

ASIAN DEVELOPMENT BANK
Operations Evaluation Department

TPA:IND 2004-05
(Final)

TECHNICAL ASSISTANCE PERFORMANCE AUDIT REPORT

ON

SELECTED TECHNICAL ASSISTANCE

FOR

FISCAL MANAGEMENT AND TAX ADMINISTRATION

IN

INDIA

July 2004

ABBREVIATIONS

ADB	–	Asian Development Bank
CIDA	–	Canadian International Development Agency
EA	–	Executing Agency
GDP	–	gross domestic product
HRDS	–	human resource development strategy
INRM	–	India Resident Mission
ITD	–	Income Tax Department
MIS	–	management information system
OEM	–	Operations Evaluation Mission
SBFAU	–	State Budgeting and Fiscal Analysis Unit
TA	–	technical assistance
TCR	–	technical assistance completion report
TPAR	–	technical assistance performance audit report
UNDP	–	United Nations Development Programme
VAT	–	value-added tax

NOTES

- (i) The fiscal year (FY) of the Government ends on 31 March.
- (ii) In this report, "\$" refers to US dollars.

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Walter Kolkma (evaluation specialist) prepared this report. Agnes Anabo (senior evaluation officer) supported the study with research assistance in Manila. Two staff consultants collaborated in this study: Mahesh C. Purohit (indirect tax consultant) and Tapas Kumar Sen (direct tax consultant).

BASIC TECHNICAL ASSISTANCE DATA

TA 2362-IND: Improvement of State Sales Tax Structure and Administration¹

Cost (\$)²	Estimated	Actual³
Foreign Exchange	83,000	84,253
Local Currency	16,500	7,536
Total	99,500	91,789
Number of Person-Months (consultants)	10.0	8.5
Executing Agency	Office of the Sales Tax Commissioner, National Capital Territory of Delhi	
Milestones		Date
President's/Board Approval		14 Jul 1995
Signing of TA Agreement ⁴		
Fielding of Consultants		10 Aug 1996
TA Completion: Expected		—
Actual		Nov 1997
TCR Circulation		13 Jul 1999
Mission Type	Number	Date
Reconnaissance ⁵	1	16–25 May 1994
Fact-Finding	1	6–7 May 1995
Operations Evaluation ⁶	1	3–19 Nov 2003

TA 2432-IND: Capacity Building of Income Tax Administration

Cost (\$)²	Estimated	Actual³
Foreign Exchange	432,000	385,115
Local Currency	118,000	133,830
Total	550,000	518,945
Number of Person-Months (consultants)	33.0	30.8
Executing Agency	Central Board of Direct Taxes	
Milestones		Date
President's/Board Approval		26 Oct 1995
Signing of TA Agreement		25 Jun 1996
Fielding of Consultants		15 Aug 1997 ⁷
TA Completion: Expected		Jun 1997
Actual		Jun 2000
TCR Circulation		Jan 2001
Mission Type	Number	Date
Reconnaissance ⁵	1	16–25 May 1994
Fact-Finding	1	16–17 May 1995
Inception	1	28 Aug 1997
Review ⁸	2	27–31 Dec 1998
		23 Sep 1999
Operations Evaluation ⁶	1	3–19 Nov 2003

— = not specified in the TA paper, TA = technical assistance, TCR = technical assistance completion report.

Note: Footnotes on pages iv–v.

TA 2668-IND: Gujarat's Reform of Public Finances

Cost (\$)²	Estimated	Actual³
Foreign Exchange	324,000	9,482
Local Currency	276,000	281,952
Total	600,000	291,434

Number of Person-Months (consultants)	75.0	52.6
Executing Agency	Finance Department of the Government of Gujarat	

Milestones	Date
President's/Board Approval	23 Oct 1996
Signing of TA Agreement	31 Oct 1996
Fielding of Consultants	29 Sep 1997
TA Completion: Expected	Dec 1997
Actual	15 Feb 1999
TCR Circulation	15 Jul 1999

Mission Type	Number	Date
Review	1	26–27 Apr 1998
Tripartite Meeting	1	24 Sep 1998
Operations Evaluation ⁶	1	3–19 Nov 2003

TA 2943-IND: Support for the Government of Madhya Pradesh Public Finance Reform and Institutional Strengthening

Cost (\$)²	Estimated	Actual^{3,9}
Foreign Exchange	485,000	502,555
Local Currency	295,000	270,506
Total	780,000	773,061

Number of Person-Months (consultants)	62.0	55.8
Executing Agency	Finance Department of the Government of Madhya Pradesh	

Milestones	Date
President's/Board Approval	15 Dec 1997
Signing of TA Agreement	4 Feb 1998
Fielding of Consultants	3 Aug 1998
TA Completion: Expected	—
Actual	15 Aug 2001
TCR Circulation	25 Nov 2002

Mission Type	Number	Date
Operations Evaluation ⁶	1	3–19 Nov 2003

TA 3576-IND: Supporting Fiscal Reforms in Kerala

Cost (\$) ²	Estimated	Actual
Foreign Exchange	673,000	540,560
Local Currency	327,000	175,849
Total	1,000,000	716,409
Number of Person-Months (consultants)	79	50
Executing Agency	Finance Department of Kerala	
Milestones		
		Date
President's/Board Approval		13 Dec 2000
Signing of TA Agreement		25 May 2001
Fielding of Consultants		3 Sep 2001 ⁷
TA Completion: Expected		31 Aug 2001
Actual		Sep 2002
TCR Circulation		21 Apr 2004
Mission Type		
	Number	Date
Consultation	1	10–16 Feb 2000
Fact-Finding	1	24–29 Jul 2000
Reconnaissance and Inception ¹⁰	1	4–10 Nov 2001
Follow-Up Reconnaissance and Inception ¹⁰	1	15–21 Dec 2001
Review	2	29 Jan–18 Feb 2002 ¹¹
		12–30 Apr 2002 ¹²
Operations Evaluation ⁶	1	3–19 Nov 2003

TA 3856-IND: Value-Added Tax Reform: Capacity Building at the Post-Implementation Stage¹³

Cost (\$) ²	Estimated	Actual ⁹
Foreign Exchange	338,000	246,869
Local Currency	262,000	121,462
Total	600,000	368,331
Number of Person-Months (consultants)	20.0	21.8
Executing Agencies	Part A: Department of Revenue, Government of India Part B: Commercial Tax Departments of the Selected State Governments	
Milestones		
		Date
President's/Board Approval		11 Apr 2002
Signing of TA Agreement		30 Jul 2002
Fielding of Consultants		1 Oct 2002
TA Completion: Expected		31 Aug 2002
Actual		Dec 2003
TCR Circulation		TCR planned in 2004
Mission Type		
	Number	Date
Fact-Finding ¹⁴	1	20 Sep–2 Nov 2001
Operations Evaluation ⁶	1	3–19 Nov 2003

¹ Back-to-office reports of review missions were not found among the project files.

² Financed by the Asian Development Bank.

³ Operations Evaluation Department estimates.

⁴ The Asian Development Bank and the Government did not enter into a TA Agreement in view of the small amount of the TA and the absence of any unusual obligations on the part of the Government.

⁵ In conjunction with an economic reconnaissance mission.

- ⁶ The mission comprised W. Kolkma (evaluation specialist and mission leader), M. C. Purohit (indirect tax consultant), and T. K. Sen (direct tax consultant).
- ⁷ The actual fielding of consultants under this TA was delayed.
- ⁸ In conjunction with the gathering of information for the Sector Paper on Employees State Insurance.
- ⁹ The TA account was still open as of 9 January 2004.
- ¹⁰ In conjunction with the reconnaissance mission for the then-proposed Public Resource Management Program Loan.
- ¹¹ In conjunction with the fact-finding mission for Loan 1974-IND: *Modernizing Government and Fiscal Reform in Kerala (Subprogram 1)*.
- ¹² In conjunction with the consultation mission for Loan 1974-IND: *Modernizing Government and Fiscal Reform in Kerala (Subprogram 1)*.
- ¹³ Since this TA was administered and implemented by the Resident Mission in Delhi, and the consultants were likewise based in Delhi, no formal review missions were held. The project officer was in regular touch with the consultants and attended the workshops.
- ¹⁴ Intermittent.

EXECUTIVE SUMMARY

The Asian Development Bank (ADB) has had a special interest in fiscal management in India since the mid-1990s, which is reflected in its country strategy. India's fiscal deficits have been among the highest in the world, underscoring the importance of adequate fiscal management. ADB's program has consisted of major public resource management loans for three of India's states, a number of technical assistance (TA) projects associated with these program loans, and three stand-alone TAs in tax administration. The programs combined funding for multiple activities on revenue generation with budget and expenditure management. The first major ADB program loan provided \$250 million for public sector resource management in Gujarat. Its first tranche was released by December 1996. The second program loan, also for \$250 million, was for a similar program in Madhya Pradesh, with the first tranche released by December 1999. Three years later, the first tranche of a third program loan for \$200 million was released for Kerala. This program included expanded activities in governance. A public resource management program is also under consideration for Assam, another of ADB's focal states. With ADB's completion reports of the programs in Gujarat and Madhya Pradesh scheduled for 2004, this technical assistance performance audit report (TPAR) concentrates on six TAs in improving fiscal management and tax administration from 1996 to 2003:

- (i) TA 2362-IND: *Improvement of State Sales Tax Structure and Administration* (\$99,500);
- (ii) TA 2432-IND: *Capacity Building of Income Tax Administration* (\$550,000);
- (iii) TA 2668-IND: *Gujarat's Reform of Public Finances* (\$600,000);
- (iv) TA 2943-IND: *Support for the Government of Madhya Pradesh Public Finance Reform and Institutional Strengthening* (\$780,000);
- (v) TA 3576-IND: *Supporting Fiscal Reforms in Kerala* (\$1 million); and
- (vi) TA 3856-IND: *Value-Added Tax Reform: Capacity Building at the Post-Implementation Stage* (\$600,000).

While the broad goal of the TAs was to contribute to putting the Government's finances on a more sustainable footing, their specific purpose was to build capacity and institutions in three areas: (i) sales tax improvement and the introduction of a value-added tax (VAT), (ii) other means of revenue generation, and (iii) budget and expenditure management.

Sales Tax and VAT. In 1991, the Tax Reform Committee recommended replacing the sales tax regimes in the states and the center with a new VAT system. VAT was seen as a more efficient tax, allowing India to become more competitive internationally by giving zero tax rates to imported and exported goods, and preventing double taxing of goods. At the same time, VAT would allow India to include more commodities and services in the tax net, reducing the need for dealers to go to tax departments and limiting tax evasion. The sales tax regimes administered by the states generate about 60% of their revenue; the new VAT was expected to improve on this percentage. ADB's approach relied heavily on the introduction of this tax reform. Five of the six TAs reviewed in this report have dealt with, at least in part, capacity building for this reform. So far, however, the approach has not paid off. Although the Government announced in 1999 that VAT was to be introduced by 2002, it has been postponed several times—officially due to insufficient preparedness by some states (not the ADB focal states). Tussles between the center and the states regarding compensation for initial losses arising from the switch to the new tax system also might have played a role. Some organized stakeholders also have lobbied against the new system. A new date for the introduction of VAT had not been announced at the time of this TPAR. ADB's TAs have worked on legislation in six states and have built capacity to manage VAT, although generally not very efficiently. Much more remains to be done. Because

of India's developing relationship with the World Trade Organization and the South Asia Association for Regional Cooperation, VAT probably will be introduced in due course. If VAT is implemented, the Operations Evaluation Mission (OEM) concluded, the TA funded by ADB and some other external agencies will have been a useful contribution.

Other Revenue Administration. Four of the six TAs were partly or wholly devoted to improving revenue administration other than sales tax and VAT. The first attempt focused on income tax administration by the central Government. Income tax generates about 10% of the central Government's total tax income, and is equivalent to 1.4% of the gross domestic product. The TA, which started in 1997, complemented larger TA funded by other external agencies. It set up three training centers in Chennai, Delhi, and Mumbai, where hundreds of tax office staff were trained in computer operations during the TA, and thousands afterwards. The TA did not have sufficient resources to achieve its more ambitious objectives, such as raising capacity for risk assessment and tax analysis. The three program-oriented TAs in Gujarat, Kerala, and Madhya Pradesh aimed to rationalize several minor taxes, notably in the field of property taxes (but also stamp and registration duty, entertainment tax, and some others). The efforts delivered good results, particularly in (i) property valuation for tax purposes in Gujarat and Madhya Pradesh, (ii) stamp and registration duty, and (iii) entertainment tax in Gujarat. Due in part to the limited capacity of the TAs to follow up on recommendations, some work has not produced results. Minor taxes, however, do not have much potential for turning around fiscal deficits.

Budget and Expenditure Management. The three TAs in Gujarat, Kerala, and Madhya Pradesh provided advice on budget and expenditure management, complementing their activities in VAT and other revenue management. In Gujarat, some budget and expenditure reforms have taken place. However, government officers said the reforms recommended by the TA would have gone through without the TA. Progress on reforms has slowed in recent years due to the fiscal consequences of the earthquake in 2001 and other setbacks. In Madhya Pradesh, the focus has been on computerization and strengthening the newly created State Finance and Budget Analysis Unit. Although the efforts have not borne fruit yet, this might change when the new networked treasury management information system is fully online. In Kerala, reforms have concentrated on the budget side, with assistance on drafting laws, rationalizing budget classifications, new procedures, and manuals. Many proposals for further study supported the state government's Modernizing Government Program. Thus, some level of follow up is likely. Overall, the changes made were technical and dealt with legislation, procedures, and computerization. Fiscal deficits in Kerala and Madhya Pradesh improved, but are still very large. Madhya Pradesh also has had to deal with a bifurcation into two new states in 2000. Political will ultimately will determine whether real reductions of fiscal deficits take place. Technical improvements and expanded legal mandates are not sufficient preconditions for this.

TA Ratings. The TPAR rated three TAs successful:

- (i) TA 2432 on income tax administration established training centers that have been useful in capacity building, and more generally in creating an atmosphere conducive to more systematic computerization and networking of the income tax offices all over the country.
- (ii) TA 2943 in Madhya Pradesh triggered computerization of budget and treasury functions, while also preparing the tax department for the introduction of VAT.
- (iii) TA 3576 in Kerala provided some good outputs, which were followed up by the Modernizing Government Program.

