



J & K ECONOMY: Reform and Reconstruction

A report on economic
needs assessment

June, 2004

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DESPITE AN overwhelming presence of state economies in the overall level of economic activity, a basic analytical framework to study the macroeconomics of state economies has not been evolved. This is much more evident in the case of Jammu and Kashmir (J&K) which is perhaps the least studied sub-national economy in the country.

J&K by virtue of its special and unique constitutional position in the Indian Union is a case sui generis. Quite apart from being a special category state in the fiscal federal set up of India, (which entitles it to a liberal form of central assistance to state plan), the institutional structures within which instruments of tax, transfers and public spending are designed and implemented are in many ways different from other states. The institutional differences have meant that the enabling environment within which the states' economic activity takes place is unique and has had an important bearing on the development experience of the state and also on its future growth and development. (See Appendix I)

Notwithstanding the distinctiveness of the state as a political entity, and its special fiscal relations with the Union, its economic problems have been almost identical to those of most other states in the Union. Among these problems is the high fiscal imbalance, excessive reliance on the Union for resources, underutilized growth potential, low capital productivity, existence of parallel markets, and a small and shrinking productive base. These imbalances and problems can in part be attributed to the geographical location of the state, very real exogenous difficulties and inherited production structures. Indeed, the government has often sought to justify poor plan performances in these terms.

These generic problems have been compounded and new specific problems have cropped up in the last fifteen years because of extremely adverse political conditions. Since 1989, there has been an armed insurgency in the state that has wrecked the economic system and had a debilitating impact on the socio-economic performance of the state. It would be appropriate to classify the state economy as a "conflict devastated economy".

The conflict in Kashmir has transformed the

society, and a return to the past may neither be possible nor desirable. This is especially so since the inequities and fragility of the economy and the weak governance structure in Kashmir played a significant role in creating the conditions for conflict. What is needed, therefore, is the reconstruction of the enabling conditions for a functioning peacetime economy.

The loss of human capital, destruction of physical assets, disruptions of trade networks and relations and devastations are a major part of the problem. But from an economic point of view, it is the decimation of institutional capacity that is the biggest damage. The state now has a virtually non-existent economic administrative capacity. This had resulted in a situation where normal economic and financial relations were not working; existing taxes have not been realized, non-tax revenues not collected.

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There are thus two distinct, though mutually reinforcing, sets of problems. First the set of generic problems faced by most states and second the specific problems arising out of civil strife and militancy. For analytical and prescriptive purposes, it will help to keep the two separate. The first set of problems can be dealt with through a package of economic reforms and second through a set of reconstruction initiatives. The challenge and objective is to blend the two together but not to merge them.

In this context, it may help to make a distinction between government and economy. Given the complete dominance of the government in the sphere of economic activity, this distinction tends to get blurred in the state's economic policy. The government's finances are a mess and consequently its function, primarily in terms of governance and provision of services and ability to deliver are impaired. Thus, what is needed is to reform the government and reconstruct the economy. The state government has started a reform program which will be discussed later. The primary focus of this paper will be on the reconstruction strategies.

Even though the most far reaching economic policy decision - land reforms - which shaped the land, labor and credit markets in the state was taken in 1948, the process of planning and development

started in 1955. This followed the restructuring of the institutional arrangement of the state with the Union. It was in 1956, that the financial integration between the Centre and the state took place. In effect the first phase of planning in J&K started with the second five year plan.

Phases of growth

Starting from 1956, the macroeconomic growth of the state in terms of output and employment can be divided into four distinct phases. These phases are demarcated not only on the basis of output performance but in terms of the nature of policy regime followed, changes in the institutional arrangements with the Union and also in terms of the political situation.

The start of the first phase, which coincides with the financial integration of the state with the Union and the second five year plan, extends from 1955/56 to 1964/65. During this phase, driven by access to central resources, the state got its first dose of "autonomous public investment". This was used primarily for creation of social, economic and administrative infrastructure. The first phase, thus, is one of basic infrastructure building in the state and is not very different from the national program except that there were no major industrial investments.

During this phase the rate of growth in the state SDP was of the order of 8 per cent. Given the fact that the state's own resource generation was almost non-existent, the driving force of the growth was central aid and assistance. But more than the level of central transfers it was the policy ad hocism at the central level which translated into a soft budget constraint for the government. This, in the long run, has proved to be detrimental and has had an adverse impact on the culture of management of state finances. The Centre, since that period, is expected to underwrite whatever expenditure the state government makes.

The second phase of economic growth starts from the mid-sixties and lasts till the mid seventies. To be precise, it starts from 1966/67 and ends in 1975/76. In this phase most of the changes in the

institutional relationship with the Union were brought about which may not have had a direct impact on the economy but did constrain the efficient functioning of the economic system. The most important being the political instability. The phase of political ad hocism translated into extremely weak governments whose legitimacy was in question and accordingly, the willingness to pursue rational economic management in terms of either raising resources or pruning expenditures was extremely limited. In fact the level and structure of expenditure and the desire to raise taxes was determined by the need to take populist measures to gain administrative acceptability, if not political legitimacy.

However, the most important change during this phase was the growth in the economy as distinct from government. The commercialization of

agriculture and its market orientation reached a peak as the horticulture sector showed unprecedented growth in output and revenues. In a large measure the growth in horticulture was induced by policy changes, mainly the radical restructuring of land and land relation, which took place in the first phase. The differential pattern of growth also led to a structural change in the economy. The economy became much more export oriented and vulnerable to external shocks. Even though the government and

the economy are detached from each other - the government did not benefit from the exceptional growth performance of the economy - they are linked by one characteristic; dependence. While the government was dependent on the Union for resources, the economy was dependent on external markets. This made the economy open ended and hence constrained the development of the productive base. The essential link between the generation of resources and the realization of value was snapped. Towards the end of this phase, there is an effort to realign the expenditure policies along prudent lines but that did not last long as there was a change in the political leadership.

The third phase (1980/81 - 1990/91) is a classic one that can be observed nationwide; high growth via deficits, debt and inflation. During this period re-

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newed political instability aided the process of fiscal recklessness. At the same time, on the economic front, the state began to face serious competition in its agro and horticulture exports led by states like Himachal Pradesh. The net result was there was a relatively slow growth in the prices of the exports of the state. This along with the higher increase in the prices of imports - which were mostly consumption items with very low elasticity of demand -- meant that the terms of trade became adverse resulting in a reverse flow of resources from the state.

These developments were compounded by the fact that by late eighties, the government of India itself was facing strains on its budgetary resources and was forced to evolve a long-term fiscal policy. Even though this did not have a one to one correspondence with the transfers made to the state, the soft budget constraint seemed to be tightening. The response of the state government to the fiscal hardening was the demand for changing the pattern of central plan assistance to state from 70:30 loan-grants to a 90:10 grant-loan composition. Interestingly, this demand was never conceded till the onset of militancy in 1990/91, which marks the beginning of the last phase.

The fourth phase, 1990/91 to 2001/2002 is the phase dominated by the political turmoil in the state. Its economic implications are a total collapse of the tertiary sector activity led by tourism and on the capital base of the economy. Given the structure of the economy, which external markets - both for horticulture and crafts, drove exports - the growth in output was to some extent insulated. But the productive capacity of the economy in the secondary sector and the tertiary sector was more or less destroyed. The biggest damage in this phase is on the public infrastructure. As can be seen from the following graph, the growth in index of infrastructure sharply dipped in 1991 till which year it was closely in line with the rate of growth of national index. This is not to suggest that the level of infrastructural availability was at par with the national level. The availability was far less but the rate of growth was more or less the same.

Interestingly, even as the creation of infrastructure was reduced sharply in the 90s, its impact in terms of output was much lower than what would

be expected. This brings forth an important analytical point; in the eighties, infrastructure was not a constraining factor to the realization of higher growth. In fact the existing level could support much higher levels of growth than what was attained by the economy in the earlier phases. This indicates a basic inefficiency of capital use and more importantly a distorted structure of public expenditure.

This is also borne out by the asset utilization. The asset utilization shows a major jump in the post-militancy period and so does profitability. These trends or inferences should not be misconstrued to mean that there is or was no need to develop infrastructure. Instead, what it points to is a fundamental re-orientation of the linkages between the real and the financial sides of the economy of J&K. This disjuncture between the real and the financial sides need to be addressed.

Sectoral and social disarticulation

In addition to this, a holistic macroeconomic framework to understand the growth and development in the J&K economy has to take into account the operation of the growth dynamic on the real side. In the real economy, the critical feature of the J&K economy's growth process is not so much the sectoral distribution in terms of agriculture, industry and services, but the sub-sectoral composition and the relationship between these.

For instance, within the agricultural and allied sector, there is a "reform" sector that includes the subsistence agriculture and there is a "non-reform" sector that includes the horticulture and plantations sector. Similarly, the industry sector is heavily skewed in favor of the artisans and crafts segment and the tertiary sector is made of an export depended "tourism" sector and a public expenditure driven government administration.

The unique aspect of the growth process in the J&K economy is the relatively autonomous nature of growth of these various sub-sectors. There is no basic relation evident between the performance of either the sector or the sub-sectors. The logic of this not far to seek. The dynamic part of agricultural sector, which is horticulture, finds its market outside the administrative boundaries of the state

The relation between the production and consumption capacities over the years did not imply a relationship between the returns to investment and the returns to labor thereby resulting in a "socially disarticulated" economy.

and so does the output of the crafts segment with the secondary sector. In the case of the secondary sector, growth is largely fuelled by the inflow of tourists from external markets. What links all these sectors is the fact that their growth is determined by the growth and performance of external markets. In other words, these are exogenously determined.

These two facets of growth when seen in tandem means that the growth process shows a high degree of sectoral disarticulation wherein the traditional forward linkages for the production of primary products and the backward linkages in the industrial production are not developed. Or better put, have not been developed through concerted policy actions.

Industrialization under this kind of sectoral disarticulation that is evident in J&K implies external dependence for the import of capital goods and technology. More importantly, it places an exogenous factor as a necessary constraint on the domestic capacity to produce.

At the same time, the performance of the export sector and the nature of the terms of trade between the state-union markets are determinants of accumulation within the state economy, especially the "modern" sector.

What this implies in macro-economic terms is that the necessary relation between the production and consumption capacities of the state economy does not imply a relationship between the returns to investment and the returns to labor. This has resulted in the economy being "socially disarticulated". Thus the major structural problem with the economy of J&K is sectoral and social disarticulation. It is this that needs to be addressed through concerted policy action.

Traditionally, in the export oriented economies the "modern" sectors capacity to produce is determined by the return to investment that creates derived demand for the production of exportables; the capacity to consume is developed externally by the demand for exports. But in the case of J&K, the structure of exports is such that there is not even the derived demand generation for investment goods. The returns to capital are therefore not invested in any productive activity and go in part to sustain luxury consumption or invested in real estate. It is an amazing fact that the rise in the prices of real es-

tate prices in J&K is the fastest in the country. It is now a major area for speculative investments.

Not only is the consumption expenditure pattern of J&K radically different from any other state with comparable GDP, the fact is that the consumption in J&K has the highest import intensity from among all the states the country barring the north-eastern states. As such the multiplier effects are generated elsewhere.

Given both unfavorable terms of trade and the limited investment opportunities, the marginal rate of return in agriculture and manufacturing is well below the opportunity cost. It is then only rational that all economic agents divert resources primarily from these sectors to either the tertiary sector or to

Given the unfavorable terms of trade and the limited investment opportunities, the marginal rate of return in agriculture and manufacturing is well below the opportunity cost

the real estate. While this is in line with short-term economic rationality, the long-term implications have been that both agriculture and industry have stagnated.

Post the civil strife, the inflows into tertiary sector have also not been made, since the tourist activity came to a sudden and grinding halt. This meant more resources going into the trade seg-

ment and of course development of real estate.

