50% of their GSCB salary. The amount recovered by the cell will be deposited in an escrow account after meeting the administrative expenses of the cell, and used to settle the outstanding GOG loans received by GSCB.

36. Highlights of the financial performance of the merged/amalgamated enterprises pre- and postrestructuring are presented in Table A4.3. Following the amalgamation of Gujarat Leather Industries Corporation Ltd. with Gujarat Industries Marketing Corporation Ltd., the operating performance has improved marginally with net profits of the merged entity increasing by Rs0.23 crore. Postmerger annual subsidies received from the Government have decreased. The operating performance of the newly merged GSHHDCL has not changed significantly. It recorded a marginally higher loss in FY2003 as compared to the premerger period. GSHHDCL continues to receive subsidies from GOG, although the amount received in FY2004 of Rs1 crore

was lower than the Rs3 crore received prior to merger. Financial information for GSCB and GHB was not available to the Operations Evaluation Mission (OEM).

Table A4.3: Financial Performance of Enterprises Identified for Merger/Amalgamation

| State Department (in Rs Crore) | Govt investment - pre reforms | | | Govt investment - post reforms | | | Performance before | | Performance after | |
|---|-------------------------------|-------------|-------------|--------------------------------|--------------|-----------|--------------------|------------------------------|-------------------|------------------------------|
| | Loans | Equity | Guarantee | Loans | Equity | Guarantee | PAT | Accumulated profit / loss | PAT | Accumulated profit / loss |
| Gujarat Rural Industries Marketing Corporation | 2.10 | 6.59 | | | 9.17 | | 0.40 | 0.02 | 0.35 | (0.81) |
| Gujarat State Leather Industry Dev. Corporation | | 1.90 | | | | | (0.28) | (0.69) | | |
| Merged entity | 2.10 | 8.49 | | | 9.17 | | 0.12 | (0.68) | 0.35 | (0.81) |
| Gujarat State Handloom Dev. Corporation | 3.75 | 5.48 | 1.75 | 9.17 | 10.23 | | (1.53) | (4.24) | (3.62) | (22.14) |
| Gujarat State Handicrafts Dev. Corporation | 1.80 | 2.61 | | | | | (1.93) | (7.15) | | |
| Merged entity | 5.56 | 8.09 | 1.75 | 9.17 | 10.23 | | (3.46) | (11.38) | (3.62) | (22.14) |

Govt = Government, PAT = profit after tax.

Source: Reports of the Comptroller and Auditor General of India.

5. SOE Restructuring—Closure

37. Four SOEs were identified to be closed: Gujarat State Textile Corporation Ltd. (GSTC), Gujarat Dairy Development Corporation Ltd. (GDDC), Gujarat Fisheries Development Corporation Ltd. (GFDC), and Gujarat State Construction Corporation Ltd. (GSCCL). Although closure was not defined in the design, it was inferred that at least operating closure would be achieved and steps toward financial closure would be initiated.

38. **Gujarat State Textile Corporation.** With the performance of GSTC's mills deteriorating in the 1990s—all mills recorded losses resulting in erosion of their net worth—GOG sought BIFR approval to close the mills. BIFR approved closure in June 1996, and GSTC closed 11 of its 17 mills by November 1996. All 13,900 textile workers received the VRS. The Gujarat High Court issued closure orders in February 1997, with an official liquidator being appointed to oversee the process as per the provisions of the Companies Act (1956). Though valuation for sale of assets of all 17 mills was undertaken, only the plant and machinery of 4 mills and buildings of 3 mills could be disposed of with Rs22 crore being realized. The assets of another mill were auctioned for Rs14 crore, but the sale is delayed by a challenge pending in the Gujarat High Court. The proceeds from the sale of assets will be available if any balance remains after settling all GSTC liabilities. Around Rs634 crore of GOG investments in terms of equity and loans remained blocked in GSTC as of FY2004. Part of these investments may be unblocked only after conclusion of the windup proceedings following the settlement of all GSTC's liabilities and dues.

39. **Gujarat Dairy Development Corporation Ltd.** GDDC was closed in 1999 after receiving BIFR approval. All but five employees were given the VRS in FY1999, with the VRS being partly funded by the SRF and partly by utilizing intercorporate deposit amounts placed by other SOEs with GDDC. The GDDC land is likely to be transferred to GOG, with the plant and machinery having already been disposed of. Around Rs114 crore of GOG investments in terms of equity and loans remained blocked in GDDC as of FY2004. Part of these investments may be released only after conclusion of the windup proceedings following the settlement of all GDDC's liabilities and dues.

40. **Gujarat Fisheries Development Corporation Ltd.** GFDC was closed in 1997 after its operations were suspended, and all assets and liabilities transferred to Gujarat Fisheries Corporation Association. All employees were given the VRS and subsequently redeployed in Gujarat Fisheries Corporation Association. The windup process of GFDC is currently in progress. Around Rs4 crore of GOG investments in terms of equity and loans given were blocked in GFDC as of FY2004.

41. **Gujarat State Construction Corporation Ltd.** GSCCL was closed in 1997 following suspension of its business operations. All but 14 employees were given the VRS. The windup process of GSCCL is still in progress. Around Rs11 crore of GOG investments in terms of equity and loans given remained blocked in GSCCL as of FY2004. Part of these investments may be released only after conclusion of the windup proceedings following the settlement of all GSCCL's liabilities and dues.

42. Table A4.4 summarizes key parameters pertaining to these four enterprises, which were subject to closure. About Rs444 crore was blocked in the enterprises in the form of GOG investments in equity and loans at the time of closure (Rs764 crore in FY2004). VRS payments totaling Rs291.2 crore have been disbursed to 15,874 employees of SOEs subject to closure, from the SRF. Moreover, the VRS payback period for GFDC was 1 year, considering the VRS payout vis-à-vis the reduction in annual recurring GOG support, post closure. Since the extent of Government support to GDDC and GSCCL actually increased after operations were completed, the computation of payback period for these enterprises is not relevant. Financial information on GSTC, post closure, was not available to the OEM.

Table A4.4: Key Parameters for GOG Enterprises Subject to Closure

| State Department | VRS payout (Rs Crore) | No. of employees for VRS | Capital blocked at the time of closure (Rs Crore) | Payback (Years) |
|------------------|-----------------------|--------------------------|---|-----------------|
| GSTC | 225.00 | 140.00 | 386.59 | |
| GDDC | 60.00 | 15.00 | 44.99 | |
| GFDC | 1.23 | 1.21 | 4.22 | 1.0 |
| GSCCL | 4.96 | 2.53 | 7.99 | |

GDDC = Gujarat Dairy Development Corporation Ltd., GFDC = Gujarat Fisheries Development Corporation Ltd., GOG = government of Gujarat, GSCCL = Gujarat State Construction Corporation Ltd., GSTC = Gujarat State Textile Corporation, VRS = voluntary retirement scheme.

Sources: Note on VRS by Bureau of Public Enterprises, Department of Finance, Government of Gujarat and Reports of the Comptroller and Auditor General of India.

6. SOE Restructuring—Sale/Lease of Assets or Unbundling of Activities.

43. Three SOEs were to be restructured with the focus in one, TCGL on the sale and/or lease of assets, and in the other two—Gujarat Maritime Board (GMB) and the Gujarat Electricity Board (GEB) on significant restructuring and unbundling of activities.

44. **Tourism Corporation of Gujarat Ltd.** GOG proposed selling or leasing a number of TCGL assets. The final subtranche covenant of the Program required GOG to sell or lease 20 properties in addition to the 10 properties disposed off prior to release of the first tranche. However, the sale or lease of 10 of the 20 remaining properties could not be concluded due to litigation arising out of the inadequate drafting of the lease agreements, leading to the process being discontinued. Fifty-two employees were given the VRS. As per the report of the

Comptroller and Auditor General of India for FY2004, a decision has been taken to close all unviable units of TCGL with all employees attached to these units being offered the VRS. GOG provided Rs9.5 crore as subsidies to TCGL during FY2004.

45. **Gujarat Electricity Board.** Initiating power sector reforms was one of the final subtranche conditions for the Program that required GOG to develop a time-bound action plan for designing a regulatory framework for the power sector in consultation with ADB. The final tranche covenants required GEB to convert, on a pilot basis, two of its distribution districts into independent profit centers with the objective of increasing cost efficiencies by commercializing the operations. The Gujarat Electricity Regulatory Commission was established in November 1998, and approved the tariff revision proposal of GEB in 2000. GEB has already established two profit centers at the Anand and Rajkot distribution circles. Table A4.5 outlines some key features of GEB's financial performance before and after restructuring.

46. In accordance with program requirements, a progress report on the proposed power sector projects in the state, prioritized in accordance with preestablished parameters, was submitted to ADB in 1999. Additionally, the core investment program for the power sector based on this report was included in the state's overall core investment program. GEB's performance has deteriorated postrestructuring with net losses of Rs475.81 crore recorded in FY2003. In FY2004, GOG had to support the operations of GEB by providing loans of Rs2,034 crore and subsidy of Rs1,056 crore. In addition, the Government provided guarantees of Rs700 crore during the year.

Table A4.5. Highlights of Financial Performance of GEB

| State Department (in Rs Crore) | Govt investment - pre reforms | | | Govt investment - post reforms | | | Performance before | | Performance after | |
|--------------------------------------|-------------------------------|--------|-----------|--------------------------------|--------|-----------|--------------------|------------------------------|-------------------|------------------------------|
| | Loans | Equity | Guarantee | Loans | Equity | Guarantee | PAT | Accumulated profit / loss | PAT | Accumulated profit / loss |
| GEB | 2,705.92 | | 3,007.00 | 2,754.33 | | 6,648.86 | 119.48 | 771.62 | (475.81) | (5,427.22) |

GEB = Gujarat Electricity Board, PAT = profit after tax.

Source: Reports of the Comptroller and Auditor General of India.