The TPAR rated three TAs partly successful:

- (i) TA 2362 had some success in computerization, which in 1996 was just being initiated in the Delhi Sales Tax Department. But efforts to start a pilot of its good blueprint for the introduction of VAT in the Delhi area were not successful.
- (ii) TA 2668 in Gujarat delivered a few good outputs, but overall it operated too much in isolation from the Government.
- (iii) TA 3856 on VAT auditing was incomplete. It was supposed to build capacity further, as well as fine tune a manual and audit selection system for state tax departments once VAT was introduced. But this did not happen. Even after an extension of the TA, the VAT audit manual and the computerized selection system could not be tested.

As a group, the three state-oriented TAs (TAs 2668, 2943, and 3576) were broadly successful. The focus on state finances was highly relevant. The efficacy was good, particularly of the latter two TAs (TAs 2943 and 3576). The efficiency was variable, but the sustainability of the capacity was built up, and institutional impacts were also significant. They played a distinct role in capacity building for—and sometimes in preparation of—the large program loans to which they were linked.

The three other TAs on VAT and income tax (TAs 2362, 2432, and 3856), not related to program loans, were partly successful. Although they were relevant and were coordinated with TA of other external agencies, they remained fragmentary, and the needs were underestimated. This hindered their efficacy and sustainability. The efficiency was variable, while institutional impacts were modest.

Key Issues. The TPAR identified some key issues:

- (i) The Government's decision in 1999 to introduce VAT nationwide has not been implemented. Based on consultations during the OEM, the finance and tax departments consider VAT to be beneficial to the economy in the long run, and an important and just means of revenue generation for the Government. The failure to introduce VAT means a loss of effort and built-up capacity. It also damages the credibility of government decisions. Meanwhile, the Government might have underestimated the requirements for the nationwide introduction of VAT, making too few resources available for the preparation. Since the complexities in India are huge, capacity building in this area requires a larger and more sustained intervention than the Government and external agencies have mustered.
- (ii) Many technical changes have been made to the fiscal management and tax administration systems over the past decade. However, these have not produced smaller deficits, proportionately larger revenues, more client-friendly tax services, or more efficient expenditure management. Therefore, fiscal management should remain a top priority for the Government and supportive external agencies. Innovative approaches are needed, but even those might only lead to cosmetic changes in the absence of the political will to reduce deficits.
- (iii) ADB's policy of focusing on the fiscal management of the states—and supporting that approach with TA—has been useful. The states need policy reform and capacity building. However, the experience with VAT also pointed out that

preceding and parallel action at the center would be beneficial. A complementary central approach is needed.

- (iv) Public scrutiny of reforms in public resource management could increase due to its ramifications for public services, user charges, and possible government staff retrenchments. A tense atmosphere might affect the implementation of TA in this context. Adequate public information is needed regarding the nature of such TA. In addition, TA consultants on the ground, as well as the usually more remote ADB resident mission, must establish a consistent approach to contacting the media and stakeholders outside the Government.

Lessons Learned. Some of the main lessons learned are:

- (i) Successful fiscal management is only partly related to improvements in technical and organizational skills, or legal and procedural instruments. Many factors, such as political will and the absence of calamities, are beyond the control of the TAs or ADB. TAs will do best when embedded in larger government programs, which have confirmed priority and commitment.
- (ii) TA that combines capacity building in such vast areas as revenue generation, budget preparation, and expenditure and debt management should only be undertaken in the context of fiscal management-oriented public resource management programs. These can build upon the TA's outputs. Stand-alone TAs in fiscal management that are confined to one of these components—and pursue capacity building over an extended period—would do better. Generally, ADB needs to have clear fiscal management strategies in countries receiving fiscal assistance.
- (iii) Study tours and foreign training of senior government staff as part of TAs often are not very effective, because of the frequent transfers of senior officers in India. Such instruments might be useful for objectives that can be achieved within a short period, or in cases where decisions need to be made based on the study of systems in foreign countries.

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I. BACKGROUND

A. Rationale

1. Persistent fiscal deficits in the public sector have been the major macroeconomic weakness of the Indian economy. The deficits are among the highest in the world.¹ In the early 1990s, the public sector deficit reached 11% of the gross domestic product (GDP). Due in part to structural adjustments linked to World Bank loans, the deficit fell to 8% in 1995–1996. However, the decline was based on expenditure cuts, not increased tax revenue. As the government wage bill increased in the latter part of the decade, the fiscal deficit rose once again to around 10% of GDP. While the Government initiated fiscal reforms, the Asian Development Bank (ADB) approved two stand-alone technical assistance (TA) grants in 1995—one in preparation for the introduction of a value-added tax (VAT) system, the other on income tax.² In 1996, ADB's new country operational strategy study identified fiscal management as one of the critical areas for development. Shifting policies, ADB increased its focus on support for state-level macroeconomic and sector-level reforms. This was justified by the fact that around half of the deficit was incurred at the state level. ADB first supported a public sector resource management program in Gujarat,³ followed by one in Madhya Pradesh.⁴ Recently, ADB started a third program in Kerala.⁵ The World Bank, meanwhile, implemented similar programs in Andhra Pradesh, Uttar Pradesh, and Karnataka. The ADB programs were accompanied by TAs covering public finance, as well as restructuring of state enterprises. Restructuring of state electricity boards became a particular focus, because their deficits accounted for a large part of the fiscal deficits. In view of the Government's decision to introduce VAT by 2002, ADB approved a new TA on VAT audit capacity building.⁶ Although VAT had not been introduced at the time of this report, this TA was completed. The main focus of this technical assistance performance audit report (TPAR) is ADB's TA in fiscal management and tax administration at the central and state levels. ADB completed six TAs in this area:⁷

- (i) TA 2362-IND: *Improvement of State Sales Tax Structure and Administration* (footnote 2), implemented August 1996–November 1997;
- (ii) TA 2432-IND: *Capacity Building of Income Tax Administration* (footnote 2), implemented September 1997–June 2000;
- (iii) TA 2668-IND: *Gujarat's Reform of Public Finances*,⁸ implemented September 1997–February 1999;
- (iv) TA 2943-IND: *Support for the Government of Madhya Pradesh Public Finance Reform and Institutional Strengthening*,⁹ implemented August 1998–August 2001;

¹ International Monetary Fund. 2002. *India: Selected Issues and Statistical Appendix*. Washington, DC.

² TA 2362-IND: *Improvement of State Sales Tax Structure and Administration*, for \$99,500, approved on 14 July 1995; and TA 2432-IND: *Capacity Building of Income Tax Administration*, for \$550,000, approved on 26 October 1995.

³ ADB. 1996. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to India for the Gujarat Public Sector Resource Management Program*. Manila.

⁴ ADB. 1999. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to India for the Madhya Pradesh Public Resource Management Program*. Manila.

⁵ ADB. 2002. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to India for the Modernizing Government and Fiscal Reform in Kerala (Subprogram I)*. Manila.

⁶ TA 3856-IND: *Value-Added Tax Reform: Capacity Building at the Post-Implementation Stage*, for \$600,000, approved on 11 April 2002.

⁷ TA 2432 and TA 2943 were funded by the Japan Special Fund. The other TAs were funded from ADB's own TA funds.

⁸ For \$600,000, approved on 23 October 1996.

⁹ For \$780,000, approved on 15 December 1997.

- (v) TA 3576-IND: *Supporting Fiscal Reforms in Kerala*,¹⁰ implemented September 2001–September 2002; and
- (vi) TA 3856-IND: *Value-Added Tax Reform: Capacity Building at the Post-Implementation Stage* (footnote 6), implemented October 2002–December 2003.

2. Five of the six TAs were devoted in whole or in part to the preparation for VAT. The plan to introduce a countrywide VAT was conceived as early as 1991. In 1995, the Committee of State Finance Ministers made solid recommendations on the plan. However, the Government took some 4 more years—until 16 November 1999—to decide to introduce VAT by 1 April 2002. Meanwhile, a uniform floor rate for sales tax was established in 2000, which greatly reduced the inefficiencies created by disparities in state sales tax rates. VAT, however, was postponed first for a year, to 1 April 2003, and then to 1 June 2003. Its introduction was then postponed without a new date being set. The evaluation of the impact of ADB's work on VAT is based partly on an assessment of likely developments. Appendix 1 discusses the history of sales tax and VAT in India.

B. Objectives and Scope of the Technical Assistance

3. While the broad goal of the TAs was to contribute to putting the Government's finances on a more sustainable footing, their specific purpose was to build human and institutional capacity in three areas: (i) sales tax improvement and the introduction of VAT, (ii) other means of revenue generation, and (iii) budget and expenditure management. Only the last two TAs were based on a project framework that specified the goals, purpose, and outcomes with indicators. This may have contributed to the fragmentary nature of the objectives and scopes.

4. **TA 2362** (footnote 2), which was small in scale, was prepared in 1995 based on the recommendations of the Tax Reform Committee in 1991 to replace the sales tax in states with VAT. The Committee of State Finance Ministers had agreed in 1994 on the desirability of a common program for implementing VAT nationwide, and suggested several time-bound preparatory steps. In this context, the Government requested ADB assistance for the National Capital Territory of Delhi. The main objective of the resulting TA was to suggest detailed administrative steps for implementation of VAT in Delhi. Another objective was to assist in the computerization of sales tax administration, which would be compatible with the change to VAT. The scope included an action plan, a framework for rules and regulations, system design for computerization, and training. The implementation of VAT in and around Delhi was to be a pilot for the implementation in the states.

5. The objective of **TA 2432** (footnote 2), which ADB and the Government agreed upon simultaneously with TA 2362, was to assist with reforms led by the Income Tax Department (ITD). At the time, the Government depended excessively on indirect taxes, with only 30% of tax revenues derived from incomes and a narrow tax base covering only 10 million people. Outdated information systems compounded the problems. While a committee set up in 1993 advised ITD on an information technology strategy, a fundamental change in tax administration was needed first. The Canadian International Development Agency (CIDA) and the United Nations Development Programme (UNDP) became involved. The Government asked ADB for selective components, namely (i) a human resource development strategy (HRDS) compatible with the new information technology, (ii) support for macroeconomic analytic capability at central and regional levels, and (iii) staff training at the three key regional income tax centers (Chennai, Delhi, and Mumbai).

¹⁰ For \$1 million, approved on 13 December 2000.

6. **TA 2668** (footnote 8), which was agreed with the government of Gujarat in May 1996,¹¹ diverged from the earlier two revenue-oriented TAs. Its objective was to strengthen public finances at the state level, through structural reforms on revenues and expenditures. Its approval came around the time of the approval of Loan 1506-IND: *Gujarat Public Sector Resource Management Program*,¹² and the release of the first tranche of \$50 million. The TA was to contribute to the effective implementation of public finance reforms envisaged under this program. More specifically, the TA focused on building institutional capacities of the Finance Department to improve budget policy, planning, management and control systems, and modernizing and computerizing the tax and expenditure departments. Highlighting the wide range of support intended over 1 year, the TA would be involved with (i) reform of sales tax, stamp and registration duty, and other minor taxes; (ii) an action plan for VAT; (iii) municipal taxes, including *octroi* tax¹³ and property tax; (iv) expenditure management; (v) budget planning; (vi) computerization; (vii) an HRDS; and (viii) training of staff.

7. **TA 2943** (footnote 9) was approved a year later and contributed to the implementation of Loan 1717-IND: *Madhya Pradesh Public Resource Management Program*.¹⁴ Like in Gujarat, government expenditures were growing unabatedly, while the tax base remained stagnant and narrow. That was the main reason for combining advice from the TA and the loan.¹⁵ The objective was to improve development management by supporting the state government's public finance reform and institutional strengthening. This would be achieved by focusing on (i) structural reforms of the tax system and improvement in tax administration; (ii) improvement in expenditure prioritization, management, and control systems; (iii) enhanced transparency; and (iv) capacity building through training, modernization and computerization of administration, and formation of a budgeting and financial analysis unit with skills for policy development.

8. Three years later, **TA 3576** (footnote 10) conducted even wider ranging activities, in preparation for Loan 1974-IND: *Modernizing Government and Fiscal Reform in Kerala (Subprogram I)*.¹⁶ In addition to the objectives of the previous TA covering revenues (VAT) and expenditures, this TA aimed to strengthen the capabilities of local bodies to assume responsibility for social spending, and make their functioning transparent and accountable.

9. **TA 3856** (footnote 6) concentrated on the introduction of VAT, which was postponed at the time of the TA's approval from April 2002 to April 2003. The TA aimed to help develop an effective audit strategy with the appropriate selection of cases for audit. Six states would be selected to develop a database as part of a well-structured management information system (MIS). An effective market intelligence system would also be established for risk analysis.

¹¹ The selection of the states (Gujarat, Kerala, and Madhya Pradesh) was carried out in consultation with the central Government in accordance with (i) the willingness of the state government to undertake comprehensive economic reforms; (ii) the demand for assistance in terms of population, poverty level, and infrastructure investment; (iii) a satisfactory record of project implementation and an absence of substantial assistance from other donors; and (iv) the capacity of the state government to service any loan.

¹² For \$250 million, approved on 18 December 1996 (footnote 3).

¹³ Octroi tax is a tax levied by the local government on the import of goods within a city area. The tax is not levied when goods are in transit.

¹⁴ For \$250 million, approved on 14 December 1999 (footnote 4).

¹⁵ Parallel concerns existed with state enterprise deficits and with the dialogue on power sector restructuring.

¹⁶ For \$200 million, approved on 16 December 2002 (footnote 5).

C. Technical Assistance Completion Reports

10. The six TAs were completed. Five have technical assistance completion reports (TCRs). Of the three related program loans, two were completed. For the first loan, the National Applied Economic Research Council prepared an independent assessment report for ADB that also addressed, to some extent, the results of TA 2668.¹⁷ The five TCRs all rated their TAs generally successful.¹⁸ However, the qualifications noted in the TCRs are of interest.

11. **TA 2362.** Although the TA was seen as highly successful in computerizing the Delhi Sales Tax Department and preparing a blueprint for the implementation of VAT in Delhi, the inputs of domestic computer experts were a problem. The consultants' input requirements should be assessed more carefully at TA design stage. In addition, the training of seven officials was less effective, because most of the officers were subsequently transferred. ADB should be more proactive in selecting candidates for training programs. The TCR recommended that ADB provide follow-up TAs for computerization of the sales tax departments in Gujarat and Madhya Pradesh.