Policy implication

The policy implication of this pattern is straightforward. First and foremost, development of farm/rural infrastructure which will make the "reform" sector price and product competitive and thereby improving price realization and turning the terms of trade favorable. Second, is to develop the rural/agricultural infrastructure, to improve productivity and reduce the dependence on imports. This will strengthen the income generation process with the system. This in turn will make the economy socially articulated and the income generation process will be regenerative. Finally, the need to develop urban infrastructure and utilities to reduce the disadvantages of distance and make industry viable.

Along with this, the reassignment of fiscal responsibility, respecting the legal, political and social environment has to be the focus for institutional reform. The former, which is the reconstruction part and the latter, which is the reform part, will then work in tandem to promote sustained growth and employment in the state.

Introduction

THIS section profiles the state of Jammu and Kashmir in terms of economic structure, geographic characteristics and certain critical social, demographic and infrastructure. With respect to each of these indicators, the state is compared with the other special category and the all-India averages.

Each of the indicators discussed in this report has a direct relevance for analysis of the fiscal capacity of the state to finance routine development and the needs of the state for reconstruction that has been necessitated by a 15 year period of militancy and civil strife. The economic structure determines the tax base and, therefore, influences the revenue potential of the state. The social and demographic parameters, when seen in a comparative context, help estimate the availability and assess the need for expanding the provision of public services to bring it at par with other states and policy benchmarks set by the state for itself.

The geography of the state also has a direct expenditure implication. The terrain does not support large clusters of households. As a consequence, the state is characterized by a relatively large number of small habitations. Each of these has to be provided with some minimal level of services. In doing so, the state is unable to take advantage of agglomeration economies that characterize many of these services. Some threshold levels of capital and operating expenditures have to be made to achieve even small levels of service delivery, but once this is done, the capacity of the system is expandable. The result is that the average cost of delivery in J&K, driven by the large number of small habitations is relatively high. In addition to fragmentation, the nature of the terrain itself increases the cost of delivery.

Geographic features

Covering an area of 2, 22,236 sq kms , J&K has a very diverse topography ranging from the plains in the south to mountainous terrains in the north. Over 76 per cent of the area is under forest cover. As per the 2001 census, J&K population stood at 100 lakhs (10 million). On the basis of its terrain, J&K comprises three natural divisions, namely,

- a. Jammu region of sub-tropical plains which comprises six districts
- b. Kashmir region, the temperate valley, is a

lake basin surrounded by the mountains. It has six districts .

c. Ladakh, the cold arid desert area, constitutes the eastern-most part of the state comprises two districts .

However, for administrative purposes, the state is divided into two divisions with the two districts of Ladakh being a part of Kashmir Division.

Finally, another unique dimension to the state is its "disputed fragmentation and control" - with one part being under occupation of Pakistan and another under China -- and its strategic location. The state has international borders with Pakistan and China and this raises security concerns.

This type of a diverse and mixed topography makes not only the creation of infrastructure and delivery of services costly, but even the maintenance and upkeep of capital assets is very costly.

Demographics

In terms of population, J&K is one of the smallest states in the Union. According to the Census of 2001, the population (1995) of the State, excluding the illegally occupied areas by Pakistan and China, was 100.70 lakhs; less than one per cent of the national population. The density per square kilometer of area is 99 persons against the national average of 324.

Population showed sluggish growth in the first six decades and the decadal growth rate ranged from 5.75 to 10.42 during 1901 to 1961. However, the rate of growth of population during the last two decades at 29.04 % in 1991/2001 and 30.34 in 1981-1991 is substantially higher than the national growth rates of 21.34 % and 23.86 % respectively. Thus, the decadal growth rate of population in the state that was around 10% in the proceeding three decades has almost trebled in the last two decades.

Table 1: Population : Size and Distribution

Year : 2001	(in million)		
	Rural	Urban	Total
Jammu	3.39 (33.69)	1.00 (9.96)	4.40 (43.65)
Kashmir	4.17 (41.43)	1.50 (14.92)	5.67 (56.35)
Total	7.56 (75.12)	2.51 (24.88)	10.07 (100.00)

Note: Figures in brackets are percentages to the total population.

About one fifth of the population in J&K resides in urban areas with 23.83 percent of the population is urban in the state against the national Average of 25.72 per cent.

The birth rate and death rate (and thereby the natural growth rate of population) have both declined overtime and quite remarkably have reached a level below the national average. From 31.4-births/1000 populations in 1988 the number declined to 19.8-births/1000 populations in 1998. Similarly, death rates have declined from 7.9/1000 populations to 5.4/1000 populations.

Table 2. Birth and Death Rate per 1000

	1988		1998	
	Birth rate	Death rate	Birth rate	Death rate
Rural	35.5	9.1	20.8	4.4
Urban	24.0	6.0	21.0	5.6
Total	33.1	8.4	26.4	5.4

In the rural areas birth rate is considerably higher than in the urban areas. But the pace of decline in the rural birth rate values accelerated between 1990 and 1998. It is obvious that the high growth in the state is largely due to the prevailing high fertility.

The distribution of population reveals striking variation at the district level. According to 2001 figures the population is concentrated in the districts of Baramulla, Srinagar, Anantnag and Jammu. More than 53 per cent of the population is in these four districts.

In terms of age structure, the state has had a fairly stable population. More than 40 per cent of the population is in the age group of 0 -14 and 57 per cent of the population is in the three age groups of 0-14, 15-19 and 60 and above, both in 1971 and 1981. The remaining 43 per cent are in the productive age group. This indicates that the burden of dependency is high. During 1971-81, the growth in the 0-14 age group was 24 per cent and 57.49 per cent in the 15-19 age groups. This high growth shows that employment opportunity in the potential sectors needs to be created for this growing population.

Like in the rest of India, there is an imbalance in sex ratio, which is biased towards men. Though

there has been a marginal increase in the sex ratio over the period, in 2001 the ratio is 900, which is still below the national average. Importantly, there are differences between the rural and urban sex ratio, which are quite high. The maximum difference is noticed in Doda and Kargil districts where the difference is as high as almost 300 females between the rural and urban areas. As many as eight districts in 2001 had a sex ratio lower than the state average. Districts having influence of the urban agglomerations of Srinagar and Jammu have a better sex ratio compared to other districts.

The gender disparity index shows that state is well below the national average and way out of the best performing states like Kerala. Even in comparison to the neighboring states like Himachal, the state is adversely placed.

Table 3 : Gender Disparity Index

States	Gender Disparity Index Value	Rank
Himachal Pradesh	0.783	4
Jammu and Kashmir	0.584	19
Kerala	0.872	1
All India	0.620	

According to the 2001 census, 54.46 per cent of the population is literate in Jammu and Kashmir. The national literacy rate for the same period is 65.38 per cent. Jammu and Kashmir ranks thirty-three among the states and UTs of India, and is followed only by Jharkhand (54.13 per cent) and Bihar (47.53 per cent).

Table 4: Literacy Rate in Jammu and Kashmir

Total/Rural/Urban	Persons		Males		Females	
	1981	2001	1981	2001	1981	2001
Total	30.64	54.46	41.46	65.75	18.37	41.82
Rural	25.01	48.22	36.35	60.34	12.19	35.09
Urban	51.12	72.17	59.87	80.30	41.05	62.22

There is a huge gap between the rural and urban levels of literacy and also between the males and females. The rural female literacy, which was an abysmal 12.19 per cent in 1981, has risen to 35 per cent, but it is still way below the national average.

MACROECONOMIC TRENDS

Economic Structure and Performance

THE State Domestic Product (SDP), which in 2001-2002 was estimated to be Rs 14,000 crore on a net basis has with the exception of a couple of years, almost always underperformed the national output growth. The average rate of nominal SDP growth since 1994-95 at the state level is 12.7 per cent compared to the national average of 13.2 per cent.

Between 1993-1994 and 2000-2001, when the national economy registered growth of 6.8 per cent per annum, J&K real SDP grew at a rate of 5.5 per cent. This is not a bad performance considering that the average rate of growth for all special category states was 4.6 per cent. In fact, taking into account that period was one of extreme political turmoil, militancy and civil strife, it is an outstanding achievement.

Table 5: Rate of growth in SDP

Year	At current prices		In constant prices	
	J&K	All India	J&K	All India
1994-95	9.11	17.5	4.45	7.1
1995-96	16.19	16.9	4.99	7.3
1996-97	12.59	16.1	4.79	8.2
1997-98	12.83	12	5.25	4.6
1998-99	25.63	15.5	5.31	6.4
1999-00	9.47	10.1	3.78	6.3
2000-2001	5.11	7.8	1.77	3.7
2001-2002	10.28	9.5	8.97	5.7
Average	12.7	13.2	4.9	6.2

An important point about the SDP growth in J&K is its high degree of volatility. While some part of the fluctuations could be data noise, some part of it is due to the high proportion of agriculture and services in the state SDP. It is quite possible that a sudden increase in public expenditure shows up as a major spike in the SDP trends.

There is no long-term trend readily evident in the SDP growth. However, if one year (in 1993-94 SDP growth is estimated to be 55 per cent at current prices and 278 per cent in constant terms) is dropped from the trend estimates a clear pattern of growth and deceleration emerges. In phase I, from 1985-86 till 1993-94 there is a secular decline. Given the disruption in economic activity, this is only to be expected. Indeed, if there is an issue, it is about the extent of decline that should have occurred. Compared to the destruction of physical infrastruc-

ture and the choking off of various kinds of income generating service activities like tourism, the decline in SDP if anything is limited. One of the reasons for this could be that a large part of the domestic produce is sold in external markets. Second reason for the limited decline in the SDP is the increased security expenditure and the presence of a large number of security troops; phenomena called "olive tourism".

From 1993-94 till 1997-98 there is a revival, which is possible, led by the huge security expenditure made over the years kicking in. From 1998-99, there is again a phase of decline in the SDP growth. This is more related to normal factors like drought.

Trend in SDP



Sectoral growth pattern

The sectoral growth pattern reveals that the services sector was the best performing sector in J&K. At a high rate of growth of 6.8 per cent, the services sector outperformed all special category states growth of 4.7 per cent but fell short of the all-India average for service sector growth of 8.7 per cent. There are, of course, serious differences between the composition of the services sector growth in J&K and that at the national level. While the former is driven by the growth in public administration, in the latter case, it is the "productive" services segment like financial services, and transport communication and trade that has registered the growth. Agriculture grew at a healthy 4.4 per cent but industrial growth was below 3 per cent.

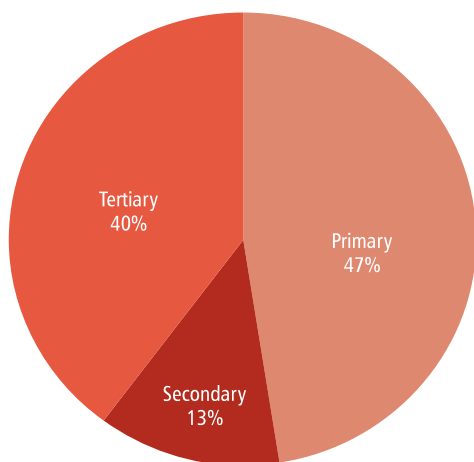
Table 6: SDP growth: Sectoral rates

	Agriculture	Industry	Services	SDP (CAGR)
J&K	4.5	2.9	6.7	5.5
All SCStates	2.0	5.8	5.5	4.4
All-India	3.1	6.9	8.7	6.6

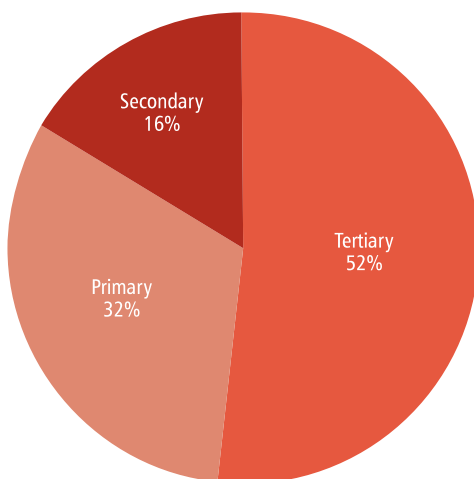
The sectoral composition of SDP shows the overwhelming dominance of the tertiary sector, which accounts for more than 50 per cent of the total SDP. Primary sector accounts for one third and the remaining 16 per cent comes from the secondary sector.