47. **Gujarat Maritime Board.** Under a restructuring plan for GMB, submitted by GOG to ADB in December 1999, the SOE intended to retain its commercial operations as a port management enterprise, while establishing a separate independent regulatory body for the port sector. The downsizing of GMB's workforce was also proposed. The expert committee appointed as part of phase II of SOE reforms recommended the creation of Gujarat Maritime Authority (GMA) under the Maritime Authority Act, with GMA having regulatory responsibilities including tariff fixation, with port development activities being retained by GMB. Legislation for implementing these reforms was drafted and is being considered by a parliamentary committee, it is expected to be passed within a year.

48. In the meantime, the Gujarat Port Development Company (GPDC) was instituted as the investing arm of GMB for directing equity into new ports to be developed in the joint sector. The Port Service Development Corporation was established to handle dredging and related port services. Eventually GMB decided to outsource loss-making operations like dredging rather than maintain them under the Port Service Development Corporation. In line with the program prescription, GOG approved and announced a build-own-operate-transfer (BOOT) policy for the ports sector in July 1997, which included a package of BOOT principles serving as a framework

for the involvement of the private sector in the construction and operation of new ports. Financial information in respect of GMB was not available to the OEM.

F. Social Safety Net Mechanism

49. The status of VRS disbursements from the SRF as of 31 March 2002 is presented in the Table A4.6.

Table A4.6: Details of VRS Disbursement in GOG Enterprises

| Item | Number of Displaced Employees | Employees Availing of the VRS | VRS Disbursed (Rs Crore) | VRS per Employee (Rs Lakh) |
|--|-------------------------------|-------------------------------|--------------------------|----------------------------|
| Gujarat State Textile Corporation Ltd. | 14,000 | 14,000 | 225.0 | 1.6 |
| Gujarat Fisheries Development Corporation Ltd. | 121 | 121 | 1.2 | 1.0 |
| Gujarat State Construction Corporation Ltd. | 266 | 253 | 5.0 | 2.0 |
| Gujarat Communications and Electronics Ltd. | 1,365 | 1,365 | 46.0 | 3.4 |
| Gujarat Tractors Corporation Ltd. | 260 | 215 | 7.5 | 3.5 |
| Gujarat Dairy Development Corporation Ltd. | 1,505 | 1,500 | 60.0 | 4.0 |
| Gujarat Small Industries Corporation Ltd.* | 339 | 323 | 11.1 | 3.4 |
| Gujarat Agro Industries Corporation Ltd. | 202 | 202 | 7.0 | 3.5 |
| Gujarat State Export Corporation Ltd. | 42 | 29 | 1.7 | 5.9 |
| Total | 18,100 | 18,008 | 364.5 | 2.0 |

GOG = Government of Gujarat, VRS = voluntary retirement scheme.

Note: 1 Lakh is equal to Rs100,000 and 1 Crore is equal to Rs10,000,000.

Source: Bureau of Public Enterprises, Department of Finance, Government of Gujarat.

50. The average VRS payout ranged between Rs1 lakh and Rs5.9 lakh per employee, computed in line with the VRS formula delineated in para. 21. In addition, about Rs158 crore were spent by individual SOEs on VRS programs implemented after April 1999, based on a separate scheme announced by GOG, encompassing 4,080 employees. All together, almost 22,100 employees received the VRS aggregating around Rs522 crore.⁶ The 14,000 employees displaced from the units of GSTC were also provided retraining support through the Gandhi Labour Institute of the central National Renewal Fund. However, none of the other employees availing of the VRS was provided this facility, although the program design incorporated the component of training retrenched human resources.

51. Interactions with representatives of the Finance Department indicated that the VRS package for displaced employees was designed to ensure that the returns from the investment of VRS compensation would protect the entire remuneration previously earned by the employees. However, discussions with SSN program experts, associated with the closure of GSTC and similar programs in other states, revealed that the VRS compensation disbursed for GOG SOEs, together with the earnings from alternative employment in the informal sector, are estimated to have protected only around 65% of the earnings of displaced employees.

G. Sustainability of SOE Reforms

52. The analysis of the SOE program indicates that GOG largely succeeded in implementing SOE reform, particularly for enterprises identified for full divestment besides those earmarked

⁶ As noted in para. 50 of the report, a detailed postprogram assessment found the *ex ante* estimates were very close to the design estimates.

for merger. With regard to SOEs identified for closure, operating closure was achieved, with financial and legal closure awaiting the completion of the liquidation process. Though GOG was relatively less successful in carrying out reforms for enterprises identified for partial divestment, GOG's commitment to SOE reforms appeared strong. This was essentially due to the apparent broad political consensus on the need for SOE reforms to more effectively utilize resources as well as make the public sector more responsive. This was evident during implementation, where despite changes in the state's political leadership, the direction and pace of reforms were maintained.

53. The initiation of Phase II of SOE reforms after Program completion, with the constitution of an independent Expert Committee for examining 13 select SOEs, in addition to those identified under the Program, for recommendations on their restructuring and divestment, besides approval of a list of another thirty SOEs for submission to the committee, is suggestive of GoG's continued commitment to SOE reforms. While a leading industrialist from the state chairs the Expert Committee, the other members include prominent academicians and businesspersons, indicating the opportunity to leverage their expertise and experience in undertaking further SOE reforms.

54. Interactions with key GOG officials associated with SOE reforms indicated a commitment on the part of the government to pursue SOE reform initiatives postimplementation of the GSPRMP. The OEM was informed that to save budgetary resources, enterprises that do not have a social purpose and are not performing would be closed.

H. Issues

55. Financial sector SOEs such as GIIC and GSFC continue to be a major source of concern, with their continued dependence on GOG resources and inadequate operating processes, controls, and professional capabilities, which have led to high levels of nonperforming assets. Enterprises in this sector accounted for around 7.3% of aggregate GOG investment in SOEs as of 31 March 2004. Experiences in other states also suggest that SOEs involved in extending loans and making investments often suffer because of politically motivated and populist financing combined with a lack of government accountability. These enterprises are often used to circumvent budgetary restrictions through off-budget resource mobilization, thereby leading to fiscal indiscipline and adversely impacting government finances. Consequently, financial sector enterprises owned by GOG must be prioritized for restructuring and divestment.

56. While some SOEs may need to be retained under government ownership because of their socioeconomic mandate, which may be dischargeable only by government, existing government practices suffer from inherent limitations in specific areas like inducting qualified and experienced professionals, enforcing adequate accountability, and motivating superior performance while discouraging underperformance. Consequently, for any SOE reform initiative to be sustainable, appropriate frameworks and mechanisms must be put in place to provide SOEs with the requisite flexibility to incorporate/follow contemporary practices in the areas of corporate governance, human resource management, operations, etc. For example, some state governments are exploring options including hiring expert resources for key SOE positions at market-linked salaries, implementing formal performance management systems in SOEs as in private sector companies, and maintaining an arms-length relationship between the government and the SOE.

57. Experience suggests that a nodal agency is needed for SOE reforms to ensure proper implementation, as the administrative departments lack requisite expertise and time for this. In case of the GSPRMP, the Technical Secretariat played this role. However, with the secretariat now disbanded, requisite capacity needs to be developed in the Bureau of Public Enterprises, operationalized in 1979 to serve as the coordinating agency for state SOEs, or any other nodal body for managing the SOE reform initiative. 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 SOE reform initiative.

58. Outcomes may be further optimized in some cases by adopting alternate SOE reform strategies. Thus, while a public listing may provide additional avenue for mobilizing capital and improve corporate governance through compliance with listing guidelines, induction of a strategic partner may be a better way of achieving fundamental improvements to SOE management and operating styles. Consequently, both GSFC and GMDC continue to be controlled by GOG and managed by bureaucrats, thereby limiting opportunities for radical performance improvement. Similarly, around Rs764 crore of outstanding GOG investments in equity and loans were blocked in FY2004 in the four SOEs undergoing closure through liquidation, a process that inevitably takes between 1 and 5 years. Possible options that could have been explored for freeing up capital invested by GOG earlier include 100% equity stake sale to potential private sector investors with GOG underwriting all existing liabilities until the date of the transaction.

59. As has been indicated in the program completion report, selling or leasing TCGL properties was held up because of litigation. Some of these complications may have been avoided by availing of expert external advice at the time of implementing the divestment exercise, a practice that was adopted subsequently.

60. The operating performance of a number of enterprises like GIIC, GSFC, and GIDC seem to have deteriorated after restructuring, with an increase in GOG support. Experience in similar situations suggests that unless some of the fundamental issues associated with government ownership including inadequate accountability and managerial responsibility, and excessive interference are effectively addressed, a one-time exercise involving financial, operating, and personnel restructuring may not be adequate for bringing in sustainable viability.

61. Discussions with key GOG officials suggest that having the divestment of a specific SOE as a tranche condition had an adverse impact on the divestment process, with some of the prospective bidders trying to take advantage of the situation by quoting lower prices, given the pressures on GOG to complete the process within a stipulated time.

62. For many of the enterprises undergoing 100% as well as partial divestment, a two-stage process of divestment was adopted, with GOG 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 enable higher value realization, it also has associated risks like (i) potential lack of interest of government to divest the balance stake because of change in policies, transfer of key officials, etc.; and (ii) possible change in interests and prerogatives of the private sector investor/partner owing to internal policies, market forces, etc. For enterprises like GTCL and GMDC, one of the primary reasons for the second tranche of divestment not materializing seems to have been adoption of this phased approach for divestment.

63. The SOE component of the Program appeared to have placed limited emphasis on assessing the socioeconomic impact of large-scale human resource displacement. No evidence is available of tracer studies to assess the impact of SOE reforms on displaced workers. While the Program initially included a separate component for retraining displaced workers for adopting alternate livelihoods, this was not implemented owing to the high support costs perceived and a view that the displaced workers would proactively adopt alternate livelihoods. However, the experience with other similar programs in states like West Bengal suggests that a formal program for counseling and retraining of displaced workers usually goes a long way to mitigating associated trauma and adverse socioeconomic impact of retrenchment.