12. **TA 2432.** The TA equipped three training centers with computers, provided funds for overseas training for nine senior officials, organized a study tour, trained 590 (of the intended 3,000) staff and 98 trainers in the training centers, and simplified income tax administration. Recommendations regarding new procedures and formats for tax forms are being implemented. However, ITD has not set up a comprehensive MIS, and has not made any progress in strengthening the tax analysis wing. Overall, ADB was judged to have provided TA at the most appropriate time, with some significant impacts, such as a surge in taxpayer compliance.

13. **TA 2668.** The TA was approved 2 months before the approval of program Loan 1506-IND (footnotes 3 and 12), and influenced the release of the second and third tranches of this loan. The TCR noted that TA reports and workshops provided important inputs to Gujarat's public finance reform process, although they came late due to implementation delays and lack of state government support. The TA was crucial to support the formulation of a reform strategy and to build capacity. The assessment report for Loan 1506-IND (footnote 17) says that TA 2668 enhanced the technical capacity of government officers to deal with the complexities of budgetary management: "Gujarat is today in a much better position to carry forward the reform agenda." On a larger scale, some problems with the program perhaps could have been addressed partly by the TA consultants. The report states that ADB overlooked the large sales tax exemptions the Government gave during the program period. The impact of those exemptions now is being felt on the fiscal situation. The aggregated exemptions are approximately 50% of the fiscal deficit.

14. **TA 2943.** The TA was approved and started 2 years before the program loan for Madhya Pradesh (footnotes 4 and 14). The Madhya Pradesh government reportedly accepted the recommendations of the extensive final report prepared by the consultants. The TA created considerable ownership on the part of the Madhya Pradesh government in formulating a road map for VAT implementation. However, the advice on the introduction of VAT has lost momentum since the central Government has postponed VAT.

15. **TA 3576.** Like TA 2943, this TA was approved 2 years before the program loan. Since the public resource management program in Kerala is not completed (footnotes 5 and 16), the

¹⁷ ADB. 2002. *Gujarat Public Sector Resource Management Program: An Assessment*. Manila.

¹⁸ At that time, ADB rated TAs in three categories: (i) successful, (ii) partly successful, and (iii) unsuccessful.

impact of the TA is unclear. The TA's final report of September 2002 mentioned some serious constraints. Bad publicity, among other things, reduced interaction of the TA team with all but the highest level of the Government. Protesters vandalized the project office in April 2002, which prompted ADB to close it. The VAT component was to develop a detailed implementation plan for the new tax and provide training modules. Due to the postponement of VAT, emphasis shifted to training.¹⁹

16. **TA 3856.** This TA's main outputs were produced by February 2003, and the TA was closed by December 2003. Due to the Government's latest postponement of VAT in April 2003, some activities were canceled. At the completion of this TPAR, a new date for the introduction of VAT in India had not been announced.

D. Operations Evaluation

17. The Operations Evaluation Mission (OEM) took place 3–19 November 2003. It was headed by an evaluation specialist of the Operations Evaluation Department, with assistance from one expert in sales tax and VAT, and another expert in direct tax. The OEM visited Delhi, Ahmedabad in Gujarat, Bhopal in Madhya Pradesh, and Thiruvananthapuram in Kerala.

18. Three main strands in the TAs were evaluated: (i) sales tax and VAT; (ii) other revenues; and (iii) budget and expenditure management. The TAs in Gujarat, Kerala, and Madhya Pradesh were assessed separately from the subsequent public resource management program loans ADB provided to these states. An aide memoire with the OEM findings was discussed with the Department of Economic Affairs in the Ministry of Finance. A draft TPAR was sent to the Executing Agencies (EAs) for comments, which were considered in preparing the final version.²⁰ The main text of this TPAR summarizes the findings derived from the OEM, and provides a broad assessment of the TAs as a group. Appendixes 2–7 review and assess each TA individually.

II. ASSESSMENT OF IMPLEMENTATION PERFORMANCE

A. Design of Technical Assistance

19. The TA objectives were broadly in line with recommendations made by a number of high-powered committees constituted to propose reforms. The finance minister in 1991 conceived the plan to reform taxes and to introduce a countrywide VAT. In 1994, the Committee of State Finance Ministers made solid recommendations for reforms. The TAs also were in line with ADB's country operational strategy study, issued in July 1996, which responded to the new sense of urgency regarding fiscal reforms. Given the potential that reforms in the sales tax and income tax systems had for increasing revenue generation, it was appropriate that the first TAs focused on these areas. TA 2362 on sales tax reform was intended only as a pilot in the Delhi area. Its main problem, however, was that it preceded a decision to introduce VAT in the country—a decision that would be made only in 1999. The lack of clarity regarding the nature of VAT to be introduced countrywide affected the plan to pilot systems for rationalizing sales tax and converting it into VAT. This eventually paralyzed the resolve, and the pilot never was implemented (Appendix 2, para. 9). Providing more assistance to the Department of Revenue

¹⁹ The recently issued TCR listed as achievements the (i) improved preparation process for state budgets and plans, (ii) issuance of the Fiscal Responsibility Act, and (iii) creation of a Secretariat for the Modernizing Government Program. The objective to strengthen the capacity of local bodies was not achieved.

²⁰ Comments were received from the finance departments of the governments of Kerala and Madhya Pradesh, and ITD. They indicated broad agreement with the TPAR findings. All comments were integrated.

on decision-making regarding VAT would have been more appropriate than starting a pilot in one area. Assistance to pilots in other states (e.g., Maharashtra) might also have been more effective. However, TA 2362 was more successful in its concurrent focus on introducing computer systems and databases to the Delhi Sales Tax Department that would be compatible with the introduction of VAT. Subsequent TAs in Gujarat, Kerala, and Madhya Pradesh were similarly hindered in their VAT objectives. New systems were proposed only to be rejected due to the parallel development of a different system at the national level, which was then adopted countrywide. Although some work was wasted, the TAs helped in preparing VAT legislation and building capacity at the state level. Unfortunately, due in part to other states being less prepared for VAT, this tax reform had not been implemented at the start of 2004.

20. TA 2432 on income tax was larger than TA 2362, and was designed to complement larger assistance provided by CIDA and UNDP (Appendix 3, paras. 5 and 17). The components to be included were closely negotiated with ITD. The TA was successful mainly in its practical computer training objectives. More ambitious aims of producing an HRDS and generating analytical capacity in the department did not lead to positive outcomes. Extended TA involvement would have been necessary to achieve these goals, something which other agencies with more resources and a longer time frame perhaps could have delivered better. Even the training needs were much larger than anticipated. Nevertheless, the TA's main contribution was the training of staff in computers in general and in some new programs developed for income tax processing.

21. The three subsequent state-oriented TAs (2668, 2943, and 3576 in Appendixes 4, 5, and 6, respectively) had a more solid foundation in ADB's overall programming. They were part of major ADB-supported public resource management programs. The design of the TAs was wide, covering most areas in fiscal management that the programs were expected to address. The findings of the TAs were intended to feed into the programs' policy matrixes and tranche-release conditions. This would then ensure the proper follow-up of the TAs' recommendations beyond their completion. Otherwise, follow-up would have been hazardous, given the numerous areas in which the TAs were involved.

22. Like the other TAs, TA 3856 on VAT post-audit capacity building anticipated a tax reform that was not implemented during the TA period. The TA was largely ineffective as a result. The TA was to start with the switch to VAT, but the new tax system was not introduced in India. Therefore, the preparation of a VAT audit manual and training was somewhat sterile. The OEM also concluded that the TA underestimated the requirements. A much longer process and more resources would have been required to support fully the new VAT audit system in the six states intended (Appendix 7, para. 25).

23. Overall, the TAs responded well to India's resolve to reform the Government's finances during the financial crisis in the early to mid-1990s. The TAs in ADB's focal states, which were set up in the context of ongoing or anticipated fiscal programs, addressed a clear need for capacity building at this level. Because ADB was not supporting any fiscal management program by the central Government, the other TAs operated more in isolation. The needs in the center and the states were essentially boundless. In retrospect, it can be questioned why more of ADB's TA resources were not directed to this field. The TAs undertaken covered the most important components of the fiscal deficit problem, albeit in limited fashion. Generally, they were well coordinated with the few TA programs of other external agencies (Appendix 8), especially in their core area of fiscal management. State-oriented TAs, however, sometimes included sector work that was coordinated less well with such programs.

B. Engagement of Consultants

24. The consultants were selected in accordance with ADB's *Guidelines on the Use of Consultants*. In five of the six cases, international consulting firms implemented the TAs in association with domestic firms. The EAs considered this arrangement generally satisfactory. The mix of domestic and international consultants usually was found appropriate, with one exception.

25. TA 2668 in Gujarat encountered problems with the selection of consultants. Since the initial terms of reference allocated only 2 person-months to international consultants, no international firm expressed interest in the TA. Only two domestic firms expressed interest when the TA was retendered, probably due to the variety and highly specialized nature of the tasks required. Despite reservations with the proposals, the EA selected one firm, which was found to be largely inadequate. The team of domestic consultants, which also changed after the award, was found to be of insufficient national standing to provide high quality outputs and then leverage its recommendations. Moreover, it would have been better if the tasks required had been subdivided into more than one contract, so several firms could have been employed in their specialized fields. Lastly, some consultants with the required national standing were found to be less interested in participating in TA outside the national capital.

26. Some assignments under TA 3576 were to be subcontracted to a domestic firm, but this did not occur due to misunderstandings between the domestic firm and the international firm. On short notice, the international firm had to recruit alternative consultants individually. Although good alternative individual consultants were found, the arrangement took an unforeseen amount of time from the team leader. As a result, he was less effective in his role towards the Government.

27. TA 3856 had a mix of international and domestic consultants. The OEM concluded that the TA should have included more experts with extensive experience in Indian tax administration.

C. Organization and Management

28. All TAs, except perhaps TA 2362, had appropriate EAs. ITD was the EA for TA 2432. The Department of Revenue of the Ministry of Finance was the EA for TA 3856. The Finance Department was the EA for the three state-based TAs. The Delhi Sales Tax Department was the EA for TA 2362. Since this department was to implement a pilot in its area, this was appropriate. However, the work required on VAT at that early stage was different (para. 19) and would have been better placed with the Department of Revenue.

29. The TAs employed working groups and steering committees in different ways. While TA 2362 had very few consultants due to its small size, its base in Delhi and the close involvement of ADB headquarters and the India Resident Mission (INRM) staff ensured that the TA was well coordinated. Similarly, TA 2432 was based in Delhi, closely managed by ADB headquarters, and benefited from specialized staff at INRM. ADB headquarters administered the three state-based TAs. In spite of assistance from INRM, their implementation was hampered by their distance from Delhi. Especially in the case of TA 2668, this remoteness contributed to the slow start and difficult implementation. ADB staff made their first visit to the TA 6 months into its implementation. The TA did not have a formal steering committee, though it was supposed to work with the new State Public Finance Reforms Committee and with new working groups. However, the committee was created toward the end of the fielding of the

consultants, and the working group mechanism did not function much as a result. The organization of TA 2943 in Madhya Pradesh was much better, especially because of the implementation arrangements. The Economic Reform Committee served as the TA's steering committee, while two state public finance reforms committees and a number of working groups also were fully involved. TA 3576 in Kerala was short, and a public finance reforms committee was constituted only at the end to examine the final report and make recommendations. An officer in the Finance Department, who was involved full time with the TA, provided much of the coordination during implementation. Progress was hampered by evolving views within ADB and within the Finance Department about the nature of the TA and the direction of the subsequent program loan. Public perceptions regarding the TA and the program loan, which was viewed as a structural adjustment loan that would lead to retrenchments, also created difficult working relations with some departments. The TA worked as part of discussion groups. In spite of the problems mentioned there was good cooperation with the Finance Department. TA 3856 was based in Delhi with the Department of Revenue as the EA. The TA achieved large savings by organizing inexpensive venues for workshops, and getting the states to pay a daily allowance for the participants of the workshops. However, the objective of providing customized services to tax departments in six states was too ambitious for the resources available. Some departments complained that the TA gave them insufficient attention. Since funds were available, an extended involvement of the TA in each of these states should have been pursued. A steering committee with participation of each of these states was not created. The link between the TA and the so-called Empowered Committee on VAT could have been stronger.

D. Implementation Schedule and Financing Arrangements

30. The progress of the TAs is reflected in Appendix 9. Most of the TAs took much longer to complete than anticipated for various reasons. Several of the TAs had planned unrealistically short durations. TA 2362 was hampered by the departure of the original, highly specialized international consultants, who moved on to other assignments after their 1-month involvement. New consultants had to be engaged to do the follow-up work. TA 2432 was delayed due to the (i) long procurement process for equipment; and (ii) slow process of setting up the computer training laboratories in Chennai, Delhi, and Mumbai, which was completed by April 2000 when the consultants were gone. The TA also experienced considerable confusion about the number of staff to be trained, with targets varying from 750 to 3,000. Of the three state-oriented TAs, only TA 2668 was seriously delayed. The EA's dissatisfaction with the consultant team, a lack of arrangements of proper office space on the premises of the EA, and a delay in the appointment of the State Public Finance Reforms Committee were the main reasons. TAs 2943 and 3576 experienced much smaller delays. As in some other cases, the equipment budget was not spent and a second contract was offered for consulting services about 1.5 years after the first was completed. Although TA 3576 was to take 8 months, it was first extended and then shortened after activists vandalized the office. ADB subsequently closed the office and sent the consultants home. The attack on the office took place during the preparation of the final report. More time was needed to reorganize the TA and reconstruct its databases after the office was closed.

31. The estimated cost of the six TAs was \$3.63 million, of which \$2.59 million (71%) was disbursed. TAs 2668 and 3856, which were approved for \$0.60 million each, had significant savings. TA 2668 spent \$0.29 million, while TA 3856 spent around \$0.36 million. For TA 2668, the somewhat rocky relationship with the EA was part of the reason for the savings, as many planned consultancies and large equipment purchases did not materialize. TA 3856 saved on workshop costs, and had to cancel part of its scope due to the postponement of VAT. In the

other TAs, savings came from canceled workshops and equipment purchases, which was indicative of the amount of work involved in these activities given small human resources in the TAs. Most contracts for the consultancies were awarded at 10–20% below the estimate, which also influenced the low disbursement ratio.²¹ More creative project administration could have led to scope changes that propped up capacity building in an area with vast needs.