The long term trends in the sectoral composition of SDP indicate that over the last decade and a half, services sector has been gaining in its share while the share of primary sector has declined and that of the secondary sector has stagnated. A comparison of the sectoral composition between 1981 and 2001 brings out the compositional changes sharply.

1980-81



2001-2002



A more detailed analysis of the composition of SDP by industry of origin reveals that unlike other states, the secondary sector is not only much smaller, but it is also dominated by construction instead of manufacturing activities. The contribution of construction has more than doubled since 1980-81. Likewise, the tertiary sector is dominated by public administration instead of trade, transport and communication as in other well developed states. The registered manufacturing accounts for just 1.25 per cent of the SDP. As a consequence of the slow growth and declining share of industry in SDP, the investment opportunities have been shrinking in J&K.

The composition of SDP in these sectors - agriculture and industry-is given in the table below.

Table 7: SDP by industry of Use: 2001-2002

	J&K (% share)	All SCS (average % share)	All India (average % share)
Agriculture	86.75	85.1	91.7
Forestry	10.98	10	4.7
Fishing	2.25	4.9	3.6
Mining	0.60	17.7	9.8
Manufacturing	31.05	34.3	61.2
- Regis	7.53	21.2	39.9
- Unregis	23.52	13.1	21.3
Construction	88.78	37.4	19.8
E, G & W	-20.44	10.7	9.3

What stands out is that the contribution of construction to the SDP originating from industry in J&K is more than two and half times that of the special category states and more than four times the national average. Registered manufacturing accounts for just 7.5 per cent of the Industrial SDP in J&K. To put this in perspective, the comparable figures for special category states is 21 per cent and that at the national level is 40 per cent.

The level of concentration of output generation activity is obvious from the fact that three sub-sectors; viz agriculture, construction and public administration account for almost 60 per cent of the SDP in 2001-2002. The higher share of these sectors in the SDP acts as a constraint on the state revenues as these sectors is not effectively taxed. Thus, from the point of view of revenue potential, J&K is in a disadvantaged position vis-à-vis its comparator special category states.

Table 8: Composition of J&K SDP: 2001-2002

Sector	Magnitude (Rs crore)	(% share)
Agriculture	3902.76	27.64
Forestry and logging	493.84	3.50
Fishing	102.52	0.72
Mining & Quarrying	14.67	0.10
Sub total : Primary	4513.79	31.96
Manufacturing (Reg)	175.82	1.25
Manufacturing (Unreg)	550.35	3.90
Construction	2087.66	14.72
Electricity, Gas & Water	-478.66	-3.39
Secondary	2326.48	16.47
Transport, Commn and Trade	720.04	5.10
Trade, Hotel and Rest	1424.53	10.09
Banking and Insurance	627.42	4.44
Real Estate	773.09	5.47
Public Administration	2184.30	15.47
Other services	1551.94	10.99
Tertiary	7281.32	51.56
NSDP	14121.59	100
Population	102.83	
Per capita	13733	

Public Administration, which used to account for less than 5 per cent in 1980-81, now contributes over 15 per cent to the SDP. Thus the increased share of the tertiary sector should not be seen as an improvement in trade or tourism related activities. It is almost entirely fuelled by an increase in the con-

tribution of public administration.

Per capita Income and Consumption Expenditure

The per capita income at Rs 13, 700 doesn't compare favorably with either the national average or the per capita income of other states. J&K ranks a distant 21 among the states. The states' per capita is less than one third of the number one ranked state, Goa. However, the per capita income of J&K is marginally above the average of all special category states put together.

The growth rate of per capita income of 2.4 per cent in J&K was 10th among the special category states. In fact it is below the average rate of growth of per capita income in all the special category states which was 2.6 per cent. Thus J&K is losing its rank and position on the basis of the level of income that it had acquired over the other states till the mid 90s. Now, special category states like Himachal Pradesh and Manipur have recorded over 5 per cent growth in per capita income and the gap between them and J&K is narrowing.

Like the per capita income, the per capita consumption in J&K is above that of the all-special category average and is quite close to the all-India national average. Also, the per capita consumption is much higher in urban areas than in the rural areas, which is the trend observed for all the states.

LIKE all state governments, the finances of the J&K government have been under strain for almost two decades. While the present fiscal stress is compounded by the political situation of the last decade or so, there have been structural reasons for the state to be in fiscal imbalance.

The structural factors generating fiscal imbalance in the state are of two kinds:

a. Generic or systemic factors of the federal system within which the state operates.

b. Specific factors relating the specificities of the J&K economy like the low tax capacity, composition of its SDP, continued populist governments

The principal generic factor catalyzing the fiscal crisis in the all the states is the Plan. The problem is that in the post fiscal reform period, the approach to financing the state plans hasn't undergone a change. All of it continues to be what it was earlier, even though the entire fiscal regime has undergone fundamental changes. The result is that it is impossible for the states to finance their plans in a manner that doesn't add to their fiscal woes. The only way to reduce the non-plan expenditure is to re-look the plan part. There is no other way to cut the Non Plan Revenue deficit.

The size and structure of the plan affects the fiscal balance adversely in two ways: first is that most states present their budgets before their plan size and its allocation is finalized. This, in most cases, means that the states go for institutional borrowings since Planning Commission rarely, if ever, finances the complete plan proposed by the states and factored into their budgets. This practice has now shown up as the states' fiscal deficit has gone up to 4.6 % when for the last decade or so it was stable around 3 - 3.5%. Now, more than the centre, the states are indebted to the institutions and the market. This is a new phenomenon. Of course, all this borrowing is done with the concurrence and consent of the central government and the RBI, since the states have to statutorily seek the centre's approval before incurring any debt.

The second is that the plan size is always linked to the additional resource mobilization (ARM) of the states. The higher the ARM, the higher is the plan size. This is a mechanical way of plan funding and most

states invariably, exaggerate the ARM in their budgets to get a higher plan allocation. This is not met and shows up as a revenue realization problem even though states own revenues grow at around 14-15%. This year the slow down has affected this rate of growth of states' own revenues. With most states having huge arrears, the Planning Commission would do well; to treat recoveries of tax and non-tax arrears as A.R.M and as a legitimate part of plan financing. This would be an incentive for states to recover their arrears and prevent them from fictionalizing their ARM.

To start with the central assistance to state plans that the Planning Commission decides does not bear any relationship with the investment requirements of the states. Plan transfers to the states, as well as its grant-loan composition are determined independent of the required or proposed plan investments, their sectoral composition, and resources

available with the states. The Planning Commission having got the gross budgetary support from the Finance Ministry has a fixed kitty from which they allot central assistance to state plans on the basis of the revised Gadgil formula.

On their part, State governments come up with a plan size, which has nothing to do with their absorptive capacity. They propose an inflated plan size and do not really work out the annual plan

based on the estimated own resource availability, which includes their own balance from current revenue, contributions of public enterprises, and additional resource mobilization. Given that these in most cases are low and in some cases negative, it is the amount of central transfers to the states as determined by the Gadgil formula that goes to determine the proposed plan sizes. However, as far as the Planning Commission is concerned, these central transfers to the states for the plan are not related to the required size or composition of plan investments. The result is that the two never meet.

Indeed, unlike in the past, the divergence is increasing. On the one hand the total resources with the Planning Commission are being curtailed. Under the pretext of fiscal stabilization, the Finance Ministry has, for instance in the current year, hiked the gross budgetary support to the plan by a mere 6 per cent. On the other, the resource position of

The specific structural factors that have constrained the finances of the J&K government and caused the fiscal imbalance are primarily the composition of SDP where the non-revenue yielding services and agriculture sector dominate

the states is so poor that they cannot even finance the same plan size as last year. Yet they are committed to a plan size that can't be lower than last year given that they have to meet the Tenth Five-year plan targets in terms of investments. Add to this the fact that no state government/political party wants a smaller plan; a bigger plan even if partially un-funded is preferred to a fully funded smaller plan.

The only option left is to take recourse to borrowings. Given that under Article 293, states have no freedom and the Planning Commission, RBI and Finance Ministry allocate market borrowings, what is left is the institutional borrowings from NABARD, LIC and others.

This leads to a system that is over-determined that leaves the states with no options: a small plan is ruled out because there is an annual component of the Tenth five year plan that has to be met; a large plan cannot be funded because the central assistance to state plan is limited and the states' own resources are low or negative; borrowings can't be increased because all states have committed to a medium term fiscal reform program with the Finance Ministry where borrowing limits have been fixed and even if these are relaxed, most of the borrowings go to finance the revenue expenditure. In fact, the last possibility that is the most probable way out is fostered by the Planning Commission by the manner in which it conducts the exercise of plan financing.

Also, while finalizing any state plan, the Planning Commission matches the overall plan outlay, i.e. revenue and capital outlay combined with the overall resources available for the plan. This seems perfectly in order, as there seemingly are no unfunded gaps left. But this aggregative approach is problematic because even as the overall balance is achieved, the resources on the revenue account are not separately matched with the revenue component of the plan. When this is done, it is found that the plan resources on the revenue account - which for normal states is the balance from current revenue, additional resource mobilization and 30 per cent of the central assistance -- are not equal to the revenue component of the plan. Therefore, a diversion of the borrowed funds is built into the plan. It is, therefore, necessary to look at the plan resources separately as revenue resources and as capital receipts and to ensure that the revenue component of the plan is not more than the revenue resources available.

It is for these very basic and simple reasons that

states have moved from a position of having non-plan surpluses in 1986-87, which was larger than their plan deficit to a position where the non-plan account starts with a deficit and has to be financed through borrowings. After this has happened, the fiscal crisis entered its last stage: a crossover of debt and revenue growth of states. The consolidated outstanding debt of states as a ratio of GDP is almost 26% with the rate of growth of nominal stock of debt higher than the revenue growth. From now on the new debt dynamics guided by structure of debt and interest rates will play havoc. This year may have been a reprieve because of the low interest rates. Once that cycle turns, it could be all over for the states and the centre.

The specific structural factors that have caused the fiscal imbalance in the finances of the J&K government are primarily the composition of SDP where the non-revenue yielding services and agriculture sector dominate. This has resulted in the tax capacity of the state being low. In fact a look at the tax mobilization record of the state, it can be classified as high effort-low capacity.