64. The Program did not unambiguously define “closure,” resulting in agencies associated with implementation interpreting the term to mean operating closure, rather than financial and legal closure of the identified enterprises. This ambiguity could create a situation where operationally closed SOEs are revived, defeating the spirit of the program measures. However, given the cumbersome process involved in the legal closure of enterprises and the fact that the Program only had a 2-year tenure, while legal closure could not possibly have been identified as an outcome, financial closure should have probably been mandated to prevent revival of operationally closed SOEs.

I. Recommendations

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

66. Using budgetary impact parameters as tranche release conditions in lieu of divestment milestones for specific SOEs is likely to provide greater flexibility to the government in implementing SOE reform. If milestones are necessary then recognizing the time and resources required to close a SOE and to ensure that at least financial closure is achieved is important.

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

68. 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 and be positively received by all stakeholders including political parties and trade unions.

FISCAL CONSEQUENCES OF MULTILATERAL ADJUSTMENT LENDING TO STATES IN INDIA¹

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 stabilization² 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 M.G. Rao Operations Evaluation Mission 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 A5.1 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 A5.1: 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.

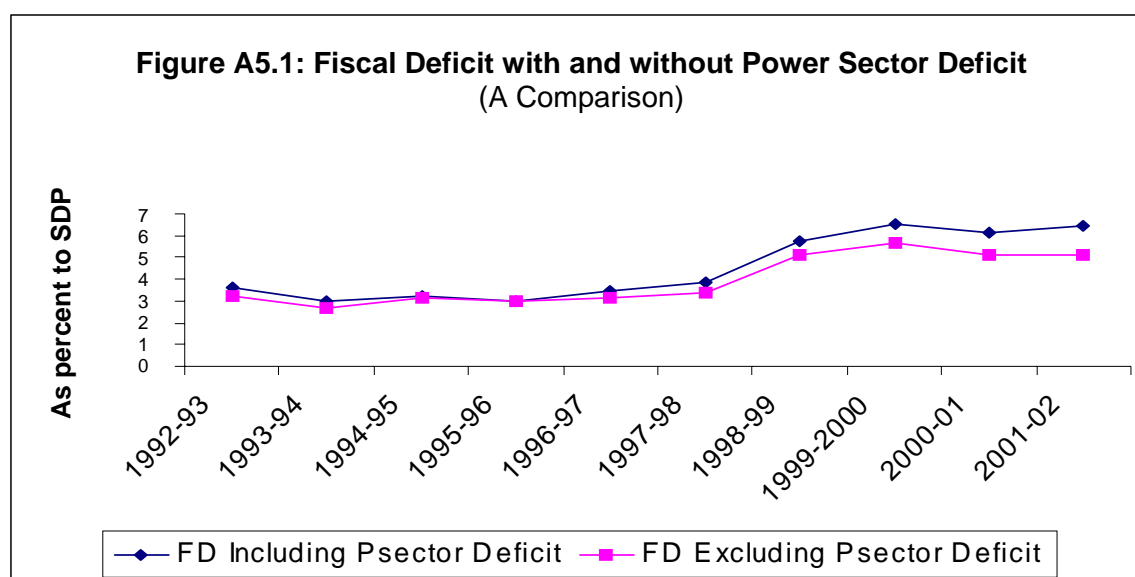
| Description | FY2001 | FY2002 | FY2003 | FY2004 | FY2005 | FY2006 |
|---|--------|--------|--------|--------|--------|--------|
| a. Education, Sports, Art, and Culture | 2.66 | 2.57 | 2.40 | 2.31 | 2.33 | 2.91 |
| b. Medical, Public Health, and Family Welfare | 0.73 | 0.70 | 0.66 | 0.63 | 0.72 | 0.73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

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 A5.1. 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.



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

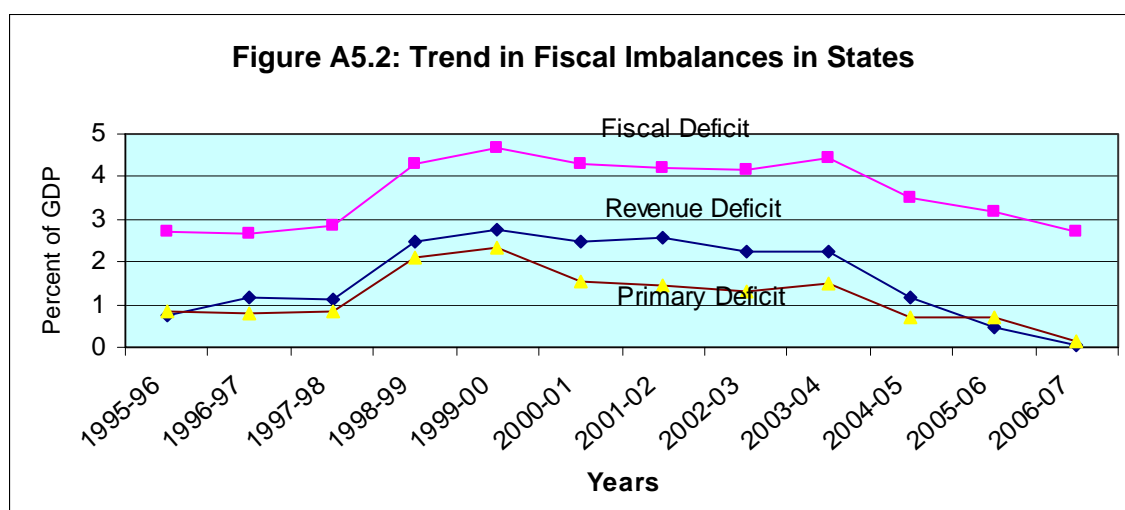
9. The fiscal restructuring plan recommended by the TFC requires that combined revenue deficits of the center and states should be eliminated by FY2008, and aggregate fiscal deficit should be contained at 6% of GDP. The state governments on their part would have to restructure their finances to eliminate 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 A5.2). 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 A5.1). 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 A5.2 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 A5.2: 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 (%) |
|-------------------|--|--------|--------|--------|--|--|
| | FY2002 | FY2003 | FY2004 | FY2005 | | |
| Fiscal Variables | | | | | | |
| 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 A5.3 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 A5.3: Fiscal Health of Individual States

| Item | Percentage of Fiscal Deficit to GDP | | | | Percentage of Revenue Deficit to GDP | | | |
|--------------------------------|-------------------------------------|-------------------------|---------------------|---------------------|--------------------------------------|-------------------------|---------------------|---------------------|
| | 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, GDP = 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 GDP. The analysis shows that, in FY2003, the correlation between revenue deficit and per capita GDP was -0.07 and between fiscal deficit and per capita GDP, 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 GDP 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.

C. Explaining Fiscal Stress: Economic and Political Factors

23. 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.

24. 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

25. 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 A5.5). 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).

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 Delhi.

Table A5.5: 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.

26. 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.

27. 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.

28. 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

29. 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 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.

30. Wide-ranging international experiences of structural adjustment loans (SAL) have produced mixed outcomes. A World Bank review¹¹ 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 Quattara¹² 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 Tiongson¹³ 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.

31. 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 A5.6. To date, Gujarat, Madhya Pradesh, and Kerala have availed of SAL assistance from ADB;¹⁴ and the World Bank has

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

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 Costa Rica, Cote D'Ivoire, 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.

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

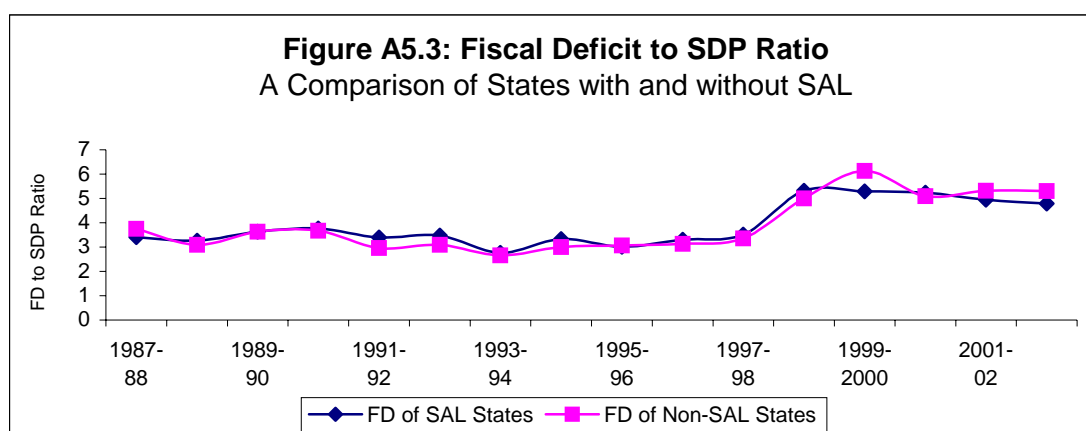
Table A5.6: Year of Fiscal Intervention through SAL

| 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.

32. The combined fiscal deficits to GDP ratio became marginally lower in SAL states than the rest of the states from FY2000 onward (Figure A5.3), 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 GDP ratio remained stagnant during FY2000 to FY2002 for the non-SAL states. By 2001, all five states had introduced fiscal reform except Andhra Pradesh, which followed in 2002. A similar trend is observed concerning revenue and primary deficits to GDP ratio of both categories of states (Figures A5.4 and A5.5). However, unlike fiscal and revenue deficits, the primary deficit to GDP 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.

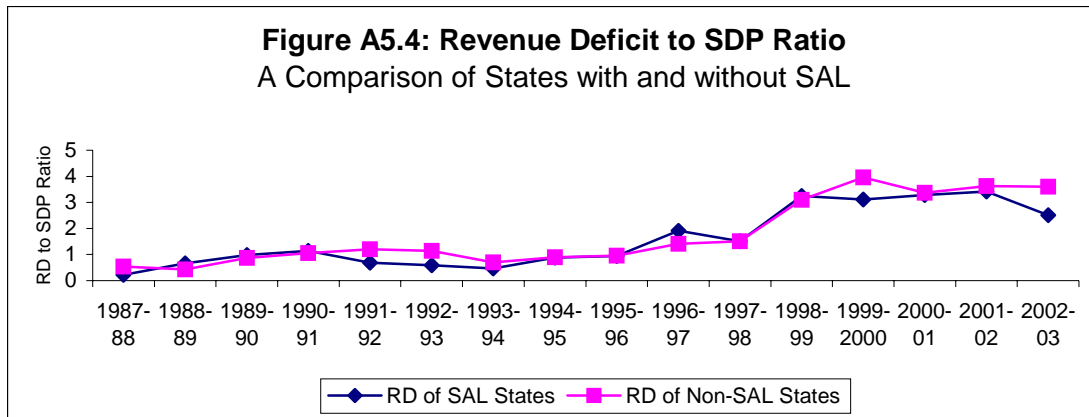


FD = fiscal deficit, non-SAL = non-structural adjustment loan, SAL = structural adjustment loan, GDP = gross state domestic product.