III. EVALUATION OF RESULTS

A. Adequacy and Quality of Reports and/or Services Provided

32. For all TAs except TA 2432, capacity building was carried out through advice given by experts on-the-job and reports. The three state-based TAs, in particular, produced a large volume of advisory materials. TA 3576 in Kerala produced 16 volumes in draft and final mode. These reports contain a wealth of information, but they were not equally appreciated by the recipient governments. TA 2668's reports for Gujarat were seen as a digest of already existing materials and, with some exceptions, not sufficiently innovative. TA 2943 in Madhya Pradesh produced highly readable and well-received reports of higher quality. It might have benefited from the earlier work done in Gujarat, although some of the work was done almost in parallel. The quality of TA 3576's reports for Kerala was also generally high, though they were generic in places rather than specifically geared to Kerala. Most of the reports came out first as drafts, which were discussed in workshops and in rounds of written comments. However, the EAs might have lacked the absorptive capacity to utilize fully the voluminous reports. This poses some limits to this type of output as an instrument of advice. In Gujarat, due in part to the lack of working groups and workshops, many of the late suggestions from ADB and the Government on the draft final report were not included in the final version. In Kerala, fewer workshops were held than planned due to security issues, and the absence of the consultants at the end prevented the final product from being as good as it should have been (para. 29). In Gujarat and Kerala, some of the wide-ranging outputs overlapped with TA outputs of other external agencies that were being produced in parallel.

33. The documents produced came in four main categories: (i) sales tax and VAT reports; (ii) other revenue generation-related reports; (iii) budget, expenditure, and debt management reports; and (iv) other reports.

34. **Sales Tax and VAT Reports.** The efforts made by five of the six TAs on sales tax and VAT administration were of variable quality and had variable success. The first product in the Delhi Administrative Area was high quality, but it suffered from the fact that the decision to introduce VAT was still far off. It also was impacted by differing views regarding the nature of the VAT system (i.e., should VAT start with only a few commodities; or with all, but initially cover only the larger dealers). Those problems ultimately prevented the authorities from conducting the pilot as intended by April 1997. In Gujarat, the TA suffered from a lack of communication with the Government, and produced outputs that were deemed largely irrelevant to the process of conversion to VAT. The report concentrated on rates, which were seen as the least problematic aspect, but did not make headway on issues such as required administrative changes, computerization, training, and VAT's revenue impact. The consultants were considered insufficient in stature for the documents to be used by the Finance Department to persuade politicians. (Gujarat initially did not favor VAT.) In Madhya Pradesh and Kerala, the advice produced was useful in preparing for the introduction of VAT and drafting legislation. In

²¹ Between 10.3% and 13.7% of the TAs' budgets funded by ADB were set aside for contingencies.

Madhya Pradesh, the consultants spent much of their time preparing and defending a proposal that contributed to a national discussion, but was ultimately rejected.

35. TA 3856 provided the only central-level advice on VAT. The VAT audit manual, which was prepared by consultants, was offered to six selected states for review. The manual also was tested during training sessions with government officers, whose comments were taken into account while preparing a later version. The Committee of State Finance Ministers accepted this version at a meeting in early 2003, but the minutes of the meeting were not made public. That has left the manual's status unclear. The absence of a steering committee to the TA might have contributed to this lack of ownership. The Ministry of Finance's Department of Revenue offered the manual to all state governments by April 2003, and recommended its use. However, the department cannot require its use, because VAT is a "state subject." The manual was to be reviewed and amended 3 months after introduction of VAT to make adjustments based on the initial experience. In spite of an extension of the TA, this activity had to be canceled. Therefore, the manual should be seen as incomplete. Although the audit manual follows standard practice in many countries with VAT, the OEM had reservations about the appropriateness of the document in the context of the Indian administration. These concerns were supported by the finding that the tax departments in three of the four states visited (including the Delhi Sales Tax Department) were unhappy with the document. They planned to adapt the manual for their own use. Gujarat and Madhya Pradesh, in particular, criticized the inappropriateness of the manual. Several sales tax departments do not have legal mandates to conduct VAT audits. The quality of databases of dealers is insufficient for the risk-based selection of audits. The TA did not help them improve the databases. Often staff was unqualified and felt inadequately trained to conduct the audits. Overall, the OEM concluded that ADB underestimated the time and resources needed for a satisfactory, locally adapted manual, and was too economical with the TA resources.

36. **Other Revenue Generation-Related Reports.** TA 2432 on income tax produced a detailed volume on the simplification of forms and rules, which was well received. The TA also produced reports on HRDS and computer training requirements. The HRDS document was viewed as unrealistic, because it did not take sufficient account of the particularities of the Indian civil service system. Thus, it was not followed up. A draft document also was prepared for a new tax analysis framework. Despite being regarded as very high quality, it was not implemented. The implications for the collection of data were not followed through, due in part to factors such as (i) the short duration of the TA, (ii) transfers of key staff, (iii) difficult logistics in a country with so many tax offices, and (iv) limited ownership by the ITD.

37. The three state-oriented TAs (2668, 2943, and 3576) produced advisory reports about taxes other than sales tax and VAT, notably property tax and stamp and registration duty. The property tax valuation systems proposed in Gujarat and Madhya Pradesh were carried through with some success. However, the system in Gujarat was said to have been based on another study, not the one produced by the TA. On the recommendation of the TA, octroi was abolished except in six big cities in Gujarat. The TA in Gujarat also made valuable proposals for reforming the entertainment tax, which were followed up. The Government did not deem the recommendations on other minor taxes²² of sufficient quality. The TA's proposal to use a system based on valuation committees in Madhya Pradesh was particularly innovative in India, and is functioning well. The TA produced an important property tax valuation manual. In Madhya

²² Minor taxes include profession tax, land revenue, stamp and registration duty, electricity duty, transport and goods taxes, luxury tax, and state excise duty. In Kerala, minor taxes include land tax, agricultural income tax, plantation tax, land revenue, building tax, luxury tax, and electricity duty.

Pradesh, stamp and registration duty was brought down significantly following the TA's report, benefiting the taxpayers. The TA in Kerala also studied property tax and other minor taxes, but few recommendations have been followed up.

38. Budget, Expenditure, and Debt Management Reports. The three state-oriented TAs produced voluminous reports on the budget and expenditures for the finance departments. TA 3576 also produced a volume on debt management. The Gujarat government considered the reports of mixed quality. Nevertheless, they were used as one of the bases for the recommendations the State Public Finance Reforms Committee issued in December 2000.²³ The reports for Madhya Pradesh covered a variety of issues as well, while focusing on computerization of the system. The TA developed a system for determining the core investment program, which was seen as useful. It was expanded to a core expenditure plan, which incorporates the recurrent budget. The TA in Kerala similarly focused on the introduction of results-based management. In a short time, the TA produced a high quality planning manual, which the Planning Department is using. The TA also helped with other initiatives, such as the (i) preparation of the Fiscal Responsibility Act, which was approved on 17 September 2003; (ii) changes in the budget preparation calendar; and (iii) approval of an Asset Renewal Policy and the creation of a (limited) Asset Renewal Fund. Another important accomplishment of the TA was the rationalization of the budget classification system, which weeded out thousands of little used categories and greatly reduced the size of the budget books. The TA in Kerala also reviewed accounting and auditing systems in local self-government institutions. Many of the TA's recommendations are being followed up by actions under the ADB-supported Modernizing Government Program, which started in 2004.

39. Other Reports. TAs 2943 and 3576 included studies on fiscal management in health and education sectors, which the OEM considered good quality. TA 3576 also conducted some work on utilities pricing for irrigation, water resources, and regulation of public service vehicles. All were good quality, but not sufficient by themselves to engender change. Kerala's Modernizing Government Program has picked up some of the studies. In all three states, advice provided by the TAs occasionally duplicated that of other external agencies. This occurred outside the context of finance and tax departments, mainly in the areas of health, education, and local government.

B. Training and Technology Transfer

40. TA 2432 on income tax was the only one to rely mainly on formal training and technology transfer as a means of capacity building. The equipment component constituted almost half of ADB's share of the cost. The training exercise was linked with the provision of equipment for three regional computer laboratories to train hundreds of tax officers (para. 12). The TA also sent three senior tax officers to Canada to study organizational arrangements for tax analysis. However, the officers were transferred to other departments or positions after their return, so the intended human resource development did not take place. TA 2362 organized a study tour to Korea for seven officers, but most of the officers similarly were transferred not long after their return. The VAT audit training exercises under TA 3856 were only partially completed, as a third round was canceled due to the postponement of VAT.

41. The three state-oriented TAs mainly organized working groups and workshops on their advice outputs. Training courses or study tours were not held under the TAs. In the working

²³ The recommendations are still being implemented and monitored by the chief secretary through quarterly meetings.

groups, heavy interaction produced on-the-job training, especially in Madhya Pradesh (and to a lesser extent in Kerala). With some departments other than the Finance Department, the negative light in which the TA and the subsequent program were seen created difficult working relationships (para. 15; Appendix 6, paras. 9, and 11). The TA in Gujarat was not effective in human capacity building, because of the low level of communication between the consultants and the Finance Department.

42. All TAs promoted computerization and networking, and most made considerable progress. TA 2432 implemented the largest transfer of computer hardware, equipping three regional centers with 63 computers and networking. Some of the TAs had provisions for equipment that were not utilized fully, such as in Gujarat and Madhya Pradesh. Only in Gujarat was ADB's contribution in this field considered substandard with no impact. The Sales Tax Department initially favored the software developed for the department, but later regarded it as obsolete. The system was considered inappropriate. In the other cases, the contributions to the computerization process were generally timely. In the Delhi Sales Tax Department, ITD, and in the Finance Department of Madhya Pradesh government, the contributions helped trigger comprehensive computerization. TA 3856 distributed 30 computers to commercial tax departments in the six states, in anticipation of the use of the software developed for VAT audit selection.

C. Institution Building

43. Institution building in the sense of building new laws or systemic functions of government organizations was undertaken as part of the three state-oriented TAs. It was successful in Madhya Pradesh, and to a lesser extent Kerala. In Madhya Pradesh, the TA and a consultant (hired separately by the government as part of the TA) helped shape the new State Budgeting and Fiscal Analysis Unit (SBFAU). A key recommendation made in some form by all three TAs was the creation of a central group of ministers and officers with budget preparation responsibilities. However, none of the states followed this up. In Gujarat, problems in budget preparation were perceived to be related to the frequent transfers of key staff. In all three states, but particularly in Kerala, assistance was provided to draft laws in different fields, and this led to institution building. Some success was also achieved with the institutionalization and improvement of medium-term fiscal frameworks and core investment programs.

D. Outcomes and Impact of the Technical Assistance

44. **Sales Tax and VAT.** Assistance for the gradual introduction of VAT in the country was a major component of all TAs, except TA 2432. India is one of the last major countries in the world without VAT. The main reason given for the postponements was that certain states are not ready for the conversion to VAT. Other reasons included the politicization of VAT, with an important trading lobby opposing the tax. State governments calculated high losses of revenue during a transition period, and the national Government committed to providing compensation for these losses. The Government's inability to honor that commitment due to a fiscal crisis might have contributed to the decision to postpone VAT. State governments refrained from introducing VAT on their own, because they did not want to lose any compensation that might be offered later. A new date for VAT might be announced after the 2004 national elections and installation of a new government. Many states, however, already have the supporting legislation in place, and some might proceed on their own if the national Government procrastinates further. Despite some initial losses in revenue due to the need to give input credit for raw materials, most of the larger states expect revenue gains from VAT. The government of Haryana state implemented VAT in April 2003, because it had already given input credit and did not have to provide the

compensation that other states are expecting. Gujarat announced the introduction of VAT in its newly approved industrial policy, implying that it will go ahead even without the nationwide introduction. Madhya Pradesh might also introduce VAT on its own. Despite the postponements, the work on VAT in various states and at the center has been so comprehensive that the OEM considers it unlikely that this process will remain uncompleted. All tax departments visited were keen on introducing VAT, since this tax (i) is self-policing, (ii) avoids double taxing of goods, (iii) creates paper trails and reduces tax evasion, (iv) is in principle simpler, (v) might lower the effective tax for individual dealers, and (vi) might widen the tax net to include the large Indian services sector for the first time. From this perspective, ADB's efforts in this area since the mid-1990s might have helped tip the balance in favor of VAT, even though it has not happened yet. In Haryana, revenues appear to have gone up dramatically since the introduction of VAT, and its experiences are being followed by tax departments all over India.

45. **Revenue Generation.** The introduction of VAT was projected to raise overall tax collection. Improvements in income tax collection were projected to increase the revenue from this source to 17% of total collections in 2006–2007. However, the tax-GDP ratio has remained stagnant at 14–15% in the 1990s and early 2000s. Indirect tax collections have declined relatively, especially customs and excise duties. Meanwhile, direct tax collections have increased from 2.7% of GDP in 1995 to around 3.3% in 2002. Revenue generation in the center and the states has not kept up with expenditures increases in 1990–2003. Appendix 10 demonstrates expanding gap in the three states where ADB's state-based TAs and programs were implemented. Kerala has fared slightly better than Madhya Pradesh, while Gujarat has performed the worst. Gujarat and Madhya Pradesh can cite special reasons for their continuing fiscal crisis. A severe earthquake hit Gujarat in January 2001, while riots in 2002 caused damage and deterred investment. Madhya Pradesh split into the two new states of Madhya Pradesh and Chhattisgarh in November 2000. The bifurcation carried a large cost to the Government, and left Madhya Pradesh with a disproportionately small share of earlier non-tax revenue generation opportunities. Sales tax has remained relatively stagnant, while other state-based taxes to which ADB TA has contributed—notably property tax and stamp and registration duty—have not made major gains. (Those minor taxes have little capacity to do so due to their small share of the total tax base.) Therefore, the overall impact of the TA on revenue generation in the three states was modest. Most of the positive outcomes were due to the modernization of income tax collection, to which ADB made a small contribution through TA 2432. This central tax rose by an average of 10–15% per year, slightly faster than the inflation rate.