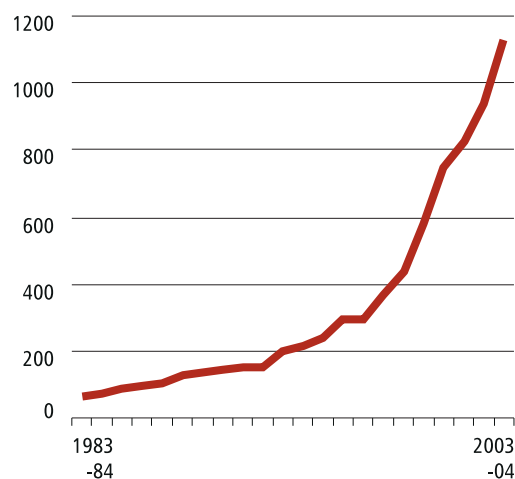
States own revenues

The structure of state's own receipts under the broad category of revenue and capital receipts in 2003-2004 is as follows:

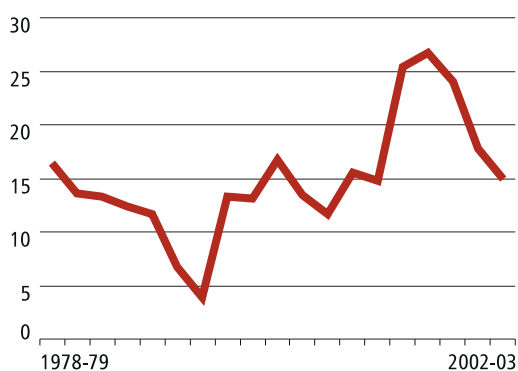
Table 9: State's Own Revenues: Size and Composition

	1980-81	1990-91	2003-2004
Tax	46.88	163.11	1129
Non-Tax	34.10	38.33	510
S.O. R	80.98	201.44	1639

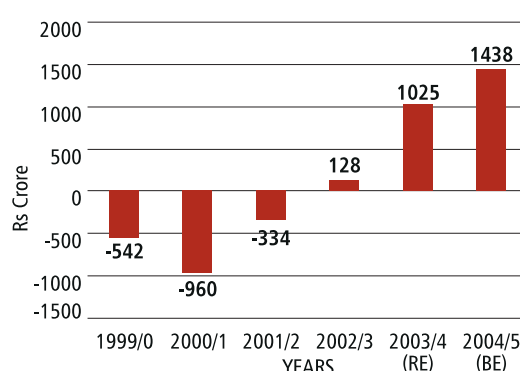
Own Tax Revenues (Rs crore)



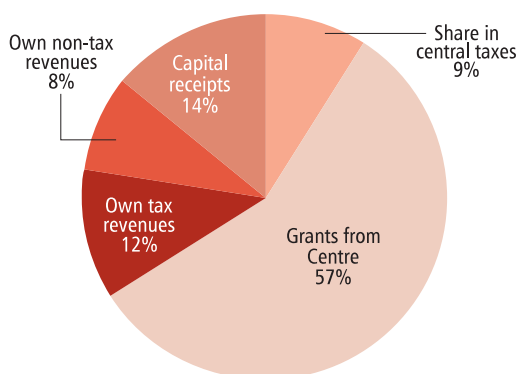
Trend of growth in Tax Revenues



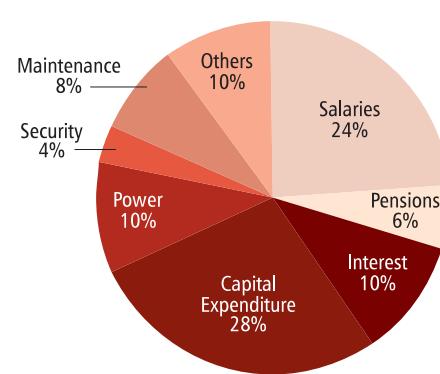
Revenue surplus: trends



Total receipts: composition



Total expenditure: composition



An analysis of tax revenues from 1978-79 till date shows that for the decade 1978-79 to 1987-88 the growth in the tax revenue of 15.4 per cent compared favorably with the performance of the high income states. But for the years 1988-89 to 1995-96, the growth slackened to 11.2 per cent which is below the rate achieved by the low-income states.

Tax revenue, as a percentage of the GDP in 1980-81 was 4.5 per cent. It increased to 5.1 per cent in 1990/91, aided by the sudden slowing down in the rate of growth of GDP. This is low even by the low-income states' standards, which have an average tax/GDP ratio of 6.4 per cent. In high-income states the tax/GDP ratio was 9.1 per cent.

Between 1990-91 and 1997-98, the tax/GDP ratio worsened and reached a level 3.92. There after it as shown a secular increase and the tax/GDP is estimated to have increased to 5.65 per cent. Under its fiscal reform package the state government has forecast the tax/GDP ratio to rise to 6.13 per cent.

An examination of the composition of tax revenues reveals that consumption taxes dominate the tax structure. Almost 92 per cent of the total tax revenue of the state is contributed by taxes levied on consumption.

There is no such buoyancy in the non-tax revenues which have stagnated in nominal terms over the years. In 1977/78, the non-tax receipts of the state were about Rs 33 crore; by 1990/91 it had reached Rs 38 crore. A better way to look at the complete lack of non-tax collections is that while the ratio of non-tax to tax receipts in 1973/74 was 0.925, in 2003/2004, by 1990/91 it was 0.23 and in 2003/2004, it was 0.40. Thus while in 1973/74, for every rupee of tax collected, 90 paise was realized as non-tax which dropped to 23 paise in 1990-91.

Expenditure: Level and composition

On the expenditure side, like most other states, growth in and inflexibility of expenditure is because of salary, and interest payments. In addition to this, in the case of J&K, two factors have compounded the problem of expenditure growth. First is the huge security expenditure and second is power purchase.

That the state government has been resorting to higher borrowing to finance Plan expenditure and yet Plan expenditure as a percentage of GDP has been on the decline is a good indicator of the health of the state finances. Also, this trend reveals the fi-

financial dynamics of the debt build up, which in turn has generated a rising interest burden.

The ratio of interest payments to total revenues (tax plus non-tax revenues) has declined from 19 per cent in 1990-91 to about 5 per cent in 2003-04 because of a change in the composition of central transfers. However, the interest payment as a percentage of the state's own revenue is almost 60 per cent in 2003-04 and shows a marginal increase compared to 1990-91. The high proportion of revenues going into financing interest payments has squeezed the capacity of the State to finance normal developmental expenditure from current revenues.

The volume of direct and indirect subsidies in the system has become unsustainable and most of these subsidies are not specifically targeted at the poor. The major State level subsidies are cheap or free power to farmers, highly subsidized road transport charges, grossly inadequate water rates charged by the irrigation departments and very low user charges in higher education and for hospital services. An increase in user charges in each of these areas is needed urgently.

However, if there is one item of expenditure which is the largest single drain on the fiscal system it is the non recovery of power expenditure (See Appendix 3). The state government has in the last financial year purchased power (from the northern grid) for Rs 1400 crore and all that it has been able to recover is Rs 390 crore, of which around Rs 200 crores are from government departments itself. In effect, what the power development department has collected is only about Rs 200 crore. These power deficit, in a financial sense, of Rs 1000 crore is not so much due to low tariffs, but because of non-recovery, operational inefficiencies and the transmission and distribution losses of around 45 to 50 per cent. Indeed, if power is excluded from the budget, the state has a perfectly well balanced budget. In 2003-2004, after the state government announced a series of fiscal reforms, the state budget shows a primary revenue surplus and a revenue surplus of over Rs 1000 crore. This is expected to increase to Rs 1500 crore in the current fiscal year.

An analysis of the fiscal indicators - revenue deficit, capital outlay as a percentage of fiscal deficit -- J&K has done well compared to other states and even the special category states. The revenue deficit to gross fiscal deficit ratio of J&K is better than average of special category states and the total cap-

ital outlay is more than the gross fiscal deficit.

However, the conventional measures of fiscal situation, like the revenue deficit and fiscal deficit cannot be used in the case of J&K as well as all other special category states. This is so because 90 per cent of the central assistance to state plan is in the form of grants which are treated in the state budget as revenue receipts.

In addition to this, if the balance from current revenue is negative, which it is to the tune of Rs 1000 crore, the planning commission meets finances this non-plan gap prior to financing the new plan. In such a situation, not having a revenue surplus is indeed difficult.

The only point that can be made regarding Central transfers is that J&K's share in total plan assistance has been declining over the years and its share in special category corpus of plan assistance has also declined. This is largely a function of the fact that new special category states, like Uttarakhand and Jharkhand, are being added every now and then. At one point of time, J&K was sharing the 30 per cent earmarked for special category states with just two other states; now it is doing so with 10 others. This has resulted in its share going down.

The story of the management of J&K finances can be better and starkly told by looking at the daily revenue and expenditure of the government. On a daily basis, the state government spends Rs 28 crore on:

- | | | |
|----|-------------|----------------|
| a. | Salary | = Rs 8.5 crore |
| b. | Works | = Rs 5 crore |
| c. | Maintenance | = Rs 2.5 crore |
| d. | Power | = Rs 3.5 crore |
| e. | Interest | = Rs 3 crore |
| f. | Security | = Rs 1.5 crore |
| g. | Repayment | = Rs 1.0 crore |
| h. | Others | = Rs 3 crore |

On the other hand, the "daily" own earnings of the government are just Rs 5.15 crore:

- | | | |
|----|---------|-----------------|
| a. | Taxes | = Rs 3.15 crore |
| b. | Non-tax | = Rs 2 crore |

The revenue flows from the Centre are:

- | | | |
|----|----------------|------------------|
| a. | Central taxes | = Rs 2.25 crore |
| b. | Central grants | = Rs 17 crore |
| c. | Total | = Rs 19.25 crore |

So, on a daily basis the government of J&K has to borrow Rs 3.5 crore, which includes Rs 1 crore from the Central government. This of course,

doesn't include the recurring average overdraft of Rs 900 crore per day. It is a stock of debt, that is being rolled over as a daily deficit.

Overdraft

The extent of fiscal stress in the State is perhaps best reflected by the fact that the overdraft has gone by 20 times in 15 years. The annual overdraft of the state government with the J&K Bank has been rising exponentially. The origins of the fiscal crisis indicated by the rising overdraft lie in 1988-89 when a part of the government expenditure was met from a bank overdraft which was meant to be used for meeting temporary mismatch in revenue and expenditures. The overdraft has increased from Rs 57.41 crores in 1988-89 to Rs 1232 crores in 2002-2003. It has been marginally reduced in 2003-2004.

Table 10: Growth in Overdraft from J&K Bank

Year	Overdraft in Rs crore
1988-89	57.41
1989-90	129.90
1990-91	241.38
1991-92	491.71
1992-93	520.31
1993-94	548.87
1994-95	548.87
1995-96	548.37
1996-97	641.26
1997-98	944.92
1998-99	950.00
1999-2000	1009.87
2000-2001	1054.54
2001-2002	1165.26
2002-2003	1232.44
2003-2004	1127.87

This level of overdraft amounts to a kind of deficit financing of expenditure on an recurring basis with the only difference that it is not monetised. In fact, the overdraft can be broken into two parts; first the structural or core deficit of about Rs 800 crores and "ways and means advances" component of Rs 400 crores.

Debt

Given that the daily expenditure and revenue imbalance is funded through an unlimited overdraft, it is not surprising that the debt burden of the state government should be mounting. At Rs 10,000 crore of internal debt, the debt/SDP ratio works out to

71.4 per cent. Most of this debt is owed to the Central government and the financial institutions like NABARD and LIC.

However, the important point about the size and composition of internal debt of the J&K government is that it is a fiscal and not a macroeconomic issue. This is evident from the fact that even though the accretion to the stock of debt has increased over the time, it is not high as a percentage of the state domestic product.

The debt issue is related to the fiscal policy that has been pursued. The manner in which the state government has been dealing with debt so far is patently dangerous since a large part of it is contracted through non-plan a deficit which is being added to the existing stock of debt.

To be sure, there is no way in which the present debt build up, given its magnitude and composition, can be resolved by any amount of fiscal prudence. At least, not in the short to medium run. The fact is that even if the rate of increase in the accretion to debt slows down, it does not in anyway reduce the existing stock of debt which will continue to strain the finances.

On the contrary, with primary revenue account in balance, if a dent is made on the debt stock, the overall fiscal balance will be automatically restored. So, there is a legitimate fiscal policy case for debt restructuring and write offs in Jammu and Kashmir. In the context of J&K, one can argue that a debt write off is not a moral hazard. Indeed, it will have a positive impact on the system. Of course, it will depend critically on the manner in which debt restructuring is carried out. The constraints on the national fiscal system put limits on the extent of debt relief that can be organized in the medium-term so it is all the more important to work out a package that minimizes the cost and maximizes the impact. The basic principle to be followed is that corrective measures should be formulated in a manner that would provide an in-built incentive for prudent use of borrowed funds. .

There is need to work out a state specific package for J&K based on an analysis of how the borrowed funds were utilized. With respect to the existing liabilities, there has to be a distinction between the central loans with reference to their end use. The loans used directly for financially non-productive purposes like education, health, public works, roads, and bridges has to be treated as

a separate class. A very large part of the borrowings have gone into these areas. These could be the first ones to be rescheduled. Then is the category of loans used for semi-productive purposes like housing, irrigation and power projects. Here, the tenure of debt can be increased. The loans for security, rehabilitation, natural calamity and socially desirable but financially un-remunerative schemes must to be written-off completely.