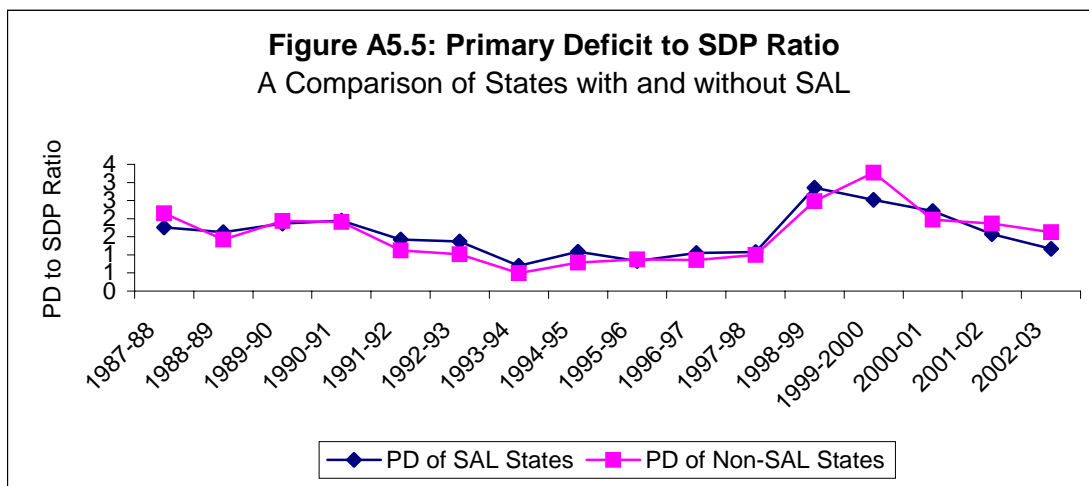
Source: Reserve Bank of India.

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.



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



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

33. 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.

34. 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.

35. 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

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

tax buoyancy was higher in the post-fiscal intervention year than the pre-fiscal intervention year (Table A5.6). 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.

Table A5.6: 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.

36. 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 A5.7).

Table A5.7: 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 | (0.287) | (0.966) | 0.626 |

Note: Figures in parenthesis are negative.

Source: (Basic Data) State Finance Accounts.

37. 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

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.

significantly in Andhra Pradesh and Uttar Pradesh (Table A5.8), 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.

Table A5.8: 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

38. 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.

39. 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 intervention dummy

S_{du} = Salary revision dummy

E_{du} = Earthquake dummy

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

b_{du} = State bifurcation dummy

40. 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.

41. The results of the state-specific expenditure models presented in Table A5.9 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.

42. 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 A5.9: 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 <i>0.619</i> | 0.858 ^a <i>2.936</i> | (0.043) | | (0.018) | |
| Gujarat | (0.335) | 0.331 <i>1.751</i> | 0.640 ^a <i>3.449</i> | (0.004) | (0.004) | 0.082 | |
| Karnataka | (1.338) ^a <i>(2.426)</i> | 0.723 ^a <i>3.154</i> | 0.281 <i>1.222</i> | 0.030 | | (0.062) | |
| Kerala | (1.262) ^a <i>(2.143)</i> | 1.076 ^a <i>4.097</i> | (0.167) <i>(0.634)</i> | 0.097 ^b <i>1.836</i> | | 0.118 ^a <i>2.613</i> | |
| Madhya Pradesh | (0.551) | 0.266 <i>0.985</i> | 0.750 ^a <i>2.946</i> | 0.022 | | (0.030) | (0.189) ^b <i>(2.013)</i> |
| Uttar Pradesh | (0.581) | 0.332 <i>1.159</i> | 0.670 ^a <i>2.509</i> | 0.056 | | (0.035) | (0.080) |

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.

43. 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:

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

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

44. 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

45. The results of state-specific revenue models are presented in Tables A5.10 (own tax revenues) and A5.12 (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.

46. In the case of non-tax revenues, the fiscal intervention dummy is significant with a negative sign in Gujarat (Table A5.11), 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 A5.10: States' Own Tax revenues

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

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 A5.11: Own Non-Tax Revenue Model

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

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

47. 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.

48. 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.

49. 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.

50. 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.

51. 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.

52. 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.

TECHNICAL ASSISTANCE FOR RESTRUCTURING STATE-OWNED ENTERPRISES OF GUJARAT

A. Background

1. Basic Data¹

| Cost (\$) | Estimated | Actual |
|--|-------------------|-------------------|
| Foreign Exchange | 440,000.00 | 435,340.13 |
| Local Currency | 160,000.00 | 155,550.00 |
| Total | 600,000.00 | 590,890.13 |
| Number of Person-Months (consultants) | 34.00 | 30.43 |
| Executing Agency: Finance Department of the Government of Gujarat | | |
| Milestones | | Date |
| President's/Board Approval | | 2 April 1996 |
| Signing of TA Agreement | | 7 July 1996 |
| Fielding of Consultants | | 4 November 1996 |
| TA Completion: Expected | | 30 December 1997 |
| Actual | | 30 April 1998 |
| TCR Circulation | | 5 March 1999 |
| Mission Type | Number | Date |
| Fact-Finding | 1 | 3–5 February 1997 |
| Inception | 1 | 12–23 May 1997 |
| Operations Evaluation | 1 | 2–28 October 2006 |

TA = technical assistance, TCR = technical assistance completion report.
Source: OED Mission.

2. Rationale

1. India's economic liberalization efforts in the 1980s and 1990s put a focus on the rationale and role of public enterprises in a changing economic environment. The 1980 industrial policy resolution of the central Government clearly acknowledged the potential role that the private sector could play in future industrial growth. Accordingly, this policy statement focused attention on the need to promote competition in the domestic market. This was also evident in the Sixth Five-Year Plan (1980–1985), where the Government revised its original policy of maintaining a direct presence in the industry sector. It also identified reasons why public enterprises were underperforming, including (i) inadequate productivity; (ii) poor managerial capacity and limited accountability; (iii) overstaffing; (iv) lack of continuous technological improvement; (v) inadequate attention to research and development, and human resource development; and (vi) increasing competition from the private sector.²

2. The Government's 1991 statement on industrial policy, reaffirmed the earlier analysis of public enterprises underperformance, and outlined a new policy to address this including (i) reviewing the portfolio of public enterprises focusing on strategic, high technology, and essential

¹ Asian Development Bank. 1996. *Technical Assistance to India for Restructuring State-Owned Enterprises of Gujarat*. Manila. (TA 2552-IND for \$600,000, approved on 2 April 1996).

² <http://siadipp.nic.in/publicat/nip0791.htm>

infrastructure; and providing an enabling environment for private investors to enter these sectors; (ii) closing financially unviable public enterprises and establishing a social security mechanism to protect affected workers; (iii) divesting part of the government's shareholding to private investors, financial institutions, the public, and workers; (iv) instituting corporate governance reforms focusing on improving the professionalism and powers of public enterprise boards, and (iv) increasing management autonomy and accountability through performance-based memoranda of understanding that would be placed before Parliament. Almost every Government budget speech since 1992 has contained statements reaffirming the Government's commitment to reforming public enterprises. In 1993, the Government established a divestment commission.³

3. Recognizing its dire fiscal situation, and taking a lead from the Government's revised public enterprise policy, the Gujarat state government (GSG) was the first state government to initiate an in-depth review of its finances including its state public enterprises, referred to as state-owned enterprises (SOEs). In October 1992, the Gujarat State Finance Commission was constituted to undertake a comprehensive review of state finances; examine alternative and new sources of revenue, and the potential for privatization of state SOEs; analyze government expenditure trends; and recommend steps to reduce such expenditure. The finance commission's report, released in April 1994, proposed that GSG substantially reduce the growth of current expenditure by (i) improving planning of executive and investment outlays, (ii) rationalizing the tax structure including better cost recovery with particular attention to the Gujarat Electricity Board, (iii) delegating some government activities to the private sector, and (iv) disinvesting and privatizing its SOEs on an extensive scale.⁴ The report formed the basis of the first state program loan of the Asian Development Bank (ADB), the Gujarat Public Sector Resource Management Program (GPSRMP).⁵ This technical assistance (TA) (footnote 1) was designed and approved during the GPSRMP design phase.

3. Objectives and Scope

4. The TA's outcome (objective) was to strengthen the Technical Secretariat to ensure effective, smooth, and transparent restructuring of SOEs.⁶ The outputs (scope) of the TA were (i) proposals prepared for divestiture or restructuring at least 12 SOEs identified under GSG's public sector reform program (PSRP); (ii) technical advice provided on divestment and privatization matters including valuation; corporate and financial restructuring; corporate management; legal, taxation, and regulatory frameworks; and associated labor issues and strategies; and (iii) an overall approach and strategies developed for the restructuring and eventual divestment of other SOEs over the medium term.

4. TA Completion Report

5. The TA completion report (TCR) rated the TA as generally successful noting that the outcome and outputs were substantially met, and the continued strong ownership by the Gujarat Finance Department, the Executing Agency. The consultant was rated satisfactory, being

³ A detailed history and updated status of Government of India and state government SOEs is provided on the Government's Divestment Department's Web site: www.divest.nic.in, accessed 20 January 2007.

⁴ Government of Gujarat. 1994. *Report of the Gujarat State Finance Commission*. Gandhinagar.

⁵ 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).