46. **Budget and Expenditure Management.** The TAs helped improve technical aspects of budget and expenditure management through (i) assistance with computerization of treasury management systems; (ii) organizational, legal, and procedural changes; and (iii) some capacity building through on-the-job training and the provision of manuals. The extent of the effect of some of the legal changes (such as Fiscal Responsibility Acts) is unclear. The significance of the computerization of budget and expenditure management has not been felt, because the systems are not fully operational yet. Budgets and expenditures in Gujarat and Madhya Pradesh often could not be contained sufficiently to reduce the fiscal and revenue deficits. In Kerala, a full turnaround has not been achieved yet. This highlights the overriding political compulsions often connected with budget management, which may be difficult to address with TAs focusing on capacity building.

47. ADB has not issued completion reports or conducted post-evaluation assessments for the public resource management programs. In Kerala, the program is ongoing. The OEM found that the state governments of Gujarat and Madhya Pradesh regarded the programs as more useful in restructuring of state enterprises and paying for retrenchment packages than in actual

tax revenue generation and budget and expenditure management. The National Applied Economic Research Council reported a similar finding in an independent assessment of the Gujarat program for ADB (footnote 17). It concluded that experience with the TAs and the program in Gujarat improved the design of the subsequent ADB TAs and programs. From a wider perspective, ADB's efforts have contributed to greater use of medium-term fiscal frameworks. The Gujarat Public Sector Resource Management Program was one of the first fiscal reform programs in the world conducted at a subnational level. It has helped motivate India's central Government to start signing memorandums of understanding on such fiscal frameworks with some 18 states. This indicates the relevance of these early experiments. The importance of changes at the central level is widely acknowledged, especially given the perverse incentives for states with big deficits. Larger deficits and larger "needs" tend to influence center-state fiscal transfer formulas, and might induce proportionately larger financial compensation by the center.

IV. OVERALL ASSESSMENT

A. Assessment

48. The Operations Evaluation Department assessed the six TAs using standard criteria to derive overall ratings.²⁴ A summary of the assessments of relevance, efficacy, efficiency, sustainability, and institutional development and other impacts of the TAs is provided in paras. 49–56. More detailed assessments are in Appendixes 2–7.

1. Relevance

49. Improved fiscal management has been a key objective of ADB's program since the mid-1990s, and all TAs aimed to help the Government in this area. Except for TA 2432, the TAs focused on VAT. In principle, this was highly relevant given VAT's large revenue and economic potential. However, the design of TA 2362 should have better anticipated the difficulties of conducting a VAT pilot run in Delhi in the absence of clear direction from the central Government at that early stage. Therefore, it was assessed as less relevant. TAs 2432 and 3856 complemented TA of other external agencies, and were assessed as relevant. TA 2432 focused on direct taxes, in line with ADB's country operational strategy study and government objectives at the time. However, it could have been more relevant had the design included more resources for capacity building in tax analysis.²⁵ TA 3856 was intended to build capacity after implementation of VAT, which has been postponed. The three state-based TAs had appropriately wide scopes in the context of the program loans. The TAs should have been designed for a longer period of capacity building, straddling the time before and after the start of the programs. For this reason, the TAs were assessed as relevant rather than highly relevant.

2. Efficacy

50. In terms of capacity building for fiscal management and tax administration, TAs 2432 and 3576 were efficacious. Mass computer training conducted under TA 2432 paved the way for large-scale computerization later (Appendix 3, para. 17). TA 3576 provided useful work on legislation, budgets, and procedures (Appendix 6). TA 2943 was assessed as highly efficacious,

²⁴ ADB uses five criteria to assess the success of its TAs: relevance, efficacy, efficiency, sustainability, and institutional development and other impacts. Four scores are possible on each criterion (e.g., highly efficacious, efficacious, less efficacious, and inefficacious).

²⁵ ADB. 2003. *Technical Assistance to India for Capacity Building for Tax Administration*. Manila. (Following up on TA provided by CIDA in 1997–2003, this recently approved TA will pay attention to tax analysis.)

mainly because it helped develop capacity in the SBFAU. This unit is turning out to be a crucial part of the department's new approach to fiscal management (Appendix 5, para. 17). The other three TAs were less efficacious. TA 2362 failed in its attempt to pilot VAT. TA 2668 failed to significantly build capacity within the Finance Department, although the outputs affected the quality of the report of the State Public Finance Reforms Committee, published a year after TA closure (para. 38). TA 3856 could not achieve fully its objective, in part due to the postponement of VAT (para. 35). Consequently, training conducted partly went to waste. However, the three TAs were not inefficacious since each had some positive outcomes: TA 2362 helped with the automation of sales tax processing and preparation for VAT (Appendix 2); TA 2668's recommendations were integrated into a report, which is still being implemented; and TA 3856's work is being adapted by several state tax departments.

3. Efficiency

51. The implementation process of the TAs was assessed as less efficient for TAs 2362, 2668, 3576, and 3856. Under TA 2362, the original consultants could not return to the project, requiring the engagement of replacements at a much later date. TA 2668 had long startup delays, did not coordinate well with the Finance Department, and encountered a lack of cooperation. The lack of a steering committee might have contributed to this situation (para. 27). TA 3576 also had startup problems. It had to find consultants locally to replace earlier agreed upon consultants, losing time and resources intended for other activities. In addition, TA 3576 received a lot of negative media attention, which its consultants were dissuaded from addressing (Appendix 6, para. 11). The TA office had to be closed down a month before the intended date. TA 3856 suffered from uncertainties regarding the introduction of VAT, as well as from changing ideas regarding the timing of the TA. The TA was extended, but it could not complete its work plan. Finally, disbursements were much less than intended for several TAs, which was surprising given the extensive capacity building required.

52. TAs 2432 and 2943 were assessed as efficient and highly efficient, respectively. They were implemented over compact periods (in spite of TA 2432's delays in the finalization of the three computer training laboratories) and had good interaction with the EAs. Savings in TA 2943 allowed another contract for consulting services some 1.5 years after the completion of the first contract.

4. Sustainability

53. The sustainability of many of the outcomes produced under the TAs in Gujarat, Kerala, and Madhya Pradesh was assessed as likely, given that many of these were linked with the policy matrixes of the program loans that followed. The fiscal policies proposed generally were implemented as planned. The SBFAU as well as the legal and procedural changes that have taken place attest to a minimum level of sustainability of TA 2943's outcomes. Given the late start of TA 2668, the sustainability of much of the work initially was less evident in Gujarat. The earthquake in 2001 and the fiscal fallout halted the reform process for about 2 years. However, some of the TA's outputs were integrated later into the report and recommendations of the State Public Finance Reforms Committee, which is still being implemented and monitored by the chief secretary. Apart from these state-oriented TAs, TA 2432's main outcome—capacity building in computer skills and systems—has also proved sustainable. Almost 9,000 staff of income tax offices have been trained, and the computer laboratories still function. The computerization works also produced sustainable outcomes in TA 2943, in Madhya Pradesh particularly, and TA 2362 in Delhi (albeit mainly on strengthening sales tax administration). However, the procedural and legal VAT work done under this TA has not been used. The TA's overall

sustainability, therefore, was assessed as less likely on average. The sustainability of the main outputs of TA 3856 was assessed as less likely, given the aborted implementation process. Hopefully, the Government will pick up the work on the audit manual once VAT is implemented.

5. Institutional Development and Other Impacts

54. Institutional development took place mainly under TA 2943 in Madhya Pradesh, with the strengthening of the SBFAU and the benchmark VAT legislation that was an example to other states. In TA 2432, the computer training conducted under the TA, and later through use of the computer laboratories, helped induce the large-scale automation and networking of income tax offices all over India. In Kerala, the TA has had legal and procedural impacts as well as institutional impacts by influencing the Modernizing Government Program (assessed under the efficacy section). In the cases of TAs 2362, 2668, 3576, and 3856, the intended and unintended institutional impacts were assessed as modest.

6. Overall Rating

55. Applying weights to the assessments under the five criteria provides the overall ratings for the TAs.²⁶

Reference	Rating ^a
TA 2362-IND	Partly Successful
TA 2432-IND	Successful
TA 2668-IND	Partly Successful
TA 2943-IND	Successful
TA 3576-IND	Successful
TA 3856-IND	Partly Successful

IND = India, TA = technical assistance.

^a Using a four-category rating system (highly successful, successful, partly successful, and unsuccessful).

56. As a group, the three state-oriented TAs were broadly successful: the focus on state finances was highly relevant, the efficacy of the latter two was good, the efficiency was variable, and the capacity built up showed some good sustainability. The three other TAs, on VAT and income tax, were less successful as a cluster. Although they were relevant and were coordinated with TA of some other external agencies, they remained fragmentary. The TAs also underestimated the needs, which affected their efficacy and sustainability. The efficiency was variable, whereas institutional impacts were modest.

B. Asian Development Bank's Performance

57. ADB's performance was assessed as satisfactory. In most cases, ADB supervised the TAs intensively. INRM in Delhi supervised TA 3856 directly. While the other TAs were supervised from headquarters, INRM contributed significantly in all cases. The supervision of the state-oriented TAs was combined with the more intensive supervision of the preparation and implementation of the program loans. In Kerala, more attention to a media strategy would have been appropriate. Consultants of TA 3576 with considerable experience with media attention perhaps should have been instructed to respond more directly to allegations made in the press.

²⁶ ADB. 2000. *Guidelines for the Preparation of Project Performance Audit Reports*. Manila. Table 1. Available: <http://www.adb.org/Documents/Guidelines/PPAR/default.asp?p=evaltool>

C. The Executing Agencies' Performance

58. The EAs' performance was assessed as variable. The Delhi Sales Tax Department was not committed to implementing a VAT pilot. ITD was committed to the computer training objectives of the TA, but less so to other objectives. The Gujarat government should have done more to interact with the TA. The governments of Madya Pradesh and Kerala were committed to the TAs in their states, and were decisive in turning these into successful capacity building exercises. The central Government's Department of Revenue, while fully supportive of the TA on VAT audit, lacked sufficient oversight and control over the six states included in the TA's scope. When the nationwide VAT was postponed, the department did not insist on continued capacity building in auditing at the level of the state tax departments.

V. CONCLUSIONS

A. Key Issues

59. The Government's decision in 1999 to introduce VAT nationwide has not been carried out. The finance and tax departments consulted during the OEM considered the introduction of VAT to be beneficial to the economy in the long run. They also viewed VAT as an important and just means of revenue generation for the Government. The failure to introduce VAT eventually would mean a loss of effort and built-up capacity, as well as a loss of credibility of government decisions. Since politicians, producers, wholesalers, retailers, and the public still harbor many misconceptions, the Government should consider a VAT information campaign.

60. Reform of public resource management could face increasing public scrutiny, given its ramifications for public services, user charges, and possible government staff retrenchments. Implementation of TA in this context might be affected by a tense atmosphere, as was demonstrated by TA 3576. Adequate public information is needed regarding the nature of such TA, and a consistent approach by consultants and INRM to handling the media and stakeholders outside the Government should be developed.

61. The Government and international agencies have underestimated the requirements for the nationwide introduction of VAT. As a result, too few resources have been made available for preparation. In some TAs, resources were available, but administered too economically. In a large and diverse country such as India, the complexities are bound to be huge. Capacity building in this field requires a large and sustained intervention, and a coordinated approach. The consultants for TA 3576 wrote in their final report that the requirements of VAT demand a sea-change in the operations and culture of the commercial tax departments. VAT audit capacity building still needs much attention.

62. Many technical improvements in fiscal management and tax administration have occurred over the past decade in India. However, these have not yielded smaller deficits, proportionately larger revenues, more client-friendly tax services, or more efficient expenditure management. Fiscal management, therefore, remains a top priority for the Government and supportive external agencies. Innovative approaches are called for, but political commitment to reduce deficits is fundamental. The perverse incentives at the central level, which sometimes reward states with large deficits by large transfers of funds from the federal pool, should be discontinued. The 12th Finance Commission should address this issue.

63. ADB's policy of focusing its attention on fiscal management reforms in the states—and supporting this policy with TA—has proved useful, but not sufficient. States harbor much of the

need for policy reform and capacity building. However, the experience with VAT also pointed out that preceding and parallel action at the center is needed. Much of the funds for the states are distributed by the center according to finance commission awards, and the center is intent on coordinating fiscal management. Consequently, the OEM supports the intention to shift some of the focus of ADB's country strategy and program back to the center. A two-pronged approach is necessary, covering the center and states simultaneously.

64. ADB will need to assign higher priority to support for the modernization of audits in various tax areas (e.g., income tax and VAT) in its program on fiscal management in India.

65. Many of the government departments have moved ahead with computerization and networking, which should significantly increase efficiency in the medium term. In the three finance departments visited in Gujarat, Kerala, and Madhya Pradesh, some of the exciting developments include automation and networking of main and district treasuries, performance management-related classifications, expenditure control, and reconciliation of accounts. However, the advantages have not been captured yet due to the long gestation periods connected with such undertakings. The efforts also might have been too piecemeal. Government efforts need to be continued and supported, and emerging systems studied, harmonized, and standardized.

B. Lessons Learned

66. Successful fiscal management is only partly related to improvements in capacity building or the institution of legal and procedural instruments. Many factors, such as political will and the absence of calamities, are beyond the control of the TAs or ADB. TAs will do best when capacity building is embedded in larger fiscal programs of the Government, which carry top priority.

67. ADB's capacity building TAs for programs often are designed with short durations, so the advice or capacity built up can feed into these programs before their intended start dates. In addition, these TAs often have a wide scope and large numbers of consultancy assignments to be conducted within a short period of time. Since the purpose is not loan preparation but capacity building, longer TA durations that straddle the period before and after the approval of program loans are appropriate. Given that the capacity building needs are very large in this area, flexibility in the employment of TA resources is important to allow all resources to be used.

68. Short duration, wide scope fiscal TAs also run the risk of duplicating work of TA funded by other external agencies. This is particularly true in agencies other than the finance departments, such as health, education, and local government agencies. Such TA needs to be carefully coordinated during implementation.

69. TA that combines capacity building in revenue generation, budget preparation, and expenditure and debt management should only be undertaken in the context of fiscal management-oriented public resource management programs. These programs can build upon the TA's outputs. Stand-alone TAs in fiscal management that are confined to one of these components would do better. Generally, ADB needs to have clear fiscal management strategies in countries receiving fiscal assistance.

70. To make the case for necessary reforms that finance and revenue departments wish to implement, the strategic use of TA outputs in fiscal management is usually important to win the endorsement by governments. TAs in fiscal management preferably should include advice from

(i) international experts, as they often are perceived to be more objective; (ii) national research institutes; or (iii) domestic consultants with a national standing, who command respect across party lines. Direct advice by ADB can also play this role, and more direct assistance from ADB staff for administering TA is essential. For practical as well as strategic reasons, conducting advisory work through high level committees and frequently meeting with working groups is very important, as the experience with some TA has shown.