This can be supplemented by a scheme for encouraging retirement of debt from the proceeds of disinvestment of equity holdings of State Governments. In this scheme relief should be linked to the use of funds for the reduction of outstanding debt. All these together would make a tangible impression on the debt burden of the state. Also, this kind of debt re-structuring would hammer home the point that in the long run there is no escape from the rule that the rate of return on borrowed funds must be greater than the rate of interest at which they are held and that the use of a part of borrowing for consumption makes the need for earning an adequate return on investments in productive enterprises that much greater.

Per capita resource flows:

While the inter-governmental flows are favourable, the indicators of overall resource and capital flows to the state don't present a healthy picture. It is a startling fact that per capita public and private investment in J&K is just Rs 17,000 compared to Rs 52,000 for Himachal Pradesh. In fact it is even lower than Tripura which is otherwise far behind than J&K in every respect. The credit-deposit ratio is also adverse at 33 per cent.

Table 11: Financial Inflows to the state : 2002

	CD ratio	Public & Pvt investment	Plan Outlay	Institutional investment	Credit Utilization
J&K	33.5	16916	2036	812	3290
Assam	38.1	42158	642	624	1411
HP	25.7	52102	2871	177	3132

However, the credit utilization at Rs 3290 crore is the highest among all special category states. This is a bit of a curious mix of indicators which needs more detailed work. A low credit-deposit ratio, a poor public and private investment, average plan outlays and institutional investments coexist-

ing with the highest credit utilization.

The economy lacks financial depth and a large part of the trade is financed through the unorganised segment. The fact that the state has one of the lowest credit-deposit ratios is an indicator of this.

Financial institutions: Deep crisis

With only one bank, the Jammu and Kashmir Bank, operating to full capacity, the financial infrastructure lacks depth and strength.

The Jammu and Kashmir State Financial Corporation, set up in 1959 for development of SSI in the state, was working satisfactorily till 1989-90 and was earning cash profits. Indeed, it was rated amongst the top ten corporations of the country as it has no unpaid liabilities towards SIDBI, IDBI or commercial banks upto 1990.

The working of the Corporation suffered a serious set back because of the militancy. Almost all SSI units particularly in the valley were closed down. Hotels and houseboats became non-functional due to no tourist inflow. Transport sector also suffered due to frequent "bandhs" and "hartals". This affected the plough back of the Corporation directly, since most of the units financed by the Corporation did not meet the financial obligations of the Corporation.

The dramatic collapse of the financials can be seen by looking at the pre-militancy accounts and comparing them with a militancy period year.

Table 12 : Quantum of defaults in the State Finance Corporation as on 31.03.1990

	No	Principal	Interest	Total
Industries	3646	15.9	16.44	32.34
Hotels	272	4.18	3.71	7.89
Transport	1894	9.16	4.34	13.50
Total	5812	29.24	24.49	53.73

Table 12 : contd' Default as on 31.03.1997

	No	Principal	Interest	Total
Industries	8610	77.13	182.74	259.87
Hotels	155	13.80	33.92	47.72
Transport	3069	43.99	48.98	92.97
Total	11834	134.92	265.64	400.56

Table 12 : contd' Default as on 31.03.2003

	No	Principal	Interest	Total
Industries	1614	73.76	419.34	493.10
Hotels	114	5.42	36.19	41.61
Transport	1725	23.64	100.82	124.46
Total	3453	102.82	556.35	659.17

It can be seen from these tables that the between 1990 and 1997, the NPA portfolio by 645.5 per cent. From the date of onset of militancy till date the rise in default has been 1126.8 per cent.

The state of other Corporations, like SIDCO and the cooperative banks is no different. The number of NPA accounts has increased from 8 to 68 over the same period and the total amount of infected assets in SIDCO is Rs 198.78 crores. There is a dramatic rise in their NPA portfolio during the period of civil strife. With the NPA rising from Rs 10.67 crore in 1990 to 146.78 crore in 2002-2003, the level of NPA's is around 28 per cent of the advances.

This existing situation in the financial institutions calls for a major overhaul of the financial architecture of the state. This should involve a series of well planned mergers and acquisitions including a change in the promoters.

Towards aiding this process, there is need to create an institution along the lines of an asset reconstruction company at the state level, with participation from the Union government, for taking

over all the infected assets of the private and public sector. This would be the first step which will clean up the balance sheets of the financial institutions as well as make the existing private investors and projects lendable to the commercial banks.

The broad picture that emerges from the above analysis is that the structure of the economy, particularly because of the weak performance of the industrial sector, is no conducive to developing a strong and diversified revenue base in the short term. Terrain and habitation patterns don not allow the state to exploit scale economies in public service delivery and therefore increase the cost of delivery a minimum level of services

The historical phenomenon of low level of investment, coupled with the debilitating impacts of civil strife, the state has a very poor infrastructure base at the moment. Substantial investments will be needed to enhance the growth potential of the state; these need to be maintained and operated to derive full value. Transfer calculations need to take into account the increased exposure on operating and maintenance costs in the coming years.

INFRASTRUCTURE

In this report we have developed indices of infrastructural availability for J&K for the years 1985, 1990 and 2001. These indices reflect the divergence from the national average and also in some case from the comparable states.

Infrastructure can be measure either in terms of investment, output or in terms of availability of facilities. In this report we first estimate and analyze the availability of infrastructure. Once this is done, we work backwards to estimate the investment requirements to bring the state infrastructure at par with the national average. The total investment is a representation of state action and how much of it has been converted into usable concrete capital.

For the purpose of this report we have measured infrastructure through 24 variables (listed along with the methodology in Annexure 1) classified into eight sectors which map the economic sectors. These sectors are, agriculture, banking, electricity, transport, communication, education, health, and civil administration.

These are further classified under three heads; Economic infrastructure (a to e), Social Infrastructure (f & g) and Administrative Infrastructure. The indices are constructed by a two-stage procedure using principle components and the correlation with SDP as the basic principle for generating the weighting rules.

Aggregate infrastructure index

With the all-India SDP per capita index and the aggregate infrastructure index pegged at 100, the relative disadvantage of J&K vis-à-vis the national average is given below:

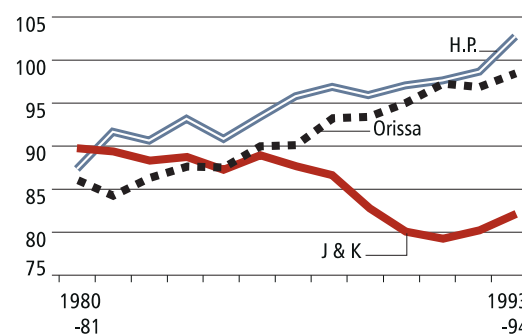
	1985	1990	2001
SDP per capita Index	105.89	84.89	92.64
Aggregate Infra Index	77.29	76.07	72.03

While the state has throughout been better placed on the SDP index, the growth in infrastructure has been slow and deteriorating. The fall is much sharper between 1990 and 2001. This should not come as a surprise.

A time series of infrastructure index based on the CMIE data on infrastructure bears out our estimates. As the graph below shows, the infrastructure index of J&K has been on a secular decline that has become very sharp after 1989-90. Compared to this, two states Himachal and Orissa which were

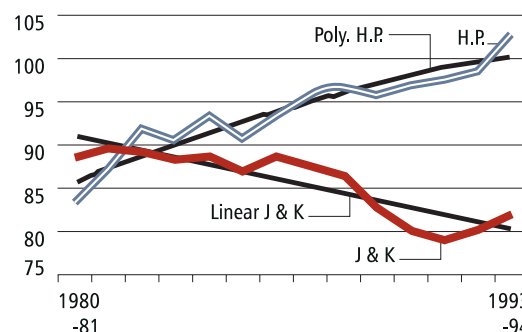
at the same level in 1980-81 and moved in tandem with J&K till 1987-88, have seen a consistent rise in their infrastructural index.

Infrastructure index: A comparative picture



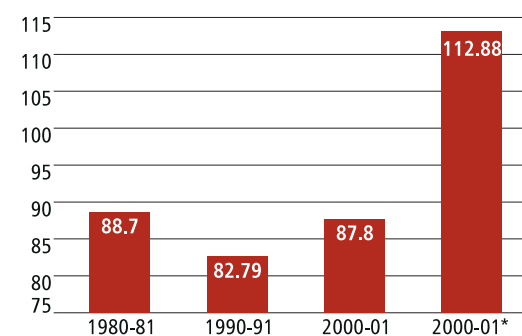
In fact, the index for Himachal pradesh, a neighboring and broadly similar state has an index higher the national average. The divergent trends in the development of infrastructure between Himachal Pradesh and J&K are brought out in the graph given above.

Infrastructure: A counterfactual



If the trend rate of growth of Himachal and Orissa were to be applied to the J&K infrastructure index after 1986-87, the "loss" in infrastructural availability can be estimated. With a normal trend growth, the aggregate infrastructural index for J&K

The "lost" infrastructure



in 2001-2001 should have been around 113. The gap between what would have been and what is the existing level of infrastructural availability is the "Lost infrastructure" or the infrastructural gap because of the political turmoil.

Comparing the increase in the aggregate infrastructural index across states and over time with the total budgetary developmental capital outlay of the states, it is estimated that on an average, it takes Rs 750 crore to make a 1 basis point improvement in the index. On this basis to get to a 25 basis point increase in the J&K index, thereby bringing it at par with what it would have been had there be no disruption in infrastructure building and destruction of infrastructure, will require Rs 18, 466 crore.

In other words, the financial resources needed to bring infrastructure to the levels it would have been in the absence of the destruction of infrastructure and the low level of investment because of divergence of investible resources to security and other areas will be around Rs 20,000 crore.

This is admittedly a rough estimate as it depends on the composition of infrastructure. Decomposing aggregate infrastructure into its three main components, we find that the damage is not evenly spread. While the gap between the national average and that of J&K's availability has widened in all three sub-categories of infrastructure, it is the building up of social infrastructure that has been most adversely affected.

Sectoral infrastructural assessment:

Economic Infrastructure that includes electricity, transportation, communication, agriculture and banking and has a combined weight of 80 per cent in the aggregate infrastructure has seen a secular decline from 133. In the decade of 90's, it has declined by about 9 per cent. The brunt of the decline within economic infrastructure is borne by agricultural and banking infrastructure. Qualitative assessment suggests that this the reduced availability of agricultural infrastructure is pointing to the physical destruction and lack of maintenance of irrigation canals and culverts. Although it carries a weight of only 15 per cent in aggregate infrastruc-

ture and 19 per cent in economic infrastructure, it is a vital component of infrastructure in as much as 40 per cent of GDP originates from this sector.

In the case of banking, it is not so much the physical destruction, as it is the withdrawal of almost all the major banks and the closure of their branches in the state in the 90's. It is this that is showing up as reduced availability of banking infrastructure. Also, during the same period, there has been a phenomenal rise in the financial infrastructure across the country. The two combined have led to the yawning gap between J&K and the rest of India.

In social infrastructure, the drop in availability in the period 1990 to 2001 is 20 per cent. With this sub-sector, it is the health infrastructure that is relatively worse off with a decline of 19.7 per cent followed by educational infrastructure with 10 per cent. In fact in terms of availability, health infrastructure is the almost that same that was in 1985. With population have grown at a rapid pace, the availability per capital has come down very sharply.