⁶ The requirement that TA papers included a TA framework was introduced 3 months after the approval of this TA. Consequently the design describes the objective and outputs with no reference to indicators, risks, or assumptions.

adaptable and innovative in addressing changes in implementation, and the Finance Department was satisfied with the consultant's professional advice. The TCR notes the implementation arrangements were effective, and the Finance Department, consultants, and ADB worked as a team. The TCR recommended that GSG continue its SOE reform efforts and policy dialogue to enhance the restructuring process through the GPSRMP.

B. Assessment of Implementation Performance

1. Design

6. The outcome and outputs in the TA design (footnote 6) reflect an appropriate level of ambition. However, the proposed time frame of 16 months is quite ambitious, given that this is the first TA extended to a state for restructuring complex SOEs, which requires time to change the attitudes of government officials.

2. Engagement of Consultants

7. Six firms were short-listed, and five proposals submitted. The five proposals were evaluated, and on 8 July 1996 the consultant selection committee invited Price Waterhouse International Privatization Group, U.S. to negotiate the contract. A contract for a maximum of \$595,000 was signed on 18 October 1996, for implementation over 16 months. Consultants were fielded on 4 November 1996, the fieldwork was to be completed by February 1998. Price Waterhouse provided five consultants: an international team leader, and privatization and corporate restructuring policy expert (7.2 person-months); accountant and valuation expert (7.67 person-months); valuation expert (6.93 person-months); and two national specialists, including an investment banker and a corporate lawyer (totaling 13.8 person-months). Two contract variations were made to accommodate GSG's request to hold a workshop, and discuss the SOE studies at the final stage of the TA.

3. Organization and Management

8. The GSG Finance Department was the Executing Agency. A cabinet subcommittee was established, to be supported by the Technical Secretariat, to undertake the preparatory and technical analysis of the SOEs, and prepare proposals for their restructuring and divestment. The Technical Secretariat was overseen by the Finance Department.

4. Implementation Schedule and Financing Arrangements

9. The TA was approved on 2 April 1996 and signed on 17 July 1996, with a planned completion date in December 1997. However, the consultants were not fielded until 4 November 1996, and the completion date was extended to 30 April 1998. The TA was closed on 31 March 1999. ADB approved \$600,000 financed by the Japan Special Fund; \$590,890, or 98.5% of the total estimated budget, was utilized.

5. Supervision

10. The TA was supervised from ADB headquarters with monitoring also provided by India Resident Mission staff. The project officer assigned to the TA was promoted, and replaced by another staff, who retained responsibility until TA completion and wrote the TCR. The GPSRMP review missions also reviewed TA progress.

C. Evaluation of Outputs

1. Outputs

a. Proposal for Divestiture or Restructuring of at Least 12 SOEs Identified under the PSRP

11. An inception mission in February 1997 approved the consultant's inception report including the work program, confirming that both the consultant and GSG had a mutual understanding of the objectives and scope. They agreed to develop restructuring proposals for 10 SOEs instead of 12; and within that subset, prepare a valuation report for one SOE that was supposed to be a conduit for the proposed lending facility.⁷ The consultants assisted the Technical Secretariat to prepare the required studies, which provided the basis for specific SOE reform measures. A final tripartite review mission was fielded in November 1997, and the consultants organized a workshop to present study findings.

b. Technical Advice on Divestment and Privatization of SOEs

12. The workshops, on-the-job training, and proposals provided under the TA were useful in giving knowledge and information necessary for the process of SOE restructuring. During TA implementation, a significant number of Technical Secretariat and SOE staff were trained and advised on the restructuring process. GSG officials acquired a better understanding of the issues and strategies for restructuring SOEs. The TA succeeded in providing a support to the GPSRMP, and laid the foundation for a restructuring program.

c. Overall Approach and Strategies for Restructuring and Eventually Divesting other SOEs over the Medium Term

13. As a result of the on-the-job training of Technical Secretariat staff, the phase II of divestment and restructuring is now in progress. The Technical Secretariat, headed by ex-additional chief secretary and four professional staff, now meets on an as-needed basis. The secretariat serves as an advisory body to Cabinet and also to the Finance Department and other line ministries in developing divestment proposals for SOEs. As a result of this TA, an institutional mechanism for the public sector restructuring program has been institutionalized. GSG has created a subcommittee of the Cabinet, chaired by the chief minister with the ministers of finance and industries as members, to review and approve the details of modality, extent of privatization or divestment, and pricing and restructuring of SOEs. Proposals for SOE reforms, prepared by the Technical Secretariat are submitted through the Finance Department to this subcommittee for consideration. The TA also helped set up an effective social safety net mechanism to simplify budgetary procedures for the voluntary retirement scheme, by constituting a state renewal fund under the direct control of the Finance Department. GSG introduced three sets of policy resolutions regarding the voluntary retirement scheme, with the last resolution shifting responsibility for scheme payment from the government to the concerned SOE.

⁷ This is also known as the Gujarat Private Sector Infrastructure Facility, which was envisaged to provide assistance for the development of key infrastructure subsectors in the private sector. This assistance is subject to the development of a satisfactory regulatory environment in the infrastructure subsector being targeted and the availability of viable project pipeline. The facility was never developed.

2. Performance of Consultants

14. Both GSG and ADB found the performance of consultants to be generally satisfactory and commended their high degree of professionalism. The consultants understood the needs of GSG and the Technical Secretariat. The consulting team worked well together and with senior government officials. Delay during implementation resulted from (i) some SOEs providing limited support; (ii) GSG's request to update valuation analysis to reflect latest audited figures; and (iii) difficulty in subcontracting the legal study of an SOE. The final report was submitted almost 4 months after the tripartite meeting because the consultant had to wait to incorporate the comments of GSG and the SOEs. The quality of the reports on SOEs was considered good by the users, with excellent analytical treatment of issues and valuation. The consultant's recommendations were generally well accepted by GSG, and served as guidelines for privatization and restructuring by the technical secretariat.

3. Outcomes and Impacts

15. The TA assisted GSG to improve the efficiency and productivity of the SOEs, and lessened their financial burden on the government. The SOE restructuring studies were implemented through the GPSRMP. Of the 24 SOEs identified for restructuring and closing, 7 were closed, 2 were privatized, 3 were partially disinvested, and 8 were in an advanced stage of restructuring. More than 22,000 employees availed of the voluntary retirement scheme, resulting in annual recurring savings of Rs11 billion from the state budget. In continuing the PSRP, GSG has constituted an outside independent expert committee to study all SOEs and joint sector companies. The committee has made recommendations on 6 of 13 SOEs reviewed to date.

D. Overall Assessment

16. The Operations Evaluation Mission rates the TA overall as successful.⁸ The TA was highly relevant (footnote 9). The TA was consistent with the GSG PSRP and ADB's India strategy, in particular the GPSRMP outcome. The TA is rated as effective.⁹ The TA succeeded in providing a supportive role to the GPSRMP and laid the foundation for the restructuring program; the three outputs and outcome were met. However, the time frame for implementation of 16 months was too ambitious taking into consideration that it was linked to a 2-year program loan, which was extended. A successful mix of international and national consultants, and the use of appropriate training methods, leads to the TA being rated as efficient.¹⁰ The continued use of manuals, updating of training materials, and the reported phase II of the PRSP, results in the TA being rated as most likely sustainable.¹¹

⁸ 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 $2.7 \leq S \leq 1.6$, partly successful $1.6 < PS \leq 0.8$, and unsuccessful < 0.8. ADB. 2006. *Guidelines for Preparing Program Performance Evaluation Reports for Public Sector Operations*. Manila.

⁹ Based on a four-point scale, from 0 to 3, as follows: ineffective (0), less effective (1), effective (2), and highly effective (3).

¹⁰ Based on a four-point scale, from 0 to 3, as follows: inefficient (0), less efficient (1), efficient (2), and highly efficient (3).

¹¹ 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).

E. Conclusions

1. Key Issues and Lessons

17. Given the complex and time-consuming nature of SOE reform, provision of sufficient TA resources to assist GSG to see through the reforms agreed is important. In this case, a 16-month TA was designed to start 6 months before approval of a 2-year program loan. The program loan took 4 years to complete, and even then a number of specific SOE reforms had not been completed. Consideration needs to be given during design to the realistic time and therefore resource requirements of this kind of TA.

2. Follow-Up Actions and Recommendations

18. In designing TA to support future reform programs, mission leaders should ensure that sufficient resources are allocated to address requirements that arise through implementation.

TECHNICAL ASSISTANCE FOR CAPACITY ENHANCEMENT OF GUJARAT INDUSTRIAL INVESTMENT CORPORATION

A. Background

1. Basic Data¹

| Cost (\$) | Estimated | Actual |
|--|-------------------|-------------------|
| Foreign Exchange | 385,000.00 | 345,068.30 |
| Local Currency | 115,000.00 | 72,585.00 |
| Total | 500,000.00 | 417,653.26 |
| Number of Person-Months (consultants) | 24.00 | 24.13 |
| Executing Agency: Gujarat Industrial Investment Corporation | | |
| Milestones | | Date |
| President's/Board Approval | | 30 May 1996 |
| Signing of TA Agreement | | 18 November 1996 |
| Fielding of Consultants | | 24 February 1997 |
| TA Completion: Expected | | September 1997 |
| Actual | | 31 March 1998 |
| TCR Circulation | | 8 December 1998 |
| Mission Type | Number | Date |
| Fact-Finding | 1 | January 1996 |
| Inception | 1 | 3–7 March 1997 |
| Operations Evaluation | 1 | 2–28 October 2006 |

TA = technical assistance, TCR = technical assistance completion report.
Source: OED Mission.