71. Study tours and foreign training of senior government staff as part of TAs are often not effective for building long-term capacity, because of the frequent transfers of senior officers in India. Such instruments might be useful for objectives that can be achieved within a very short period, or in cases where decisions need to be made based on the study of systems in foreign countries.

72. Advisory work in several states through TA, and followed up by program loan policy matrixes, has proven to be capable of piloting new practices and systems (e.g., VAT preparation, medium-term fiscal frameworks, fiscal responsibility acts, computerization of treasuries, etc.). Thus, they provide examples for other states to follow. At the same time, pilot activities in states that need nationwide decisions can lead to wasted effort if not well prepared at the central level.

C. Follow-Up Actions and Recommendations

73. The Department of Revenue of the Ministry of Finance needs to distribute the draft VAT audit manual to important stakeholders, such as chambers of industry and commerce, for comments. The VAT audit manual should be published on the department's website, and reactions from producers, wholesalers, retailers, and consumer organizations should be sought. This could help in finalizing the VAT audit system once VAT is introduced. Creative ways need to be found to entice commercial tax departments in the states to improve and complete their databases, so these can form a basis for the necessary risk analysis and audit selection. All of this needs to be completed before the start of VAT implementation.

74. A comprehensive public information campaign on VAT is needed. As soon as a date for the introduction of VAT is announced, the Government should initiate this campaign.

75. Further capacity building in VAT auditing is another high priority as soon as a date for VAT implementation is announced. The Department of Revenue needs to coordinate this with the states' commercial tax departments. Immediately upon the introduction of VAT, ADB should approve another TA on VAT audit, an audit information campaign, and VAT implementation capacity building, with emphasis on training officials.

INTRODUCTION OF VALUE-ADDED TAX IN INDIA¹

1. Reform of indirect taxes has been an integral part of economic reforms in India in the 1990s. India's indirect tax system is unique. The Constitution provides the Union Government (the central Government) with the authority to impose a broad spectrum of excise duties on production and manufacturing, while states are assigned the power to levy sales tax on consumption. In addition, the states are empowered to levy tax on many other goods and services in the form of state excise, luxury tax, entry tax, *octroi*, entertainment tax, electricity duty, motor vehicles tax, passengers and goods tax, and others. Due to this dichotomy of authority, India has been slower to adopt a value-added tax (VAT) than countries where VAT is the responsibility of the central government only. This situation also has created an obstacle to introducing a European-style VAT, although tax reform committees have recommended over the years that union excise duty, sales tax, and other domestic trade taxes be replaced by a comprehensive VAT on all commodities and services.²

A. Replacement of Union Excise Duties

2. At the time of independence, India inherited a system of commodity taxes in which union excise duties (UEDs) were levied on about a dozen articles, yielding a small proportion of total tax revenue to the central Government. Following independence, the rates were raised, the base was enlarged, and more and more items were brought into its net. Over time, UEDs were extended quickly. It was not only levied on finished goods, but also on covered raw materials, intermediate goods, and capital goods.

1. Cenvat

3. In 1986, reforms in the basic UEDs were initiated for the first time through the introduction of a modified VAT (modvat).³ This provided for taxes to be paid on inputs. Initially, modvat covered only a small number of selected commodities. Gradually, it was extended to almost all. In the 2001–2002 budget, modvat was replaced by a central VAT (known as cenvat).

4. The reforms in UEDs over the past 15 years have simplified its structure, especially through cenvat. The large number of rates has been brought down considerably over the years. Looking ahead, the Union Government aims to have one-rate category for all items under cenvat. Through cenvat, credit can be taken by the manufacturer immediately on receipt of eligible and duty-paid goods in the factory. The manufacturer does not need to file any declaration or obtain any permission.

5. The structure of cenvat indicates that the reforms introduced in the last few years have resulted in transparency of the tax burden under the UEDs. The cascading effect of input tax has been reduced, along with the pyramiding effect of the tax. The cenvat structure also has generated a mechanism to check tax evasion through self-policing. Empirical studies on the introduction of cenvat show a definite positive effect. In fact, industrial units have been able to

¹ Prepared by Mahesh C. Purohit, indirect tax consultant.

² VAT is a multipoint sales tax with set-off or tax paid on purchases. It is collected in installments at each transaction in the production-distribution process. It does not have a cascading effect due to the system of deduction of tax paid at earlier stage or credit mechanism.

³ This was based on the recommendations of the report of the Jha Committee. See Government of India. 1978. *Report of the Indirect Taxation Enquiry Committee*. Ministry of Finance, New Delhi.

save on interest (0.5–1.0% of the total duty paid). The overall effect has been revenue neutral, and has not had any effect on prices.⁴

2. State Value-Added Tax

6. At the state level, many taxes are levied on commodities and services. These include sales tax, state excise, motor vehicle tax, and passenger and goods tax, etc. Sales tax is the most important tax, yielding almost two thirds of the states' tax revenue.

7. **Structure of Sales Tax.** All states levy sales tax at the first point of sale within the state under the state's sales tax laws. Interstate transactions are covered under the Central Sales Tax (CST) Act of 1956. Under the CST Act, tax is levied at the rate of 4% when the sale takes place between registered dealers of different states. The tax rate is 10% or higher (depending upon the local sales tax rate of the exporting state) when the sale is made to an unregistered dealer in another state.

8. A registered dealer collects the state sales tax in most states at the first point of sale (or purchase). The rest of the dealers in the chain of transactions buy "tax-paid goods." Delhi and Punjab levy tax, in general, on the last sale (or purchase) by a registered dealer. Even in these states, a large number of commodities are taxable at the first point of sale, which yields more than half of the sales tax revenue in the respective states. Haryana is the only state that has introduced VAT to replace the existing sales tax, with effect from 1 April 2003.

9. **Efforts to Introduce State-VAT.** Given the inefficiencies of the sales tax system, efforts have been made for the past several years to replace sales tax with VAT.⁵ The Committee of State Finance Ministers (in 1995 and 1998) and of the Chief Ministers (in 1999) formally recommended replacing sales tax with VAT. These were ratified by the Conference of Chief Ministers and Finance Ministers on 16 November 1999. In this conference, the chief ministers and finance ministers resolved to introduce major reforms.

10. The adoption of a four-rate (i.e., 0%, 4%, 8%, and 12%) sales tax structure was the first reform. In addition, two special rates of 1% and 20% are for a few specified items. The recommended rates are floor rates. The states have the freedom to adopt a higher rate on any of the commodities from the list, but they cannot go below these rates. This checks rate wars, and prevents the diversion of trade. When the states started implementing the four-rate categories immediately after the conference, many found it difficult to follow the floor rates in some commodities. Either they had problems with the classification or encountered administrative difficulties. In response, the Standing Committee of Finance Ministers made a few changes in the items falling under the exemption list. The Empowered Committee has come up with two rate categories of 4% and a revenue neutral rate of 12.5% (instead of four rates given above) for all the states.

11. The second reform involved the abolition of sales tax-related incentives. Previously, all the states granted such incentives to new industries. These exemptions from tax were given in one form or another on the purchase of inputs, as well as on the sale of finished goods. Incentives were also available in the form of sales tax loans and/or tax deferral. Studies and

⁴ National Institute of Public Finance and Policy. 1989. *The Operations of Modvat*. New Delhi.

⁵ VAT has been introduced in a large number of countries due to its advantages over the cascade type sales tax. In general, VAT is a neutral, transparent, and efficient tax. It eliminates cascading and, hence, there are no tax induced distortions in the economy. It tends to reduce incentive for evasion of tax because the impact of the tax is not concentrated at any given level.

committee reports⁶ have argued against such incentives. In terms of loss of revenue, all the states combined sacrifice about 25% of the sales tax base due to incentives. In addition, the incentives take the form of tax competition (war) or harmful tax practices. In view of this, all the new units that are likely to come up now would not be given such sales tax-related incentives. The states would find it convenient to adopt VAT, once these reforms are implemented.

B. Past Experiments with Value-Added Tax in Indian States

12. The experience of Indian states that introduced VAT (in some form or another) is of great importance to other states. Some of the states that have experimented with VAT faced many administrative or operational problems.

13. Andhra Pradesh introduced VAT on some items on 1 April 1995, for resellers only, with a tax rate of 4% on inputs, applicable to all manufacturers. Before introducing VAT, Andhra Pradesh abolished the surcharge and turnover tax, and also reduced the rate-slabs to only six.

14. Kerala levied VAT on resellers on a few commodities. At the same time, it did not grant set-off⁷ for the tax paid on inputs. No efforts were made to rationalize the tax structure before the introduction of VAT. In addition, a graded surcharge was levied on dealers based on the different levels of turnover. However, Kerala withdrew VAT on 1 April 1997, and replaced it with a new type of sales tax.

15. Maharashtra moved towards VAT on 1 October 1995. It attempted to simplify the tax structure before introducing VAT, abolishing "additional tax" as well as "turnover tax." Maharashtra also moved towards providing set-off on input-tax to manufacturers. Under the rules at the time, the input credit was available for the tax paid above 4%. Taking into account nonrecoverable taxes, such as "additional tax" and "turnover tax," the effective burden on inputs of the manufacturer was more than 6%. This was reduced to 4%. In addition, the rate-slabs were reduced from 20 to 7. VAT initially was levied on all dealers with a turnover above Rs10 million. The coverage was extended to dealers with a turnover above Rs5 million in 1996, and to Rs4 million from 1 June 1997. The input credit also was increased. Due to non-economic or non-administrative considerations, the state withdrew VAT and replaced it with a first-point sales tax from 1 April 1999.

16. Madhya Pradesh also followed the threshold approach, introducing VAT on 1 April 1997 for dealers with turnover higher than Rs10 million. It brought down the threshold to Rs5 million a year later. The state introduced one rate-slab of 8% for all dealers falling under VAT. However, Madhya Pradesh has not given set-off for the tax on inputs, in spite of the announcement made long back to do so. The tax on resellers was not in the true spirit of VAT. The most important aspect of VAT is to make the system neutral and transparent.

17. As is described in Appendix 2, the national capital territory of Delhi intended to conduct a VAT pilot in April 1997, assisted by small-scale technical assistance (TA) from the Asian Development Bank (ADB). However, this pilot was abandoned before it started.

18. Except for Maharashtra, no state has attempted the introduction of a proper form of VAT. It is a misnomer to label a tax on resellers as VAT. Moreover, levying VAT on a few

⁶ See especially the *Report of the Finance Ministers Committee to Chart a Time Path for the Introduction of VAT* (August 1998) and the *Report of the Committee of Finance Secretaries for Identification of Backward Areas* (November 1999).

⁷ Set-off or input credit refers to claiming credit by a taxable person for the tax paid on purchases (i.e., input tax).

commodities also is not a proper form. The first and foremost prerequisite of VAT is to give input credit for all purchases of all commodities. The second prerequisite is preparedness by the tax department, which has not been demonstrated in these experiments.

C. Reforms in Governance of State-VAT

19. The VAT experiments in different states suggest the most pressing need is to reform the governance of state-VAT. Reforms have not been completed in all the states, including the ADB focal states of Gujarat, Kerala, and Madhya Pradesh. The first and foremost requirement relates to operating state-VAT through a single master file, based on a unique tax identification number (TIN). Not all of the states have completed this.

20. To effectively and efficiently govern state-VAT, suitable computer technology must be adopted. Even more essential is the proper coordination among the states to adapt software to their requirements. Pooling resources for developing requisite software programs could be cost effective. ADB TAs attempted to develop software for VAT in Gujarat and Madhya Pradesh, but the initiative was not successful (Appendixes 4 and 5). In Kerala and Delhi, the commercial tax departments are well ahead with computerization. However, the efforts are not coordinated.

21. In most states, training of personnel is a priority. The staff administering the sales tax system is not adequately trained, much less so for VAT.

22. The officers of the commercial tax department are generally drawn from the state finance services. In some states, this service does not exist. At no stage of recruitment or promotions are these officers sent for appropriate training for the assessment of taxes. In some states, these people do not even belong to the taxation department. It is important, therefore, that those posted to the commercial tax department undergo intensive training at the beginning of their careers for at least 6 months.

23. An important aspect of reform relates to procedures. All the dealers are called into the office of the sales tax with books of accounts, which is not a cost-effective procedure. It is important that a switch is made to a system of selective assessment. Selection of cases for assessment has to be made in accordance with established criteria, such as size, turnover, and risk evaluation. It might be useful to select a fixed proportion of large- and medium-sized dealers for assessment on a regular basis. Further, the assessment of VAT dealers should be supplemented with cross-checking of invoices. The most important aspect relates to the use of a discriminate function system (DFS) for audit selection. This function could use other relevant sources, such as names of suppliers, number of taxpayers deviating from the normal trend, data on imports supplied by the customs department, and information on the fast-growing sectors of the economy. TA 3856 gave more importance to variables related to returns, and should have used more external variables to adapt the DFS.

24. A decision about the size of the firm under VAT is critically important. It is impractical to include all the small dealers under VAT. In the view of the Operations Evaluation Mission (OEM), the states should have a threshold of at least Rs0.5 million for registration. Dealers with a turnover between Rs0.5 million and Rs2.5 million could be assessed a 1% tax on their turnover. Dealers with a higher turnover would fall in the VAT system. However, dealers

involved mainly in exports requiring a refund could always go in for VAT, irrespective of their size. This would enable them to claim full refund of taxes on exports.⁸

25. These steps would gear the tax machinery so that the administrative cost of VAT would be low and the compliance cost—as well as the harassment to the taxpayers—would be kept to a minimum. The practice of monitoring the inflow of goods at check-posts should be abandoned with the introduction of VAT. However, no state has done this. Eliminating such posts would facilitate the free flow of goods, save truck time, and reduce corruption.

26. An important step in the introduction of VAT is making taxpayers understand that VAT will be levied on value added by them only, and not on the gross value of turnover. This would help reduce resistance to the new system and increase tax compliance. Public information campaigns have been minor so far, even in the ADB focal states.