The financial resources needed to bring infrastructure to the levels it would have been in the absence of the destruction of infrastructure and the low level of investment because of divergence of investible resources to security and other areas will be around Rs 20,000 crore

**Table 13 : Economic Infrastructural Indices :
By sub-sector**

J&K:	1985	1990	2001
Economic Infra	75.48	71.39	64.7
Agricultural Infra	143.1	133.6	101.7
Banking Infra	21.0	19.1	15.3
Electricity Infra	85.7	81.5	78.7
Transport Infra	45.9	44.5	39
Commun Infra	43.6	41.5	38.8
All India	100	100	100

**Table 14: Social Infrastructure Indices
by sub-sector**

	1985	1990	2001
Social Infra	86.8	100.6	80.4
Education	96.2	91.4	81.4
Health	85.7	102.7	82.4
All India	100	100	100

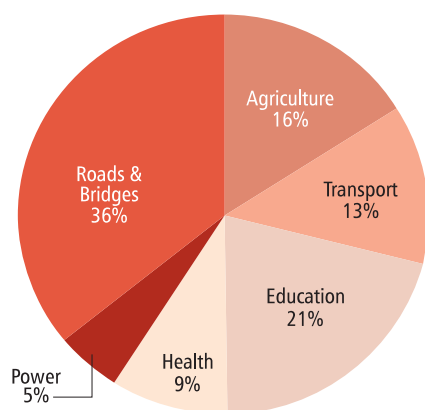
Damage by sector

In addition to the relative deprivation of J&K and increasing gap in infrastructure because of lack on investments and faster pace of growth in other

states, a major onslaught of the conflict has been on the destruction and damage of public property. The main targets were the educational institutions, hospitals, dispensaries, bridges, seed stores, power transmission and distribution systems, vehicles and departmental buildings of the government.

The estimates of these have varied from Rs 300 to 500 crore. But more important than that is the distribution of damage by sector, which gives a certain feel to the decline in sectoral indices, observed above. For an estimated total destruction of Rs 518 crore, the sectoral shares are given in the accompanying graph.

Destroyed Infrastructure: Sectoral impact



Infrastructural availability by districts

It is not possible to construct intra-state indices of infrastructure because of the lack of availability of data. To start with, in J&K, the Net State Domestic Product or Per Capita Income is not available at the district level. Even production estimates or yield rates of agricultural crops at district level are not available. However, to get a sense of the district-wise level of infrastructural availability, we have used some indicators that are essentially in the nature of proxies for assessing the development of various districts. Some of the important indicators include the following.

The ranks of various districts in terms of the agricultural development, Social development Infrastructure development and of Economic development is given below. In terms of development, Jammu and Srinagar Districts are the best off. These are followed by Kathua, Pulwama, Badgam, Anantnag, Baramulla, Leh, Kargil, Udhampur, Rajouri, Poonch, Kupwara and Doda.

The position of Jammu, Kashmir Valley and Ladakh in terms of the said indicators is as follows:

S.No	Indicator	Jammu	Valley	Ladakh	Rank of		
					J	K	L
A. Agricultural Development							
1.	Cultivable Area as % of Reported Area.	79.75	20.35	31.25	1	3	2
2.	Cultivable Area per cultivator (2001) (in hectre)	0.47	0.61	0.42	2	1	3
3.	Gross Area Irrigated as %age of Gross Area Sown	37.77	41.52	100.00	3	2	1
4.	Area Sown more than once as %age of Net Area Sown.	75.33	321.36	5.36	1	2	3
5.	Area under commercial crops as %age of gross area sown	27.78	27.28	1.16	1	2	3
					8	10	12
B. Social Development							
1.	Literacy percentage	53.64	341	3	2	1	3
2.	%age of Female literates to Total literate population	37.79	26.92	16.09	2	1	3
3.	Students upto High/Higher Sec. Classes per lakh of population.	20410	16451	18145	1	3	2
4.	Population density	169	341	3	2	1	3
5.	Urban Population as %age to Total population	22.82	26.92	16.09	2	1	3
6.	No. on Live Register of employment exchange per lakh of population	2392	1001	3360	2	1	3
7.	No of BPL Households as %age to Total Households	55.12	61.35	55.82	1	3	2
					11	14	17
C. Infrastructural Development							
1.	Area covered per bank branch (in sq. Km)	70	38	2572	2	1	3
2.	Population coverage per Health institution	2401	3429	728	2	3	1
3.	Population coverage per school	531	795	319	2	3	1
4.	Area covered per School (in Sq. Km)	3.17	2.33	81.13	2	1	3
5.	%age of villages covered under potable Drinking water	100.00	10.00	10.00	1	1	1
6.	%age of villages electrified	96.64	98.54	84.94	2	1	3
7.	Population coverage per telephone connection	43	83	46	1	3	2
8.	Road Density (road length per lakh population)	107	131	790	3	2	1
9.	Area per post office	30.68	22.72	557.98	2	1	3
					17	16	18
D. Economic Development							
1.	%age of workers engaged in manufacturing and processing as %age of main workers	1.31	11.58	1.54	3	1	2
2.	No. of registered factories per lakh of population	15	5	neg	1	2	3
3.	No. of non agricultural enterprises per lakh of population.	1882	2287	2782	1	2	3
4.	Per capita Deposits (in Rs.)	11813	8516	11973	2	3	1
5.	Per capita advances	2553	5012	1116	2	1	3
6.	No. SSI units per lakh of population	470	380	588	2	3	1
					11	12	13

The above indices show that in agriculture, Jammu is the best off followed by Kashmir and Ladakh. In terms of social development also Jammu is much ahead of Ladakh and Kashmir. In terms of economic development also Jammu, Kashmir and Ladakh are in descending order. However, in terms of infrastructure development, Kashmir is the best of followed by Jammu and Ladakh.

The Annual Plan outlay 2002-03 for various Districts is indicated below:

S.No	District	Outlay (Rs. crore), 2002-03	Percentage of Distt. Sector outlay
1	Srinagar	46.57	6.16
2	Badgam	56.62	7.49
3	Anantnag	65.92	8.72
4	Pulwama	54.19	7.17
5	Baramulla	72.42	9.58
6	Kupwara	49.95	6.61
7	Total Valley	345.69	45.75
8	Jammu	61.76	8.17
9	Udhampur	58.52	7.75
10	Kathua	45.14	5.97
11	Poonch	35.82	4.74
12	Rajouri	44.16	5.84
13	Doda	61.72	8.17
14	Total Jammu	307.16	40.65
15	Leh	51.88	6.87
16	Kargil	50.80	6.73
17	Total Ladakh	102.69	13.60
18	Grand Total	755.54	100.00

The outlay, 2002-03 per capita and per sq. Km of area works out to the following level.

S.No	District	Per Capita Outlay (In Rs.)	Outlay Per Sq. Km. (Rs. in lacs)
1	Srinagar	344	1.96
2	Badgam	793	3.94
3	Anantnag	485	1.53
4	Pulwama	732	3.65
5	Baramulla	542	1.48
6	Kupwara	685	1.99
7	Total Kashmir Region	555	2.04
8	Jammu	351	1.92
9	Udhampur	695	1.21
10	Kathua	729	1.61
11	Poonch	847	2.02
12	Rajouri	809	1.58
13	Doda	789	0.50
14	Total Jammu Region	616	1.11
15	Leh	4091	0.06
16	Kargil	4112	0.36
17	Total Ladakh Region	4101	0.11
18	Grand Total J&K	664	0.07

The per capita outlay was more than Rs.4000 in Leh and Kargil only. It ranged between Rs.500 - 100 for Badgam, Pulwama, Baramulla, Kupwara, Udhampur, Kathua, Poonch, Rajouri and Doda. It was less than Rs.500 for Srinagar, Anantnag and Jammu districts only. In terms of area, the allocation per Sq. Km was more than Rs.3 lakhs for Badgam and Pulwama districts only. It was less than Rs one lakh in respect of Leh, Kargil and Doda which are quite sparsely populated.

NEEDS ASSESSMENT

Concept and estimates

THE infrastructural indices that we have constructed can be worked backwards and used as a criteria for the distribution of resources for building infrastructure. If the relative and absolute aggregate gap in infrastructure is the "need", and its sectoral break up between economic and social infrastructure (ignoring administrative infrastructure) is the distribution parameters, then we can allocate resources on the basis of need, assessment and requirements.

Looking at the "gap" from this perspective and using the absolute size of the infrastructure gap between the all-India level and that of the state as the distribution criteria, it is recommended that about 64 per cent resources should be deployed for building economic infrastructure and 36 per cent for bringing the availability of social infrastructure at par with the national level. For simplicity sake, we are assuming the cost of adding one unit of infrastructure is the same for economic and social infrastructure. This is not a valid assumption and the above ratios can be calibrated and normalized for cost differentials.

The next step in allocation is between rural and urban areas. It is impossible to get rural-urban break up for infrastructural availability. The broad thrust is a policy decision and given the existing situation, it is advocated that the best that we can do here is to go along with population and use that ratio as the benchmark. This will work out to 70:30 in favor of the rural sector.

Layered on top of all this is the political sensitive allocation across the two regions of the state viz; Jammu and Kashmir allocation. While it is a fact that Kashmir suffered most of the damage in the period of conflict, the division has to bear a close relation to population distribution and the infrastructural availability.

In order to ensure that the development of all the three regions takes place in such a manner that the feeling of regional discrimination, and alienation is removed progressively, the activities which have potential for growth in each region will have to be clearly de-

lined and promoted. Besides, the outlay for various districts must be made to conform to a consciously decided proportion based on a criterion which should take into consideration population, area, scheduled caste/tribe population, livestock population, gross cropped area, backwardness etc. Some areas are inaccessible for quite a few months of the year. These have been declared bad pockets. Outlay for such areas for the sectors in which these have a potential for development should be provided at a higher level than that for the district on the normative basis. The amount should be earmarked in the plan and not allowed to be diverted.

Given all these considerations, and assuming that ADB's loan for reconstruction of J&K Rs 1200 crore, following is the distribution that can be worked with.

TABLE 17: Area and sectoral allocation

	Rs crore		
	Rural areas	Urban areas	Total
Economic Infrastructure	665	100	765
Social Infrastructure	165	270	435
Total	830	370	1200

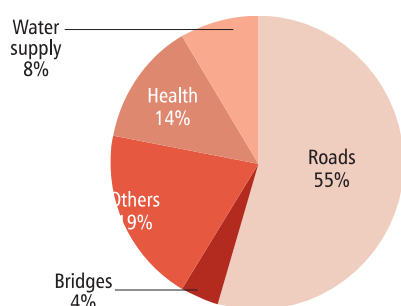
TABLE 18: Distribution by area and type of activity

	Rs crore		
	Rural areas	Urban areas	Total
Roads	450	150	600
Bridges	35	15	50
Others	160	40	200
Health	115	50	165
Water supply	70	115	185
Total	830	370	1200

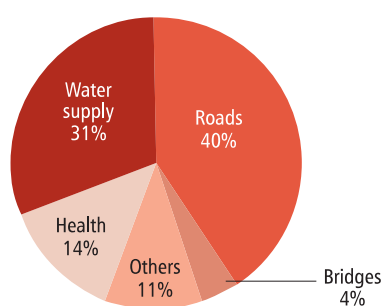
TABLE 19: Distribution by Region

	Rs crore		
	Rural	Urban	Total
Jammu	300	160	460
Kashmir	530	210	740
Total	830	370	1200

Rural Areas : Distribution by activity



Urban Areas : Distribution by activity



THE process of transforming an economy ravaged by civil strife into a market-oriented one where normal economic processes work is long and complicated. It involves manifold political, social, and economic aspects that interact in diverse and changing patterns, often in unpredictable ways. It is impossible to lay out in detail prospective paths and policymaking packages, especially those of a concrete and immediate nature. They must be formulated on the strength of empirical and casuistic information.

Each economy that has undergone sustained civil strife amounting to devastating systemic changes is a singular case. Not two cases of reconstruction have proved to be or can be identical. Beyond the adoption of a generic macroeconomic program of fiscal reform and stabilization, subsequent steps have to be specific to the context. The reasons for working out a specific reconstruction strategy are two-fold:

First, conditions in each society are greatly divergent. These would include, but are not limited to, levels of economic and social development, degree of modernization, cultural particularities, nature of people's expectations, and the like. Second are the political preferences regarding the socioeconomic model to be pursued, the perceived aspirations of the population, and the population's tolerance for diverse kinds of policy measures.