2. Rationale

1. The state and central governments in India have long recognized the need to upgrade and expand infrastructure to accelerate economic growth, and in particular, that significant private sector investment would be required to improve infrastructure facilities and services. Moreover, they recognize that empowering the private sector to be partners in development would not only mobilize additional resources, but also improve the efficiency of public service management practices. Gujarat has long been one of India's more progressive states, and in 1994, the Gujarat State Finance Commission produced a report with recommendations to reform the state's finances, including rationalizing the many government agencies responsible for developing infrastructure. This report formed the basis of the first state program loan of the Asian Development Bank (ADB), the Gujarat Public Sector Resource Management Program (GPSRMP).²

2. The Gujarat Industrial Investment Corporation (GIIC) was established by the Gujarat state government (GSG) in 1968, to catalyze industrial growth and development in the state. It

¹ Asian Development Bank. 1996. *Technical Assistance to India for Capacity Enhancement of Gujarat Industrial Investment Corporation*. Manila (TA 2579-IND, for \$500,000, approved on 30 May).

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).

adopted a two-pronged strategy of being a development banker providing term loans to establish small, medium-sized, and large industrial units; and an entrepreneur promoting medium-sized and large projects in joint partnership or association with leading industrial private sector companies. By 1995, GIIC had expanded its financial services to include leasing, bill discounting, infrastructure development, and investment banking; with infrastructure project development being a relatively new area of operations. At the time of technical assistance (TA) design, GIIC was implementing a chemical port terminal project and processing four projects in the port and transport subsectors, and had several projects under preparation. GIIC was expected to be able to build on its appraisal skills for industrial projects to develop, with proper guidance and training, expertise in infrastructure development and financing. A fact-finding mission visited Ahmedabad in January 1996 to discuss the scope and objectives, cost, implementation arrangements, and terms of reference of the TA. The TA (footnote 1) was approved by the President on 2 April 1996, during the GPSRMP design phase.

3. Objectives and Scope

3. The TA's outcome (objective) was to enhance GIIC's capacity to promote infrastructure development, mobilize financing, and supervise the implementation of infrastructure projects sponsored by the private sector, especially in the roads, transport, ports, and power infrastructure sectors in Gujarat.³ The TA had five outputs: (i) Strengthen the capability of GIIC to design and develop proposals for private infrastructure projects using build-own-operate and build-operate-transfer arrangements. This included undertaking full project appraisal—technical feasibility, financial and economic appraisal, environmental and social analysis, risk assessments, and review of legal agreements and other documentation—and monitoring and supervising project implementation. (ii) Develop GIIC's ability to finance infrastructure projects, including suitable financing mechanisms such as build-own-operate, build-operate-transfer, and their variants; and to access the domestic capital market through appropriate financial instruments and schemes. (iii) Build GIIC's risk management capacity with emphasis on management of foreign exchange risk to effectively channel foreign funding for infrastructure projects, including hedging against foreign exchange risks. (iv) Enhance the sustainability of GIIC's capacity to support private infrastructure projects. (v) Identify GIIC's future training needs, and the potential scope of possible partners, and operating arrangements for technical collaboration of GIIC with other domestic or international organizations.

4. TA Completion Report

4. The TA completion report (TCR) rates the TA as successful. GIIC's capacity was considered to have been enhanced through the training and provision of manuals. The TCR notes that, at the time of TA completion, follow-up actions and recommendations for the divestment of GSG's 26% share in GIIC and GIIC's restructuring under the GPSRMP had been delayed significantly. The TCR recommends that GIIC should fulfill the commitment and continue its efforts to enhance its capability in infrastructure. It also mentions that the proposed lending facility⁴ pipelined in ADB's 1999 country strategy and program, considered that GIIC could be one of the channeling financial institutions.

³ The requirement that TA papers include a TA framework was introduced 2 months after approval of this TA. Consequently the design describes the objective and outputs with no reference to indicators, risks, or assumptions.

⁴ The Gujarat private sector infrastructure facility was proposed to provide resources to attract private sector investment to develop key infrastructure sectors.

B. Assessment of Implementation Performance

1. Design

5. The TA was designed assuming that GIIC was in a healthy financial position that would continue through the life of both the TA and the GPSRMP. The design of the outputs is overly complex and could be simplified to three outputs. Three of the five outputs involve building staff capacity in three different areas of expertise—designing projects for private sector participation, financing infrastructure projects, and risk management. The fourth output deals with the institutional structure, and the fifth involves preparing a training program for the future. This final output was not included in the terms of reference of the TA consultants.

2. Engagement of Consultants

6. A contract was signed with the Hagler Bailly Consulting, Inc. U.S., in association with Price Waterhouse LLP, U.S., and Dalal Consultants & Engineers Pvt., India, on 14 February 1997. The TA proposed 11.5 person-months international consulting services and 12.5 person-months national. The actual person-months provided totaled 24.13 person-months. The international consultants included a power expert/team leader, port expert, road and surface transport expert, and investment banking expert. The national consultants included an infrastructure expert, investment banking expert, environment and social expert, and economist. Consultants were fielded on 24 February 1997, and proposed to complete the fieldwork by September 1997. No major contract variations were made, except for the reallocation of some person-days. The total expenditure was within the TA budget.

3. Organization and Management

7. GIIC's support to the TA as Executing Agency was satisfactory. It made the necessary arrangements to provide consultants with necessary office accommodation and support. However, GIIC's administrative department was not assigned executing agency responsibilities, which is considered unusual.

4. Implementation Schedule and Financing Arrangements

8. The TA was approved on 30 May 1996 with funds from the Japan Special Fund. The TA letter was signed after 5.5 months, on 18 November 1996. The TA was originally scheduled to be implemented over 9 months, commencing September 1996, and to be completed by May 1997. Actual implementation started on 24 February 1997, and actual training ended September 1997. Although the required training materials were given to GIIC staff on time, a final report and manuals acceptable to ADB were submitted in March 1998. The total cost of the TA was estimated at \$550,000, with GSG contributing the equivalent of \$50,000 in the form of office accommodation, transport, remuneration and per diem of counterpart staff, and other support services. The actual disbursement was \$417,653.26, or 83.5% of the estimated cost.

5. Supervision

9. The TA was supervised from ADB headquarters. At the time of the Operations Evaluation Mission (OEM), GIIC staff were unable to recall seeing an ADB review mission, although they recalled the name of the ADB project officer. ADB documents show that an inception mission was undertaken in May 1997, along with a TA review during the Reconnaissance Mission for the proposed facility lending. By this time the main training

program had been successfully concluded. The consultants and the ADB project officer had frequent e-mail exchanges. Why ADB accepted the consultants' final report is unclear, as the report presented the proposed investment facility as a reality, when ADB had responded that this facility was not approved, and sent correspondence to the consultant and GIIC accordingly.

C. Evaluation of Outputs

1. Outputs

10. The first three outputs involved building GIIC staff capacity through intensive training, based on manuals prepared by the consultants, focusing on the project cycle; mobilization of funds for financing infrastructure projects; and risk management with emphasis on management of foreign exchange risk. Training was provided in a 2-day orientation workshop, 3-week intensive training, and 3-day wrap-up meeting. GIIC staff used these manuals for some case studies developed from actual projects, and in processing some infrastructure projects valued at over Rs10 billion in 1998 and 1999. Of the 24 GICC staff who underwent training, only four remain with GIIC. The fourth output on enhancing sustainability of GIIC's support for private sector infrastructure projects required restructuring GIIC; the initiation of this was slow. The fifth output was not included in the consultant's terms of reference and was not achieved.

2. Performance of Consultants

11. GIIC found the performance of the consultants to be satisfactory. They felt that the consultants understood completely the needs of GIIC, and helped them do the required work. However, in the TCR, ADB found the performance of consultants as less than satisfactory. Although the consultants provided various training manuals, their initial assumption that ADB would provide additional funds was inappropriate. The draft manuals sent the wrong signals to GIIC staff and GSG officials regarding ADB's position on the proposed infrastructure financing facility. This confusion continued throughout the TA despite ADB's efforts to correct it.⁵ ADB had not committed to make any loan to GIIC, nor had it identified potential terms and conditions. The minutes of the GIIC board meeting on 12 September 1997 indicate that in principle ADB had agreed to extend a credit line to GIIC. Unfortunately the contents of the consultants' final report was not revised with only a note before the contents page inserted stating "the Revolving Line of Credit mentioned in this Final Report has not been approved by the ADB Board, and the provision of this TA does not commit the ADB to provide a loan to the GIIC. All of the terms and conditions related to the ADB loan mentioned in this report and manuals are indicative only of those typically found in these types of loan agreements and not bind either ADB or GIIC."

3. Outcomes and Impacts

12. The TA was designed to enhance GIIC's capacity to develop and finance infrastructure projects in Gujarat. Twenty-four GIIC officers in sector teams (roads, ports, and power), were trained under the TA to implement the seven manuals defining standards for appraisal and financing of infrastructure projects developed by the TA. However, GIIC's financial position deteriorated from 1996, when new accounting rules imposed by the Reserve Bank of India forced the recognition of interest reversals and provisioning for nonperforming loans, and the company simultaneously began to suffer a steep loss in the market value of its investment

⁵ Gujarat Industrial Investment Corporation staff were still raising these questions in TA wrap-up meeting of September 1997.

holdings.⁶ A 1997 valuation report of GIIC's financial status, quality of investment portfolio, and size of its operations⁷ indicated that gauging the depth of the company's problems with its nonperforming loans is difficult because no systematic effort has historically been made to assess the recovery scenarios and to estimate losses on a loan-by-loan basis. In 2001, GSG engaged consultants to conduct a due diligence assessment of GIIC operations. They recommended GIIC suspend lending activities, focus on recoveries of old dues arising from past loans in addition to creditors' settlement, and restructure GIIC finances to clean up its balance sheet. This was done, however it undermined achievement of the TA objective, and as the training had been conducted prior to the valuation and due diligence procedure, meant that the scope of training was inappropriate for the immediate tasks facing GIIC.

13. Since 2001, GIIC has undertaken a number of measures as part of an operating and financial restructuring plan, including halving its staff numbers through the introduction of two voluntary retirement schemes. In financial year 2006, GIIC had a total market capitalization of Rs490 billion. Of the 59 companies GIIC has invested in, 31 were making a profit, while 28 continued to make a loss.