27. While sufficient lead time is required to prepare for the introduction of VAT, states have extensive experience administering a turnover tax and first-point sales tax. Reducing the rate categories and computerizing the system of administration have begun in many of the states. The National Institute of Public Finance and Policy has prepared *A Model VAT Law* for the implementation of VAT, and this has been adopted by some states. Given these conditions, the time available until 2005 should be sufficient for the Government to anticipate the transitional problems associated with VAT reform, and to implement policies and procedures for a smooth transition.

D. Schedule of Activities for Introduction of State-Value-Added Tax

28. Some work is pending before VAT can be introduced. In the view of the OEM, the states should undertake the following activities before introducing VAT:

- (i) Finalize the design of VAT for interstate transactions (i.e., the decision on rates for CST). This should include VAT coverage (whether to include services) and transitional measures (tax-paid inventories, continuing contracts, etc.). Time needed: 1 month.
- (ii) Except for Gujarat, Kerala, and Madhya Pradesh, prepare draft VAT procedures, including registration of VAT payers, collection procedures, processing of returns, VAT audit, design of VAT return forms, and VAT payment form (*chalan*). Time needed: 3 months.
- (iii) Organize a workshop on business processes and computerization for VAT administration, and determine system design and resource requirements. Time needed: 6 months.
- (iv) Train officials more extensively at the state level. Time needed: 8 months.
- (v) Launch a publicity campaign with articles, brochures, advertisements, etc. Publish the detailed procedures for VAT, including business process models, and design the criteria for the selection of cases for assessment. Time needed: 9 months.
- (vi) Test computer software and hardware for VAT, begin registration process with new TIN for VAT, and interact with banks on procedures for receiving returns and VAT payment. Time needed: 9 months.
- (vii) Complete allocation of new registration numbers. Time needed: 9 months.

⁸ The design by the Empowered Committee suggested that dealers should be taxed 1% tax on turnover, but did not suggest that these dealers should invoice proper tax to their purchasers. However, this would create two separate systems: sales tax for these dealers and VAT for others.

E. Reforms in Sales Tax on Interstate Transactions

29. Along with reforms of sales tax on intrastate transactions, it is important to have reforms in sales tax on interstate transactions, which is subjected to a CST levied by the exporting states.

30. Historically, CST was introduced to (i) maintain competitive conditions between local and non-local dealers, (ii) ensure that the exporting states get a small share of the tax levied on a commodity, and (iii) regulate and monitor interstate trade. Accordingly, it prescribed two different rates of tax: 1% on interstate sales to registered dealers, and 10% on interstate sales to unregistered dealers. The higher rate is charged on sales to unregistered dealers, because the state sales tax is also charged on the sales made by registered dealers in the consuming state. However, no tax is charged by that state on sales made by unregistered dealers.⁹ The higher rate of tax on the unregistered dealer prevents him from entering into interstate trade for any competitive advantage. By the same logic, the low rate (1%) is charged on registered dealers, because the same commodity also is taxed by the importing state. The rate differential brings about equity of treatment of registered and unregistered dealers.

31. Over time, the Union Government abandoned the regulatory objective of the tax and raised the tax rate from 1% in 1956 to 2% in 1963, to 3% in 1966, and to 4% in 1975.

32. While the CST has regulated the flow of interstate goods within the country, the OEM considers CST economically irrational and harmful to the economy.

33. First, the high tax rate under CST has obstructed the formation of a common market within the Indian federation. Second, the high rate of CST has created a conflict with the principle of interjurisdictional equity, and caused horizontal imbalance among states. Third, CST levied on inputs and on finished goods at early stages of transaction causes cascading. This results in higher prices when inputs are sold from one state to another, and when manufactured goods are sent from one state to another bearing CST. Fourth, to the extent the tax is passed on to the buyers, CST is used as a means to "export" the tax of producing states to the consumers in other states. Therefore, it puts a higher burden on consumers in the importing states than the producing state on all commodities. This is detrimental to states that are net importers. Fifth, the tax on interstate trade puts a burden on exports.

34. In view of the weaknesses of the existing system of tax on interstate trade, its reform has been deemed of paramount importance. Reform is urgent in view of India's acceptance of the agreement to create a free-trade area comprising the South Asia Association for Regional Cooperation (SAARC) countries. If India becomes part of a SAARC free-trade zone, phasing out CST and having a destination-based system would be the only way to compete with other SAARC countries on a level playing field.

F. Further Reforms in Harmonization

35. The current tax reforms, which are linked to the overall fiscal reforms, are important. With proper procedures adopted for cenvat and the states converting their sales tax into a state-VAT, India would have a dual VAT system: a cenvat levied by the Union Government (to

⁹ If the local sales tax rate in the exporting state is higher than 10%, the unregistered dealer in importing state has to pay the higher rate.

replace the UEDs) and a state-VAT by the states (to replace the sales tax). However, India's efforts so far have been insufficient to implement such a system properly.

36. First, the management of VAT in India calls for a reorganization of the commercial tax department, and different job descriptions for many of its officers. This has not yet been completed in any of the states.

37. Second, no procedures or mechanisms are in place to coordinate all commercial tax departments of the states. These need to be instituted.

38. Third, procedures on risk management before the introduction of VAT are not ready in the states. The VAT audit manual produced under TA 3856 was not finalized, and the OEM has issues with its current contents. Further work is needed.

TA 2362-IND: IMPROVEMENT OF SALES TAX STRUCTURE AND ADMINISTRATION¹

A. Background

1. Rationale

1. In 1991, the Government of India appointed a Tax Reforms Committee to review India's tax structure. Among other things, the committee recommended measures to reform domestic trade taxes in the context of the structural reforms. Union excise duty at the central level and sales taxes at the state level were to be converted into a dual value-added tax (VAT) system—one at the federal level and another at the state level. While the central government had started converting its union excise duty into a system of central VAT, the Committee of State Finance Ministers was appointed to reform the system of sales taxes. In August 1995, the Committee recommended that VAT be adopted nationwide, and suggested such preparatory steps as (i) the introduction of uniform floor rates, (ii) the abolition of sales tax-related incentives, and (iii) the computerization of sales tax administration for introduction of VAT. In this context, the Asian Development Bank (ADB) provided technical assistance (TA) to the National Capital Territory of Delhi.

2. Objectives and Scope of the TA

2. The main objective of the TA was to suggest detailed administrative steps for the implementation of VAT in Delhi, and to assist in the computerization of sales tax administration. The scope included an action plan for implementing VAT, a framework for rules and regulations for implementing VAT, system design for computerization of the Delhi Sales Tax Department, and training of key officials on VAT. The implementation of VAT in Delhi was to be a pilot for the subsequent implementation in the then-21 states of India.

3. TA Completion Report

3. ADB issued its TA completion report on 13 July 1999. The TA was seen as highly successful in computerizing the Delhi Sales Tax Department. It also prepared a blueprint for implementation of VAT in Delhi. It was not implemented at that time, but the department intended to synchronize the introduction of VAT with four states in North India. The TA completion report noted problems with the inputs of domestic computer experts, which delayed the completion of the TA. The training of seven officials was seen as less effective, because four of them were subsequently transferred. Overall, the TA was rated generally successful.

B. Assessment of Implementation Performance

1. Design of the TA

4. The small-scale TA was ADB's first effort in this field since the start of the 1990s. It was designed simultaneously with TA 2432 (Appendix 3) and economic and sector work for the Gujarat government in preparation of a program. Since the Government had not made a solid decision on the introduction of VAT in 1995, the small size of this TA was prudent. It focused on harmonizing a sales tax system and steps required for its eventual transformation to VAT. This proved to be an ambitious target, nevertheless. An entirely different use of the TA funds easily

¹ Parts of this appendix draw on information in the TA paper and the TA completion report.

could have been imagined, for instance the funding of workshops, seminars, and a public discussion campaign on VAT.

2. Engagement of Consultants

5. A reputable international firm was contracted for consulting services. The firm used two international consultants for 2 person-months each, and two domestic consultants for a total of 8 person-months. The domestic consultants helped with the computerization of the department, though this was a very large assignment. Subsequently, more consultant inputs were provided for computerization of department functions, primarily from the resources of the Executing Agency (EA). The international consultants provided an additional 30 days of consultant inputs at no extra cost.

3. Organization and Management

6. The Office of the Sales Tax Commissioner, National Capital Territory of Delhi, was the EA of the TA. An advisory committee was constituted to steer the TA. Since the advisory committee did not include representatives of the four states of North India, with which the sales tax system was to be synchronized, this arrangement did not work well.

4. Implementation Schedule and Financing Arrangements

7. The EA used its own resources to hire domestic computer experts for systems design and implementation. The estimated cost was \$99,500, with \$83,000 in foreign exchange and \$16,500 in local currency. The actual cost was \$91,789, with \$84,253 in foreign exchange and \$7,536 in local currency. The TA was fielded in August 1996, and was scheduled to be completed in April 1997. The original international consultants moved on to other assignments, and their replacement took time. The implementation of the system design also took much longer than expected. A return visit to follow up on outstanding issues and reviews the system under development in detail had to be delayed. For this reason, the TA was completed in November 1997.

5. Supervision

8. An officer at ADB's Resident Mission administered the TA. This worked satisfactorily.

C. Evaluation of Outputs

1. Outputs

a. Adequacy and Quality of Reports and/or Services Provided

9. The international consultants prepared two reports. One was on tax policy and administration, while the other was on information technology. The first was a high quality document that not only addressed the design by the Committee of State Finance Ministers of 1995, but gave some other options as well. It also assessed the revenue implications of introducing the new system for the state. The report was well received. However, around the time of its intended implementation in 1997, a Committee of State Finance Ministers (known as the Empowered Committee) was appointed to decide on a common design—initially for sales tax and subsequently for VAT stage—to rationalize the tax system. For this reason, the Sales

Tax Department of Delhi decided to wait for the common design rather than use the work of the consultants.

b. Training and Technology Transfer

10. The international consultants assisted in the design and development of a flexible modular computer system for the department, which would administer the sales tax, facilitate a gradual switch to VAT, and administer a full-fledged VAT when introduced. The system, called the Delhi Online Sales Tax System, is still running. New features are being added, and a system for providing remote connections is underway.

11. The Korean Institute of Public Finance trained seven officials on 7–18 October 1996. The training provided an overview of the Korean system of VAT. Afterwards, the trainees provided a written account of how the system worked in Korea. The report also dwelt on the implications for the introduction of VAT in India. In retrospect, the trainees would have liked more insight on the Korean system of VAT audits, and felt hampered in their training by difficulties in communicating with Korean dealers. Over the years, the officers were transferred to other departments, and only one officer has returned.

2. Institution Building

12. The intended institutional strengthening of the Sales Tax Department by computerization was achieved. By 2001, the system under development since 1996 was put to use, and it is still being used. Since the blueprint was not implemented and the trained officers were transferred, other types of institutional strengthening of the department were not achieved.

3. Performance of Consultants

13. The performance of the consultants was excellent. However, the consulting assignments were too short to make a dent in the ways of the department beyond the area of office automation.

D. Overall Assessment

14. The TA was successful mainly in the area of computerization. Other objectives failed, partly due to slow decision-making on VAT at the national level. Another reason was the transfer of senior staff, so that training gains under the TA quickly evaporated. From another perspective, the design of the TA was unrealistic. It overestimated the speed of decision-making on VAT, and used short-term foreign training that carries a high risk of being ineffective in India. For this reason, the overall rating of the TA is partly successful.

E. Conclusions

15. **Lessons Learned.** Two lessons were drawn from the TA. First, ADB should not have designed a TA with a blueprint for VAT implementation when the national Government still was contemplating various options. Second, ADB should not have included a training program for a department that lacks permanent personnel. Delhi is different from the states in that it has no specialized state finance service. Only one administrative service exists, and the officers can be posted in any of the administrative departments. ADB could have used its TA to provide advice on the reorganization of the tax department.

TA 2432-IND: CAPACITY BUILDING OF INCOME TAX ADMINISTRATION

A. Background

1. Rationale

1. The Asian Development Bank (ADB) was asked to provide assistance in building capacity in the Income Tax Department (ITD). The assistance was to focus on computerizing income tax administration, and training and management of human resources within the department. A reconnaissance mission visited New Delhi on 16–25 May 1994, and reached an understanding on the technical assistance (TA). Assistance programs of other external agencies were taken into account. The TA was approved on 26 October 1995.

2. Objectives and Scope of the TA

2. The objective of TA 2432 was to assist the Government in continuing its fiscal consolidation program in the area of direct taxes. The assistance was based on the recommendations of the Tax Reform Committee. The TA was to help the Central Board of Direct Taxes (CBDT) modernize its income tax administration through the development and implementation of a human resource development strategy (HRDS) in line with the policy of utilizing modern information technology for tax administration. The TA was to provide support to (i) develop an HRDS for CBDT, which would be implemented in close cooperation with other aid agencies; (ii) train about 3,000 income tax officers and line operators at three regional income tax centers (Chennai, Delhi, and Mumbai);¹ (iii) develop the training programs and manuals for the envisaged training at different levels; (iv) provide the training equipment and materials necessary for the resource centers to be located at the three regional centers; (v) develop the necessary policy analysis framework for the income tax offices, including the central and the regional offices, and the framework for the macroeconomic analysis to assist CBDT in the policy formulation process; and (vi) provide overseas training to income tax officers of the targeted regions. The TA was to use 33 person-months of advisory services. The Executing Agency was to be CBDT. The TA was to be implemented over 1.5 years, concluding in June 1997.

3. TA Completion Report

3. TA 2432 was substantially completed by April 2000. The TA completion report was circulated in January 2001. The report considered the TA design and terms of reference appropriate and adequate to meet the objectives. The report identified some delays due to logistical problems, and noted that the training was considerably delayed. The contract of the international human resource development expert had to be extended by 3 weeks. The inputs of computer training consultants were not adequate to meet the training objectives at the originally agreed scale. This difficulty was partly overcome by training of trainers from within ITD. The completion report, nevertheless, considered the TA timely and the results satisfactory. The report found that the advisory component made small but significant contributions, while the training component succeeded in equipping and making functional three regional training centers (Chennai, Delhi, and Mumbai) that have contributed significantly to the computer training of the departmental personnel. The report discussed the improvements in tax compliance and collection that followed the TA, while recognizing the difficulty in isolating the impact of the TA in the process of tax structure rationalization and administrative improvements.

¹ Now eight regional training institutes at Ahmedabad, Bangalore, Chandigarh, Chennai, Hazaribagh, Kolkata, Lucknow, and Mumbai are operating.