Defining the objectives to be achieved as intermediate and final ends of the transition process is still indispensable. Clearly stating the criteria that will indicate progress and signaling the signposts of reconstruction is of utmost importance. Equally important is the overall consistency and logical coherence of the entire process of change and of its various stages must be outlined. Expediency must be prevented from resulting in synchronizing attempts among opposite value or policy systems. In the course of working out the reconstruction strategy, the basic structural changes and the policies of stabilization, and adjustment will have to be fully coordinated and harmonized with each other.

The principal premises and principles that serve as a basis for recommendations for reconstruction and development are a gradualist, bal-

anced growth type of strategy. Policies of agricultural diversification and of rational, critical economic self-sufficiency should enjoy maximum priority in the dual programs of reform and reconstruction. These should be applied as much to the production of basic goods for general consumption as to primary activities in general as well as to agribusiness.

The forward and backward link-ages among sectors and activities which at present are non-functional will have to be established at the lower or close to-market level of the production matrix, following the logic of a developmental balanced growth type of strategy.

A domestic increase in the output of tradable commodities and a favorable or equilibrated trade balance would reverse the reverse flow of resources and thereby bring about financial stability

What is most essential in the case of J & K is a well coordinated program of routine planning, reform initiative and reconstruction activity. It would yield optimum results along a gamut of fronts and would also accomplish several related objectives only if it is designed to:

- a. re-establish private initiative system relatively quickly
- b. contribute decisively

even during the short-term to the diversification and stability of the economy and to a high degree of direct involvement and self-determination regarding sub-national social identity and the proper pale of economic policy; and

- c. promote the government's fiscal and the economy's financial stability.

The stimulation of entrepreneurial activity and the accelerated increase in the production of highly necessary consumer goods would affect the first two objectives. These, in turn, would facilitate the attainment of affordable and stable equilibrium in price levels, a high level of employment, and the continued expansion of the state domestic product (SDP). A domestic increase in the output of tradable commodities and a favorable or equilibrated trade balance would promote the third objective, reversing the reverse flow of resources and thereby bring about financial stability.

The outlined program would facilitate the gradual and orderly transition from a disarticulated economy to an articulated economy through systemic, natural growth and spontaneous expansion. Growth of a well functioning market system econ-

omy under those conditions would result primarily from the energizing of private initiative of economic agents, who at present are being unable to deploy their surpluses in the given framework. It would also serve to create, once the process is launched, financial and credit markets. .

The phased rural and urban infrastructure led described strategy and policy package would stimulate the process of structural evolution toward an entrepreneurially driven economy. At the same time, it would make possible the staggered introduction of highly sensitive stabilization policies, such as the withdrawal or cancellation of existing subsidies for production and consumption activities.

The combined strategy of the three will avoid sudden breaks or discontinuities in the economic process with their consequent problems in terms of reduced production and employment.

More importantly, the proposed path is the one that most easily adapts to the existing situation, to the state's level of underdevelopment; its minuscule internal market, limited productive resources, and available cultivable land; relatively small population; climate; topography; insufficient and dilapidated energy infrastructure, transportation, communications, and distribution networks;

and many other economic and socio-psychological factors (alienation) that are to be taken into consideration to conceptualize the correct or optimal strategic approach to reform and reconstruction.

As a new social and economic reality gradually emerges, new basic structures will begin to take shape. Organizations and institutions, incentives, motivations and forms of behavior will concretize. Some of these are essential, while others support the conformation of a modern market

economy that will prove socially compatible with the historical and cultural characteristics and aspirations of the people.

This gradualist, balanced, and regionally spread organic process is probably the only one that can solve the antinomies and contradictions that are existing because of an ill conceived centre-led development strategy which has not taken into account the production structures and resources of the state.

The balanced approach (that relies on the well coordinated individualized investment sequences) should aim at the creation either of an overall horizontal (market-oriented) or vertical (production-oriented) integration and balance among sectors and activities.

The phased rural and urban infrastructure led strategy described above and the policy package outlined would stimulate the process of structural evolution toward an entrepreneurially driven economy

THE process of reconstruction has to be in line with the macro-economic strategy of the state. This means that the financing of reconstruction activity should be matched with the fiscal targets that have been set in the medium term fiscal reforms set out by the government. It also means that the plan spending should be completely restructured. The sectoral outlays and expenditure allocations will have to be recast and made complementary to the reconstruction expenditure.

The best way to do this is to make the state plan a maintenance plan in the sectors where the reconstruction activity is high. Also, given that the absorptive capacity of the state is limited, the resources "released" because of reconstruction activity being financed over and above the plan, can be used for completion of the on-going plan schemes. This would give a big developmental thrust since there are plan schemes that have been going on for the last 12-15 years.

The process of reconstruction activity has to be a three phased activity. In phase I, the focus should be on restoring and reconstructing rural infrastructure. In this phase, the priority should be to repair important physical infrastructure, including key transport, communication, and utility networks. The basic objective should be to bring the level of rural infrastructure at par with the level of rural infrastructure of the most well endowed special category state. Our infrastructural indices suggest that the special category state with the best infrastructural availability is Himachal Pradesh. So, the benchmark in Phase I is to come at par with Himachal Pradesh. In cases, where J&K is already ahead of Himachal Pradesh, it should be the aim of the state government to come at par with the best performing state. The time frame for completion of phase I should be 3 years.

In this phase, there has to be a targeting of assistance to those affected by civil strife through reintegration of displaced populations, reintegration of militants, revitalization of the local communities most disrupted by conflict through such means

as credit lines to subsistence agriculture and micro-enterprises, and support for vulnerable groups. It is important to recognise that children are especially vulnerable to societal and family disruptions since they depend on others for their care and survival. They are also vulnerable to conflict, through the indirect impact of a weaker state and social system, loss of parents or caretakers. As such there is need to formulate tools to design projects directed at children. Also, in conflict situations, women typically represent the majority of refugee or displaced populations, often as single heads of households, and often vulnerable to sexual abuse both during and after conflict. There is need to address gender issues in a social situation that is emerging from conflict by targeting women as a specific group.

For the restoration of livelihood among these groups, Rs 50 crore should be earmarked. This can be distributed on a 38:12 ratio. The Rs 12 crores can be earmarked for migrants livelihood restoration.

Using the gap in infrastructure (35 index points in economic infrastructure and 20 index points in social infrastructure) as the main distribution criteria, along with the extent of damaged infrastructure, population and priorities outlined in the report, the basic allocation recommended across regions and types of infrastructure for Phase I is given in table 20. The allocation across activities has been given in the needs assessment chapter.

Finally, in Phase I, there has to be a normalising of the financial borrowing arrangements by helping the fiscal side through a planned workout of arrears, debt rescheduling, to set the state on the longer-term path to financial normalization.

The second phase should be to rebuild and upgrade social infrastructure; that is, financing education and health, including recurrent costs. In this phase, there is also need to revamp the financial architecture of the state and rehabilitate the financial institutions and restore of appropriate legal and regulatory frameworks

The high level of non-performing loans has impaired the financial position and weakened the

TABLE 20: Parameters for distribution

	JAMMU			KASHMIR			STATE		
	Rural	Urban	Total	Rural	Urban	Total	Rural	Urban	Total
Economic Infra	20.83	0.00	20.83	40.00	13.33	53.33	55.42	8.33	63.75
Social Infra	0.00	17.50	17.50	4.17	4.17	8.33	13.75	22.50	36.25
Total	20.83	17.50	38.33	44.17	17.50	61.67	69.17	30.83	100.00

capacity of all the state financial institutions, especially the State Financial Corporations and the Co-operative banks. At the same time, it has made the balance sheets of almost all established and emerging business houses in the state un-bankable.

What is needed is to rid the institution of the bad debts they have acquired due to exogenous factors. And at the same time clean up the balance sheet of enterprises which have not been able to service their debts due to a hostile business environment. Both these objective can be met by setting up of an Asset Reconstruction Company (ARC).

Given that the amount of infected assets in the system are not very large, the ARC can be started off as an Asset Reconstruction Fund that will be used to purchase the non-performing assets of the financial institutions in the state. The state government should be asked to transfer all the budgetary support that they have given to these corporations from 1990 onwards to this fund. Also the state government should transfer their proposed budgetary support for the next three years as a one time contribution to the asset reconstruction fund.

The state government should appoint an financial restructuring authority which would be an independent government agency owning the asset restructuring fund and setting up the ARC. The financial restructuring authority should approve and monitor individual FI restructuring and lay down generic guidelines for taking over distressed accounts. The asset reconstruction fund would acquire the non-performing assets of the financial institutions and the ARC would manage and dispose of the acquired non-performing asset for a fee.

Given that the emergences of doubtful assets in the financial system have followed a crisis in the system, the ARC need not be in the nature of a permanent business. Rather it should be seen as a part of the reconstruction program and should cease to exist when the program is over. ADB can facilitate the setting up of the proposed ARC and provide technical assistance to the state.

The third phase should be to jump-start the economy through "trigger-off" investments; create the conditions for resumption of trade, savings, and domestic and foreign investment; and promote

macroeconomic stabilization.

To address the operational issue of utilisation of assistance, there is need for a reconstruction agency or other similar institutional arrangement for the reconstruction programme. There should be meaningful "sunset" provisions to ensure that the reconstruction agency does not end up competing with and detracting from the regular machinery of government as the latter gets its efficiency in place.

The state government should appoint a financial restructuring authority which will be an independent government agency owning the asset restructuring fund and setting up the ARC

The funding and finances for this agency - seen as a financial mechanism which needs to be guided by J&K's reconstruction strategy and priorities - should be broad in scope. Contributions to the reconstruction fund should earmarked for individual programmes or activities. And the spending out of the trust fund

should be in accordance with reconstruction priorities agreed upon, and specified broad programme categories. As such it is important that the government of JK has to establish clear criteria for international support. If the ADB decides to give assistance, it should be in line with what may be done by other multilateral development banks, be it the The World Bank, or thr IMF or the ADB. All these agencies can work together and channeled resouces through an umbrella trust fund. This will be far more effective and meaningful than contributions for reconstruction going directly into the myriad specific reconstruction programmes and activities.

The ERA should receive all funds from the Ministry of Finance. Government of India for implementation of all reconstruction work and other externally aided projects. The agency can either utilize these funds directly for the approved projects or release the same to Programme Implementation Units located in various departments. These funds should be outside the consolidated fund of the state.

Ideally, the ERA should be a society registered under the Registration of Societies Act, 1941. It should have a governing board which gives it policy direction but the operations should be run by a Chief Executive who can serve as the member secretary to the board. The Chief Executive of the ERA should be responsible for implementation and execution of the projects in accordance with the guidelines issued by lending agencies like the World Bank and ADB.

J&K: The institutional setting

Any economic policy or package to be successful and relevant to J&K has to take cognizance of the special and unique institutional framework within which the state economy operates.

The state of Jammu & Kashmir is on a completely different footing than all other states of the Union. The two features that set apart J&K from any other state in the Union are:

- a) its own separate Constitution
- b) its relationship with the Union defined under Article 370 of the Constitution of the India.

The most important implications of the two seen together is that the residuary powers of political, economic and social legislation vest with the state government, and not with the Centre as is the case with all other states in the Union. Also, the Constitution of India and its amendments do not apply either automatically or fully to J&K. The ramifications of these constitutionally provided specificities have a significant bearing on major issues of financial and economic policy.

Three specific examples would suffice. The Reserve Bank of India, which is the banker for all states and the states have to abide by the Ways and Means Advances limits set by the bank, is not the banker of the J&K state government. Instead, the state deals with its own bank, J&K Bank for any accommodation and the state is not bound by the RBI discipline and limits.

Second, the provisions in the Constitution of India which relate to the State Consolidated Fund, the State Contingency Fund, the custody thereof, and the Public accounts of the State don't apply to J&K as they do to all other states. Similarly, the provisions of Article 360 pertaining to financial emergency are not applicable to J&K.

There are other institutional implications as well. For instance, the Electricity Act of 2004, is not applicable to the state nor is the Insurance Regulatory Authority.