D. Overall Assessment

14. The Operations Evaluation Mission rates the TA overall as unsuccessful.⁸ The TA is rated as less relevant (footnote 7). Although GSG prioritized the capacity development of GIIC, and ADB endorsed institutional capacity building of GIIC, the GIIC financial status and quality of portfolio did not enable it to act as an investment vehicle for GSG. The TA is rated as ineffective.⁹ Prior to the conduct of an audit of GIIC's financial status, training materials were prepared and GIIC staff trained. The skills acquired were not applicable once GIIC refocused its activities solely on loan recovery. Procedures and manuals remain with GIIC, and have been referred to since, but the timing and sequencing of training was inappropriate. The TA is rated as inefficient¹⁰ as GIIC was not in a position to effectively utilize the TA resources. The TA is rated as unsustainable¹¹ as although GIIC has been relatively successful in recovering its financial position, GSG's phase II SOE reform independent advisory committee has recommended that GIIC be closed.

⁶ Nonperforming assets as a percentage of total assets increased to 31% in 2000 and 38% in 2001. With financial liberalization, access to traditional sources of concessionary finance to institutions such as GIIC have diminished in importance, leading to greater reliance on funds generated at market rates of interest.

⁷ The consultant engaged by ADB under the TA, prepared a report, *Valuation of the Common Stock of Gujarat Industrial Investment Corporation Ltd. as of March 31, 1997*.

⁸ 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 $2.7 \leq S \leq 1.6$, partly successful $1.6 < PS \leq 0.8$, and unsuccessful < 0.8. ADB. 2006. *Guidelines for Preparing Program Performance Evaluation Reports for Public Sector Operations*. Manila.

⁹ Based on a four-point scale, from 0 to 3, as follows: ineffective (0), less effective (1), effective (2), and highly effective (3).

¹⁰ Based on a four-point scale, from 0 to 3, as follows: inefficient (0), less efficient (1), efficient (2), and highly efficient (3).

¹¹ 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).

E. Conclusions

1. Key Issues and Lessons

15. The value of the TA was undermined when an independent assessment of GIIC's financial status found that it was incapable of performing its existing functions. It would be in no position to act as a conduit for a large financing facility. Had GSG's audit of GIIC been updated, and an in-depth assessment conducted during TA design, the TA would not likely have been approved.

2. Follow-Up Actions and Recommendations

16. No follow up actions.

TECHNICAL ASSISTANCE FOR INSTITUTIONAL STRENGTHENING OF GUJARAT INFRASTRUCTURE DEVELOPMENT BOARD

A. Background

1. Basic Data¹

| Cost (\$) | Estimated | Actual |
|---|-------------------|-------------------|
| Foreign Exchange | 816,000.00 | 702,525.44 |
| Local Currency | 34,000.00 | 9,546.66 |
| Total | 850,000.00 | 712,072.10 |
| Number of Person-Months (consultants) | 32.00 | 35.87 |
| Executing Agency: Industry and Mines Department of the Government of Gujarat | | |
| Milestones | | Date |
| President's/Board Approval | | 18 December 1996 |
| Signing of TA Agreement | | 23 December 1996 |
| Fielding of Consultants | | 1 June 1997 |
| TA Completion: Expected | | 23 December 1998 |
| Actual | | 1 October 1999 |
| TCR Circulation | | 28 December 2004 |
| Mission Type | Number | Date |
| Inception | 1 | August 1997 |
| Operations Evaluation | 1 | 2-28 October 2006 |

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

Source: OED Mission.

2. Rationale

1. State and central governments in India acknowledge the need to upgrade and expand infrastructure to accelerate economic growth, and in particular, that a significant level of private sector investment is required to improve infrastructure facilities and services. Moreover, they recognize that empowering the private sector to be partners in development would not only mobilize additional resources, but also improve the efficiency of public service management practices. Gujarat has been one of India's more progressive states, and in 1994, the Gujarat State Finance Commission produced a report with recommendations to reform the state's finances, including rationalizing the many government agencies responsible for developing infrastructure. This report formed the basis of the first state program loan of the Asian Development Bank (ADB), the Gujarat Public Sector Resource Management Program (GPSRMP).²

2. The government of Gujarat (GSG) recognized the need to effect structural changes including policy and regulatory frameworks, and a mechanism to coordinate private sector investment in public infrastructure. In 1995 the Gujarat Infrastructure Development Board (GIDB)

¹ Asian Development Bank. 2001. *Technical Assistance to India for Institutional Strengthening of the Gujarat Infrastructure Development Board*. Manila (TA 2716 for \$930,000, approved 18 December).

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).

was established,³ chaired by the chief minister of Gujarat, as the highest policy-making body on infrastructure development, and the overall coordinating body for the state's infrastructure program. GIDB⁴ was established to (i) formulate policies for infrastructure development particularly through privatization modes, (ii) coordinate individual infrastructure sector development plans to ensure a cohesive and integrated development plan, and (iii) facilitate the mobilization of private investment. GSG and ADB agreed during GPSRMP design to attach a technical assistance (TA) to the program loan to strengthen GIDB capacity. The TA was approved with the program loan in December 1996 (footnote 1).

3. Objectives and Scope

3. The outcome (objective) of the TA was to build GIDB capacity to take a strategic and nodal role in the formulation of infrastructure policies, and promote private sector participation in infrastructure development. The TA output statements were (i) strengthening GIDB to take a role in advising on policy, legal, and regulatory frameworks of key infrastructure sectors; (ii) developing in-house expertise of GIDB in specialized areas, for example, project development, finance, promotion, and marketing; and (iii) preparing documentation for build-own-operate (BOO) and/or build-operate-transfer (BOT) projects, and designing and conducting a related training program. The TA was to contribute to the effective implementation of infrastructure sector policy reforms envisaged under the GPSRMP loan, which had three main outcomes: (i) strengthening the state's public finances and their prudent management; (ii) reducing the role of the public sector in commercial activities; and (iii) evolving enabling policy, regulatory, legal, and institutional frameworks for private sector participation in critical infrastructure sectors, namely power, ports, and roads. The TA was designed to support the GPSRMP's third outcome.

4. TA Completion Report

4. The TA completion report (TCR) rates the TA as successful as it facilitated compliance with all the GPSRMP tranche and nontranche covenants for the third outcome. The TCR confirms that GIDB, an apex body created to develop integrated master plans with intersector coordination and synchronization, was still in operation and formulating high-level infrastructure policies. Through the October 1999 enactment of the Gujarat Infrastructure Development Act,⁶ a clear framework for private sector participation in terms of financing, constructing, operating, and maintaining infrastructure projects was provided, mitigating the risks to private sector participation in infrastructure projects. Since TA completion, GIDB expanded its responsibility to cover as many as 11 sectors including ports, power, roads, railways, airports, urban infrastructure, water, information technology, industry, gas, and tourism. The TCR points out that the success of GIDB's mission depends greatly on quality communications bilaterally (between GIDB and each implementing agency) and among all GIDB members. The responsibility to implement the plans, however, rests mostly within the agencies. It also points out the importance of political support for GIDB's mission to ensure agency cooperation. A local area network that links data and information of infrastructure projects of different infrastructure sectors for gathering information for policy development, implementation, and monitoring was a recommendation for follow-up action in the TCR.

³ The Gujarat Infrastructure Development Board was created on 19 June 1995 through administrative resolution No. 1095-867-1, and given statutory status with the promulgation of the Gujarat Infrastructure Development Act (1999).

⁴ General information about the Gujarat Infrastructure Development Board can be accessed on its website www.gidb.org.

⁵ A TA framework was not included in the TA paper, although the TA was approved 5 months after a framework was required.

⁶ Also known as the BOT Law.

B. Assessment of Implementation Performance

1. Design

5. The TA design and the consultant's terms of reference were appropriate and adequate to achieve the outcome. The design included many components covering advice on legal and regulatory guidelines, procedures, and documentation; training and development of in-house expertise of GIDB staff and officials of implementing agencies in specialized areas and BOO/BOT, and project development and evaluation; and facilitation of BOT project development and implementation. The three output statements can actually be just two output statements since the first output refers to the formation of a legal framework for public and private partnership, and the second and the third output statements are capacity-building outputs. The TA specifically proposed to establish a project development cell within all government departments dealing with infrastructure. Instead, the state implementing agencies established privatization cells that seek and follow advice from GIDB.

2. Engagement of Consultants

6. A contract was signed with Pricewaterhouse Management Consultants USA and Price Waterhouse (India) on 7 May 1997 for \$790,000. The TA proposed 28 person-months of international and 14 person-months of national consulting services, and utilized 28.6 person-months of international and 7.3 person-months of national consultants. The international consultants included an investment adviser and team leader, a BOT expert, four sector experts, and a financial expert. The national consultants included two sector technical experts, two financial analysts, and two lawyers. Consultants were fielded on 1 June 1997, and proposed to complete the fieldwork by 31 May 1998. However, 10 contract variations were required. The major setback was the premature departure of the team leader 3 months after commencement, due to a personal emergency. Recruiting a replacement took 5 months and resulted in contract variations affecting other consultants' time schedules. This delayed project implementation extending the final completion date to 9 months after scheduled completion. Other contract variations included additional technical training courses; minor adjustments in time inputs of individual team members; and replacement of certain positions, such as the lawyer and financial adviser.

3. Organization and Management

7. GIDB's administrative department, the Industry and Mines Department, was the Executing Agency. Its performance is rated as satisfactory. Counterpart staff were made available, although they did not work full time for the TA at the initial stage of implementation. With the help of consultants, a technical secretariat was created to support GIDB, and oversee TA implementation including (i) reviewing agency plans and coordinating the overall infrastructure development plan; (ii) appraising projects proposed for public-private partnership (PPP); (iii) monitoring policy implementation to address policy issues, policy gaps, and impediments of implementation guidelines; and (iv) promoting Gujarat's BOT program. In addition, nodal agency group meetings were organized with participation from both government and private sector representatives from the power, road, and ports sectors to review sector-specific policy and implementation issues. The implementation issues discussed and gathered became inputs in the creation of an infrastructure master plan. These group meetings also became a feedback mechanism while the TA was being implemented. Office space, transportation, communication, and equipment provided were adequate. The TA provided

budgetary allocation for the procurement of a set of computer hardware and software, printers, and a photocopying machine to support project implementation. This equipment was transferred to GIDB after TA completion.