What this amounts to is that the state has a much greater flexibility in managing its own affairs and the institutional environment within which policy making takes place is quite different from other states (See Appendix 2, for details regarding implementation of service tax by the Centre).

At a purely political level, Jammu and Kashmir remains an unresolved legacy from the partition of the Indian sub-continent in 1947. The princely state of J&K is divided by a "line of control", with Pakistan administering the northern half and claiming the southern half, administered by India, as well.

What began as a territorial dispute over a princely state has evolved into a highly politicized conflict that has taken on multiple dimensions. Factors such as the supply of arms from Pakistan, the Centre's policies and subsequent human rights abuses have become more closely inter-twined as the conflict has unravelled. Tens of thousands of

Kashmiris have died as a result of insurgent violence in the state.

India and Pakistan have fought three wars - 1948, 1965 and 1971 -- and were the verge of a fourth one in May 1999, and again in December 2001 after an attack on India's parliament.

Discourse on Kashmir has been polarized either in favour of secession from India, or in support of a union with India. However

holistic analysis requires careful disentanglement from the evidence and a conclusion that is not biased to any one piece of the puzzle.

Any attempt to place the Kashmir issue into water-tight compartments - Islamic militancy, cross-border terrorism, secessionist insurgency, ethno-national demand -- does less good and more damage to the variety of factors and the sheer complexity of elements that have caused the problem in Kashmir.

A comprehensive political economy framework is required to shed light on the political intrigues that thwarted the welfare maximizing benefits of the state's economic policies and how overtime ethnicity got politicised and fuelled dissent, which mobilized into militancy that has lasted about 15 years now.

During this period, the relations between the two countries, India and Pakistan sank to new lows and twice came close to a war. However, after the militant attack on the parliament in 2001, the relations have been improved considerably, primarily led by the conduct of free and fair polls in the state in 2001 and then by the peacemaking initiative of India.

In April 2003, Atal Behari Vajpayee, then India's prime minister, stressed the need for dialogue, which led to some positive unofficial meetings. In

The most important implications of J & K's special status is that the residuary powers of political, economic and social legislation vest with the state government, and not with the Centre as is the case with all other states in the Union

November 2003 the two sides agreed to a formal ceasefire, the first in decades. In January 2004 Vajpayee and Pervez Musharraf, Pakistan's president, agreed to wide-ranging talks which are expected to continue even under a new Indian government and in the face of continued violence.

The state of Jammu and Kashmir is at present ruled by a coalition government led by the People's Democratic Party. The Congress which is the leading party at the national coalition, is a partner at the state level as well. The main opposition party is the National Conference, the oldest polit-

ical party in the state founded by Sheikh Abdullah.

The major separatist political groupings is the All-Party Hurriyat Conference, which favours independence, has now split into a more moderate and a more hardline group. The leaders of the former, which outnumber the latter, met the then India Prime Minister Mr Vajpayee in January 2004.

The peace moves have had a major impact on the economic activity in the state. For instance, this year, the state has seen more to more tourist than in any year during the last 15 years. This has led to a revival of the tertiary sector activity.

APPENDIX II: UNIQUE POWERS OF TAXATION: AN EXAMPLE

Consider the case of the Service Tax Bill recently circulated by the Government. The Constitutional position regarding the authority of the State of J&K to levy taxes is that the Section 5 of the Constitution of J&K provides that "the executive and the legislative power of the State extends to all matters except those with respect to which parliament has power to make laws for the State under the provisions of the Constitution of India".

Therefore, the tax laws of other States draw authority from Entry 54 of list II of 7th Schedule of Constitution of India, on the other hand, the J&K Sales tax Act 1962 has been enacted by the legislature under the authority of section 5 of the Constitution of J&K.

The Service Tax Bill of the Government of India has been prepared as a sequel to the amendment made in the constitution of India through 95th Amendment Bill 2003. This amendment provides for insertion of Article 268-A in the Constitution to read as under:

"268-A (1) Taxes on services shall be levied by the Government of India and such tax shall be collected and appropriated by the Government of India and the States in the manner provided in clause (2).

(2) the proceeds in any financial year of any such tax levied in accordance with the provisions of clause (1) shall be-

- (a) collected by the Government of India and the States;
- (b) appropriated by the Government of India and the States.

in accordance with such principles of collection and appropriation as may be formulated by parliament by law."

Besides, the Amending Act makes the concomitant changes in Article 270 and provides for insertion of Entry 92-C in list 1 of 7th Schedule to the Constitution of India. So far as the J&K State is concerned the amendment so affected is not applicable to the state. Among other things, it needs the concurrence of the State followed by the issuance of Application Order by the president of India.

In the case of J&K list 1 (union list) is applicable in the modified form and is restricted to the entries specifically applied to the State. Entry 97 of the said schedule, which is a residuary entry under which the Government of India is presently levying tax on 58 services, is applicable to J&K only so far as taxes on foreign travel by sea or air, on inland air travel and on postal articles, including money orders, phonograms and telegrams is concerned.

It is in this backdrop that the State of J&K enjoys the authority to legislate on residuary matters and it is in exercise of these powers that in the past the works contracts and the transactions involving provision and amenities and services were brought within the tax net under the provisions of J&K General Sales Tax Act. Therefore, the competence to legislate in matters of taxing the services rests with the state unlike any other state in the Union.

Power Deficit

Power Development Department of the State Government has been facing problems all along on account of an increase in the expenditure on purchase of power with nearly 10% being added to the expenditure every year, while as the revenue recovery from the consumers has not been commensurate with the purchase bill. Besides poor recovery from the consumers, factors like T & D losses including theft of power and a wide gap in between the power tariff and the purchase cost per unit of power have added to the woes of the Department. The T & D losses are nearly 47% and the revenue gap in between purchases price and the sale price of power is nearly 40%.

The position of power regarding the purchase bill and the revenue realized is indicated in the following table: -

S.No	Year	Power Purchased	Revenue realized	Deficit*
1	1991-1992	132.82	40.07	98.75
2	1992-1993	129.67	41.49	88.18
3	1993-1994	185.47	45.14	140.33
4	1994-1995	223.07	45.73	177.34
5	1995-1996	225.008	47.92	174.088
6	1996-1997	349.94	54.33	295.61
7	1997-1998	553.717	94.76	458.957
8	1998-1999	692.405	112.04	580.365
9	1999-2000	683.83	231.52	452.31
10	2000-2001	1005.526	267.39	738.136
11	2001-2002	1050.438	268.52	791.918
12	2002-2003	1367.000	323.19	1043.81

* This excludes expenditure on maintenance, interest and other administrative costs

The State Government has been transferring 90% of its expenditure and receipts to the State Electricity Board (SEB) account every year. But nei-

ther the SEB nor this department have so far succeeded in making the losses on this account good, except that the revenue realization has gradually picked up from year to year as is clear in the aforementioned table.

The State Government has recently decided to abolish the SEB, as such, the power deficit will not be transferable to SEB's account any more. PDD now has to intensify its efforts to reduce the T & D losses by the system improvement, revamping the system, revision of tariff and by gearing up the administrative machinery to realize maximum power tariff from the consumers. The following steps are already afoot to reduce the T & D losses: -

i) **Regularization of illegal connection:** - Revision of agreements by intensive inspections, patrolling and checking and with penalty, as admissible under rules.

ii) **Metering of feeders:-** A scheme for 100% metering of feeders up to 11 KV level under phase-I with estimated cost of Rs 6.99 crore was submitted to Government of India who adopted the same for financial assistance under Accelerated Power Development Reforms Programme (APDRP) and is presently under execution.

iii) **Consumer meters:** - For installation of consumer meters, schemes covering supply and installation of 2.12 lacs meters were prepared and approved for financial assistance by REC. The supply of these meters is in pipeline. The installation of new meters was started in July, 2002 but the operation suspended temporarily in September, 2002.

iv) **Revamping of distribution system:** - Sustained efforts are under way to reduce T & D losses at least to 20%

Improvement in returns: - The State Government is committed to increase the power receipts by more than 300% during the period 2003-04 to 2009-2010

APPENDIX IV

Methodology

For the purpose of this report we have measured infrastructure through 24 distinct variables (which due to alternative normalization rules eventually become 27 variables) classified into eight sectors:

- a. Agriculture,
- b. Banking,
- c. Electricity
- d. Transport
- e. Communication
- f. Education,
- g. Health, and
- h. Civil Administration.

These are further classified under three heads; Economic infrastructure (a to e), Social Infrastructure (f & g) and Administrative Infrastructure.

The indices are constructed by a two-stage procedure using principle components and the correlation with SDP as the basic principle for generating the weighting rules. The data on all these indicators has been standardized by deflating using a suitable deflator. In some cases the choice of deflator has been governed by natural criteria, as in total number of villages for data on villages electrified or cultivated area for data on net area irrigated. In cases where such deflators are not readily obvious, either population or area has been used. In some cases both have been used, for instance in the case of hospital bed or in case of administrative measures. The standard variable was then converted into an index number by deflating with the All-India value of that year. This implies that the index numbers reflect the deviation of the state from the All-India availability of that infrastructure.

The sectoral indices have been aggregated into an aggregate index of infrastructure. In a fundamental sense all infrastructural facilities are critical for growth. For this purpose growth has been taken to mean growth in SDP. Therefore, weights have been assigned in proportion to the correlation of the identified variables with the index of SDP per capita.

The weights used in constructing the infrastructural indices is given below:

Weights used in Infrastructure Indices.

Agriculture.		0.015
Banking		0.08
Commercial Bank Branches	0.8	0.064
Cooperative Banks	0.1	0.008
Regional Rural Banks.	0.1	0.008
Communications.		0.11
Telephones per capita.	0.45	0.05
Post offices per sq Km.	0.55	0.06
Electricity.		0.29
Installed capacity.	0.26	0.073
Villages Electrified	0.39	0.109
Electricity Consumption.	0.23	0.064
Length of distribution lines.	0.12	0.034
Transportation		0.18
Villages with all weather roads.	0.26	0.049
		0.047
Total road length	0.12	0.022
Surfaced Road length	0.22	0.04
Number of registered Motor Vehicles.	0.19	0.034
Railway Route length.	0.21	0.038
Education		0.03
Primary Teacher-population.	0.45	0.013
Middle Teacher-Population.	0.19	0.006
Higher Secondary Teacher Population	0.19	0.006
Primary Schools.	0.12	0.004
Other Non-Primary Educational Institutions.	0.05	0.001
Health		0.12
Beds per Sq Km.	0.18	0.002
Beds per 1000 people.	0.67	0.08
No of PHC's per 1000 Sq.Km.	0.15	0.018
Administration.		0.05
Area per taluka	0.25	0.0125
Population per taluka	0.25	0.0125
Area per Police Station.	0.25	0.0125
Population per Police Station.	0.25	0.0125

A. AGRICULTURE DEVELOPMENT

1. Cultivable Area as % of Reported Area.
2. Cultivable Area per cultivator (2001)
3. Gross Area Irrigated as %age of Gross Area Sown
4. Area Sown more than once as %age of Net Area Sown.
5. Area under commercial crops as %age of gross area sown

B. SOCIAL DEVELOPMENT

1. Literacy percentage
2. %age of Female literates to Total literate population
3. Students up to High/Higher Sec. Classes per lakh of population.
4. Population density
5. Urban Population as %age to Total population
6. No. on Live Register of Employment Exchange per lakh of population
7. No of BPL Households as %age to Total Households

C. INFRASTRUCTURAL DEVELOPMENT

1. Population coverage per Bank Branch
2. Area covered per bank branch
3. Population coverage per Health institution
4. Population coverage per school
5. Area covered per School
6. %age of villages covered under potable Drinking water
7. %age of villages electrified
8. Population coverage per telephone connection
9. Road Density
10. Area per post office

D. ECONOMIC DEVELOPMENT

1. %age of workers engaged in manufacturing and processing as %age of main workers
2. No. of registered factories per lakh of population
3. No. of non agricultural enterprises per lakh of population.
4. Per capita Deposits
5. Per capita advances
6. No. SSI units per lakh of population.