4. Implementation Schedule and Financing Arrangements

8. The TA was approved on 18 December 1996, with the TA letter signed 5 days later, on 23 December 1996. The TA was originally scheduled to be implemented over 12 months, but actual implementation required an additional 22 months before the project was completed. The original schedule was ambitious as it took 7 months to field consultants. Finalization of the report and manuals were much delayed (para. 6), with the TA being closed in January 2004. The total cost of the TA was estimated at \$850,000, with GSG contributing the equivalent of \$80,000 in kind for space, counterpart staff, local transportation, and other services. The actual disbursement by ADB was \$712,072, or 83.7% of the estimated cost.

5. Supervision

9. The TA was supervised from ADB headquarters. ADB review missions concluded that the key objectives of the TA were adequately met. However, a review mission in January 2000, after physical completion of the TA, indicated that GIDB required further assistance in new infrastructure sectors to strengthen and fully establish the role of GIDB as the prime mover of Gujarat's BOT program. This assistance was to be provided under a \$4.5 million World Bank TA project to help (i) GIDB undertake prefeasibility studies for private infrastructure projects to be bid out to the private sector, (ii) GIDB access capacity building by way of training within India and internationally to provide exposure to international best practice, and (iii) develop information and marketing systems. The project was in the form of a 70% loan and 30% grant. However, GSG was only prepared to utilize the grant portion, which provided GIDB staff training within India, after which the project was canceled.

C. Evaluation of Outputs

1. Outputs

a. Strengthen GIDB to Advise on Policy, Legal, and Regulatory Frameworks of Key Infrastructure Sectors

10. **Legal Framework for Public and Private Partnership.** The TA proposed to develop a general policy framework and standard procedures for competitive bid evaluation, technical and financial analysis, contract terms and conditions, and procedures for BOO/BOT policies. Permanency of policy guidelines as compared to administrative orders provides transparency and consistency in the rules applied, and provides a broad policy framework for implementing private sector participation. An enabling legislation was required to implement PPP in Gujarat. The TA supported the drafting of a bill, which was enacted as the Gujarat Infrastructure Development Act, providing a regulatory framework for private sector participation in financing, construction, maintenance, and operation of infrastructure projects. It provides a fair and transparent mechanism for competitive selection of developers, including through international competitive bidding. Model concession agreements across sectors were also established. A model concession agreement is required for projects in all infrastructure sectors because the model document translates sector policies into a contractual framework, stipulating conditions on which a concession is being granted. It addresses issues of jurisdiction, and governing law. It

also addresses contractual allocation of risk between government and the private sector developer, establishing the respective roles and responsibilities.

11. **Policy Reforms.** The TA assisted GSG through GIDB to frame three key sector policies: power (1995), roads (1996), and ports (1997). These policy reforms address sector-specific issues with respect to PPP. They define the structure for the sector; and prescribe the roles, responsibilities, and rights of the government and the private sector partner during project implementation including termination and transfer issues.

12. **Gujarat Infrastructure Master Plan—Vision 2010.** The TA was designed to help with strategic planning. In 1999, GIDB developed a 10-year vision for infrastructure development in the state. Vision 2010 is based on integrated planning across infrastructure sectors identifying the strategic priorities, drivers (sectors that are prime movers and are the demand generators for other sectors), and linkages (sectors that have strong backward linkages) across sectors for coordinated development. It also detailed a list of projects for implementation over the first 5 years.

b. Develop In-house Expertise of GIDB in Project Development, Finance, Promotion, and Marketing; and Preparing Documentation for BOO and BOT Projects and a Training Program

13. **Capacity Building Programs for GIDB Staff and Government Officials.** Eight officials from GIDB and 120 staff of key implementing agencies directly involved in implementing BOT projects participated in a BOT training program. The training program included (i) briefing and roundtable discussion of the policy framework of the draft BOT Law and evaluation guidelines on BOT concession agreements, (ii) BOT project development and evaluation, and (iii) financial analysis and application of a computer-based model. Although GIDB staff considered the training too short, staff performance improved markedly over the long term. Of the eight GIDB staff who attended, only two remained with GIDB at the time of the Operations Evaluation Mission. The OEM learned that materials from these trainings continue to be utilized during in-house training of new staff creating a ripple effect within GIDB and other implementing agencies.

2. Performance of Consultants

14. Both GSG and ADB rate consultant performance generally satisfactory. The consultants understood the needs of GIDB, and communicated effectively with GIDB staff and implementing agency officials, building a very productive working relationship. The consultant reports were considered to be very helpful by GIDB staff, enabling them to frame the policies and regulatory reforms across different sectors. The consultant submitted an inception report in July 1997 and a midterm report in July 1998. The draft final report was submitted in September 1998. A tripartite meeting was held in October 1998 to present the seven-volume draft final report. Manuals for four infrastructure sectors were generally comprehensive and well prepared. The final report comprehensively discussed overall progress and achievement of the TA. After reviews by ADB and GSG, the consultant made the suggested revisions and the final report was accepted in October 1999.

3. Outcomes and Impacts

15. The Gujarat Infrastructure Development Act was a landmark law in India, where for the first time a state laid out a clear legal and institutional framework for private sector participation. Drawing on PPP experiences since its promulgation, the act was amended in 2006 to allow

projects of special nature⁷ to be directly negotiated, instead of going through the bid process. Vision 2010 was being prepared at the time of the TA completion. Vision 2010 identifies 383 need-based projects covering various sectors. GIDB coordinates with the sector-specific agencies to implement the proposed agenda. In March 2005, GIDB conducted a midterm review of Vision 2010 and produced an updated vision and strategy until 2020—the Blueprint for Infrastructure in Gujarat 2020.⁸ The blueprint moves beyond infrastructure including an assessment of social sector requirements and sets quantifiable targets for education, health, social safety, environment, governance, and gender equality. Interestingly, upper middle income countries as defined by United Nations Development Programme—Hungary, Malaysia, Mexico, South Africa, and Thailand—are considered as providing good benchmarks for social sector development in the state.

16. GIDB continues to frame sector policies including an information technology policy (1999), a gas distribution policy (2002), and a special economic zone policy (2004). GIDB has also drafted a water act that is currently under consideration by the state parliament

17. Continuous training in GIDB and other agencies is now in place. GIDB currently has 12 sector infrastructure experts and 6 interns covering power, ports, urban transport, urban water and sanitation, urban solid waste management, roads, gas grid, information infrastructure, railways, airports, and industrial parks. Sector experts are trained on the job to cover more than one sector as alternates. Because GIDB staff are highly qualified, they are attractive to the private sector resulting in frequent staff turnover. A local area network for GIDB was also set up for monitoring projects of different implementing agencies to enhance GIDB operating efficiency.

18. Although the TA suggested a promotional marketing plan during its implementation, it was only 3 years ago that GIDB as GSG's BOT coordinator put in place a strategic promotion and marketing plan for the state's BOT program. The approach to the marketing and business development activities of GIDB concentrates on both traditional and state-of-the-art mechanisms ensuring that potential investors come to know about the infrastructure offerings of the state as well as GIDB's role. It has published brochures, distributes compact discs to interested individuals, and regularly maintains its web site.

19. GIDB is now perceived as a think tank by the private sector and implementing agencies, where the relationship can be considered as a warm and fruitful partnership.

D. Overall Assessment

20. The OEM rates the TA overall as highly successful.⁹ The TA is rated as highly relevant (footnote 9). GSG prioritized the establishment of a sound policy and regulatory framework, and established GIDB as its nodal agency for infrastructure development including coordination of private sector investment in public infrastructure. The TA met GIDB's priorities, and continues to

⁷ These projects include (i) a project that is innovative or involves proprietary technology or franchise that is exclusively available with an individual globally; (ii) a project wherein competitive bidding as provided has failed to select a developer; (iii) a project to provide social services to the people including community services and public utilities; and (iv) an infrastructure project that is an essential link for another bigger infrastructure project owned or operated by the same person.

⁸ The Blueprint for Infrastructure in Gujarat 2020 is available at www.gidb.org/BIG2020.htm.

⁹ 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 $1.6 \leq S < 2.7$, 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.

be relevant to GSG's development strategy. The TA was consistent with ADB's India strategy, and in particular the GPSRMP outcome. The TA is rated as highly effective.¹⁰ GIDB was able to utilize the experience and lessons identified during TA implementation by putting in place a legal framework for PPP in a timely manner. Sector policies, procedures, and manuals contributed to ensuring order, transparency, and equal opportunities in developing PPP. The TA is rated as efficient.¹¹ The design was in general appropriate, but implementation time specifically for initial fielding consultants delayed the TA. Consultants prepared their expected outputs, which were put to good use by GIDB. TA resources were efficiently utilized with a sound mix of consultant inputs and training methods. GIDB continues to provide quality services under its mandate including (i) amendment of the Gujarat Infrastructure Development Act; (ii) new sector policies; (iii) preparation of the Blueprint for Infrastructure in Gujarat 2020; (iv) continuous training; (v) strong promotional and marketing plans including a web site, distribution of brochures, compact discs, and initiating forums; and (vi) support for changing government officials' attitudes toward private sector participation, leads to a rating of most likely sustainable.¹²

E. Conclusions

1. Key Issues and Lessons

21. The TA supported an institution that GSG was fully committed to. The quality of technical advice contributed to TA success. As noted in the TCR, GIDB has moved into new areas and would benefit from technical advice focused on new knowledge areas. This raises a challenge for ADB, with its limited TA funds, as to how it can support future needs of institutions it has previously successfully assisted.

2. Follow-Up Actions and Recommendations

22. No follow up actions.

¹⁰ Based on a four-point scale, from 0 to 3, as follows: ineffective (0), less effective (1), effective (2), and highly effective (3).

¹¹ Based on a four-point scale, from 0 to 3, as follows: inefficient (0), less efficient (1), efficient (2), and highly efficient (3).

¹² 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).