The outputs of the TA were not discussed in any other ADB document, and only recently a subsequent ADB TA can be seen as related.²

B. Assessment of Implementation Performance

1. Design of the TA

4. TA 2432 was designed to give a boost to ITD's income tax processing and analysis capacity through training and computerization. The program to create three computer training centers, which would be equipped and networked, came at the right time. The training component was similarly appropriate, although unrealistically high targets for people to be trained by the consultants created confusion. The HRDS component in the context of this computerization was allocated only 1 person-month of expertise from an international consultant, and could not be expected to have a significant impact. The component to build tax analysis capacity also did not work very well. The anticipated TA from other agencies to complement these components did not materialize.

2. Engagement of Consultants

5. The TA first appeared in ADB's *Business Opportunities* in May 1994. An international organization won the contract, in association with a reputable national consulting firm. The domestic firm already was involved with ITD for the development of software, and subsequently would be engaged by the United Nations Development Programme (UNDP) to carry out additional tasks related to computerization. At the time of the Operations Evaluation Mission, the company was still working with ITD on maintenance of software and modifications to suit changes in tax laws, rules, and procedures. This long involvement of the company gave a large measure of continuity to the capacity-building process supported by ADB, Canadian International Development Agency (CIDA), and UNDP.

3. Organization and Management

6. While CBDT was the EA, a steering committee provided coordination with other assistance programs. ITD supervised the implementation of day-to-day activities. One of its directors was responsible for liaison with the consultants, and for providing semiannual progress reports. This arrangement worked satisfactorily.

4. Implementation Schedule and Financing Arrangements

7. The TA was to be implemented from December 1995 to June 1997. However, the consultants were not fielded until August 1997, and they completed their assignment in April 2000. The delays were related primarily to the late completion of the training centers and training programs. The advisory component was completed in February 1999. The delays also were linked to the Government's consideration of a plan to substitute the Income Tax Act with a new one. The draft of the new act was prepared and circulated by the committee set up for this purpose.³ This prompted some changes in the terms of reference of some of the consultants.

² ADB. 2003. *Technical Assistance to India for Capacity Building for Tax Administration*. Manila.

³ In the event, the draft was ultimately shelved and the old Act continued in operation with some changes. It was argued that the draft did not make any major change to justify the costs involved in legislating and implementing a new act.

8. ADB approved a TA for \$550,000, while the amount utilized was \$518,945.

5. Supervision

9. ADB changed the project officer during implementation. The resident mission was closely involved in this TA from the reconnaissance mission onwards, providing a large measure of continuity. This helped in sorting out problems coordinating work between consultants. Seven formal review meetings were held, besides the regular informal contact the resident mission maintained with the EA.

C. Evaluation of Outputs

1. Outputs

a. Adequacy and Quality of Reports and/or Services Provided

10. Recommendations in the HRDS report that involved substantive departures from accepted policy were not implemented. Indian civil service conditions would not permit the flexibility in personnel that was required. The Government did not favor a major recommendation on regional boards.

11. Recommendations on tax analysis and the creation of sample-based income tax databases generally were appreciated as desirable goals, but were not implemented. The report was confined to detailed slide presentation materials. The annual collection of a sample of income tax returns from all income tax offices across India for systematic analysis by the central office was deemed too laborious and complicated.

12. The domestic consultants submitted a detailed report on the simplification of tax forms and procedures. This report generally was adequate and utilized, leading to the abandonment of over 300 forms.

b. Training and Technology Transfer

13. To equip three regional computer laboratories in Chennai, Delhi, and Mumbai, 63 computers, 3 servers, 6 printers, and networking equipment were purchased and installed. Almost 9,000 income tax staff have been trained since, most by trainers trained under the TA. The Pentium II generation computers installed some 5 years ago recently were replaced by Pentium IV computers, the old computers having been reassigned to income tax officers.

14. The output was expressed in the number of persons trained under the TA. The original target was 3,000 staff, but this number was found to be impractical due to a lack of space. Instead, a number of trainers with the necessary aptitude within ITD were trained, so they could continue the training after the TA. By the end of the TA, 590 staff and 98 trainers had been trained. The component was successful, as the Government has taken over the training.

15. A study tour to familiarize three senior staff with tax analysis processes in Canada was not very successful, as these officers were transferred not long after their return.

2. Institution Building

16. Recommendations on the management information system (MIS) and tax analysis had the potential of triggering significant institution building in the tax analysis wing. However, progress was very slow. Institution building based on MIS occurred after the TA through another TA. A full-scale networked MIS was implemented across the country, linking the 500 offices. The networking was completed by April 2004.

3. Outcomes and Impacts of the TA

17. The TA was a minor part of the external assistance provided, with CIDA and UNDP providing the bulk of it. However, ADB's TA played a role indirectly, familiarizing large numbers of tax officers with computerization. That helped smooth the path for the major automation and networking initiatives being undertaken in income tax offices all over India. Computerization has contributed to larger numbers of income taxpayers and income tax collections. In the past years, 5 million additional taxpayers were registered yearly. By 2005, some 50 million taxpayers are expected to be registered with ITD. However, many tax returns are empty. Income taxpayers in India probably total no more than 28 million, an extremely modest figure for a country its size. Last year, a decision was made to eliminate manual processing of tax forms, whereas the processing time of tax returns would have to remain within 4 months. The full impact of external assistance will be achieved when the planned client-oriented and user-friendly income tax system comes into operation in 2004. It will feature a full-fledged MIS to speed up the treatment of cases, access through internet, and online payment and refund through networking of the tax and banking systems.

D. Overall Assessment

18. The TA's emphasis on training was appropriate and timely, triggering the complete computerization of the department. The proposals for simplification of rules and forms were also successful. The tax analysis component and the human resource development components were less successful. Overall, the TA was rated successful.

E. Conclusions

1. Key Issues

19. Computerization has made great strides in income tax administration since the completion of the TA. To extract the full benefit of computerization, the tax analysis capacity needs strengthening. Although the TA foresaw this need, too few resources were available to pursue this objective over an extended period. With CIDA withdrawing due to the Government's recent decision to terminate assistance by some bilateral donors, ADB decided to revisit the issue through a new TA (footnote 2).

2. Lessons Learned

20. The experience shows the importance of building a critical mass of internal motivation for reform to achieve goals. The tax analysis module did not build sufficiently in interaction and capacity building. The indifference toward the HRDS underlines the need for collaboration between international and domestic consultants in areas where institutional constraints are expected to be significant.

3. Follow-Up Actions and Recommendations

21. The new TA on capacity building for tax administration should be seen as a follow up of TA 2432, although it is intended to cover both direct and indirect taxes, with two EAs. It will have six main components. The first component is related to its predecessor's tax analysis objective—the preparation of an audit and risk analysis manual and software. This should have a prominent place in TA implementation.

22. An area that needs strengthening, but which is not covered by the new TA, is capacity building in tax revenue forecasting and assessing the impact of proposed changes in the tax structure. In recent years, revenue forecasts have been way off the mark, underlining the need for better estimates. Similarly, the proper consideration of tax structure modifications might not be possible due to the weaknesses in tax analysis. Related to these two issues, a revamped system of data gathering is urgent.

TA 2668-IND: GUJARAT'S REFORM OF PUBLIC FINANCES

A. Background

1. Rationale

1. The Asian Development Bank's (ADB) Gujarat Public Sector Resource Management Program Loan¹ (the Program) was designed to support the Gujarat government in (i) strengthening public finances, (ii) restructuring state-owned enterprise, and (iii) promoting private sector participation in infrastructure development. To support the implementation of the Program, ADB and the Government agreed on advisory support in the design and formulation of public finance reforms. Institutional capacity urgently needed to be built to implement these reforms, including modernizing and computerizing concerned government departments, such as the finance and taxation departments, and providing adequate training to staff.

2. Objectives and Scope of the TA

2. In May 1996, ADB reached agreement with the Gujarat government on technical assistance (TA) 2668. Its objective diverged from the earlier two revenue-oriented TAs by focusing on strengthening public finances at the state level through structural reforms on the revenue and expenditure sides. The TA was approved on 23 October 1996, 2 months before the approval of the loan and the release of its first tranche of \$100 million on 20 December 1996. Thus, the TA was not preparatory to the loan. It was concerned mainly with building institutional capacities of the Finance Department to improve budget policy, planning, and management and control systems, and to modernize and computerize the tax and expenditure departments. Indicative of the wide range of support intended over 1 year, the TA was concerned with (i) reform of sales tax, stamp and registration duty, and other minor taxes; (ii) an action plan for value-added tax (VAT); (iii) municipal taxes, including *octroi* tax² and property tax; (iv) expenditure management; (v) budgetary planning; (vi) computerization in a variety of fields; (vii) a human resource development strategy; and (viii) training of staff. The TA began by the end of September 1997 and ended February 1999, 4 months after the intended closing date.

3. TA Completion Report

3. ADB issued its TA completion report on 15 July 1999. The report found that the TA reports and workshops provided important inputs to Gujarat's public finance reform process, although they came late due to implementation delays and lack of government support. The report also stated that the Government had begun implementing the recommendations to (i) reform the taxation system, including reducing input taxation for the introduction of VAT; (ii) improve budgetary systems; and (iii) promote better governance. A lesson learned was that TA was crucial to support the formulation of a reform strategy and to build capacity. The assessment report³ for the Program said TA 2668 enhanced the technical capacity of government officers to deal with the complexities of budgetary management: "Gujarat is today in a much better position to carry forward the reform agenda." On a larger scale, the Program encountered some problems, which perhaps could have been addressed in part by the TA consultants. The assessment report stated that ADB overlooked the large sales tax exemptions

¹ Loan 1506-IND: *Gujarat Public Sector Resource Management Program*, for \$250 million, approved on 18 December 1996.

² Octroi tax is a tax levied by the local government on the import of goods within a city area. The tax is not levied when goods are in transit.

³ ADB. 2002. *Gujarat Public Sector Resource Management Program: An Assessment*. Manila.

given by the Government during the program period, and the impact is now being felt on the fiscal situation. The exemptions aggregate to approximately 50% of the fiscal deficit.

B. Assessment of Implementation Performance

1. Design of the TA

4. The design of the TA included many components, covering state tax and non-tax revenue, as well as municipal taxes. It also covered many processes in the Finance Department, such as budgetary planning, expenditure management, computerization, and human resource development. The TA had planned 75 person-months, with the Government financing 24 of them. In retrospect, more intensive focus on fewer components might have been better. Since only 3 person-months had been allocated for international consultants, international consulting firms expressed no interest. After much delay, a domestic consulting firm was selected through a retendering. This firm lacked in-house expertise in all of the fields to be covered, contributing to the low quality of some of the outputs.

2. Engagement of Consultants

5. Selection and fielding of the consultants took 11 months longer than expected. A domestic consultant team with some experience in taxation issues, budget planning, and expenditure management provided the consulting services. However, the sales tax expert was no longer available due to the delays. The leader for the TA team was recruited directly outside the contract with the main consulting firm to carry out the responsibilities as project director and public finance expert. However, this team leader, a highly qualified expert from the Indian Statistical Institute Delhi, was not available for more than 4.5 person months. This led to supervision and coordination problems. Issues related to the firm's payment of the consultants also contributed to implementation problems.

3. Organization and Management

6. The TA was supposed to have been working under the new Gujarat State Public Finance Reforms Committee. However, this committee began its work more than a year behind schedule due to the Government's late appointment of a chairman. As a consequence, most of the assistance was provided in the absence of the committee, altering the nature of the TA provided. The constitution of the three main working groups that were agreed upon as part of TA implementation (tax reforms, expenditure management, and computerization and training) also was delayed. The Government's decision to provide offices to the team in a hostel created other start-up problems. Later, the team was housed in the Finance Department. The Government regarded the interaction with the consultants as insufficient, and attributed this in large part to a lack of effort by the team. More time should have been taken for discussion and workshops. On the other hand, the Government's comments on the draft final report were very delayed, leading to the submission of the final report 4 months late. The TA completion report attributed the lack of collaboration in large part to the Executing Agency.

4. Implementation Schedule and Financing Arrangements

7. The TA had a budget of \$695,000, with the Government providing \$95,000. Government financing was for office accommodation, domestic transportation, 24 months of domestic consultants, and a public information campaign. The Government employed some domestic consultants, and provided office accommodation to the team. The funds for the public

information campaign were not spent, although the Government created a committee that included representatives from 16 nongovernment organizations. A website also was created to inform the public.

8. ADB's portion of the TA budget was \$600,000, which was intended for consultants (\$308,000), equipment (\$150,000), training costs (\$60,000), and contingencies (\$82,000). ADB-funded TA consultancy was budgeted at 51 person-months, with 52.5 person-months utilized. The equipment component was not utilized. The cost came to \$259,239 (43% of budget). The large savings occurred mainly due to (i) cancellation of computer purchases due to the Government's adoption of a computerization strategy that updated existing computer facilities at minimal cost in accordance with the consultants' recommendations, and (ii) replacement of international consultants by domestic consultants. The contingency fund was not utilized.

5. Supervision

9. Although the TA began at the end of September 1997, the first ADB mission was not fielded until April 1998. The work program was then revised. Further review missions were undertaken in the context of the program loan, and a tripartite meeting was held in September 1998 to discuss the interim report. In January 1999, another tripartite meeting was held to discuss the draft final report. Even with the reviews concentrated towards the end of the TA, the final report was largely a repetition of the interim report, with many gaps.

C. Evaluation of Outputs

1. Outputs

a. Adequacy and Quality of Reports and/or Services Provided

10. The consultant team submitted an inception report, an interim report, a draft final report, and a final report. The final report, which comprised four volumes in addition to an executive summary, provided a comprehensive analysis and review of Gujarat's public finances. Detailed recommendations were provided for reforms to (i) the state's budgetary management; (ii) state taxes, including sales tax and the introduction of VAT; (iii) municipal taxes; and (iv) the computerization of the finance and taxation departments, including the sales tax administration. The TA completion report viewed the final report as somewhat weaker in formulating a human resource development strategy consistent with the expenditure reforms.

11. With some exceptions, the Government regarded the quality of the TA's outputs as insufficient. The outputs were seen as often based on reports of the committees and commissions set up by the Government in the past. Many of the recommendations, nevertheless, were found to be useful, which the State Public Finance Reforms Committee acknowledged in a report.⁴ A committee, chaired by the chief secretary, was set up to review progress on the recommendations four times per year. Good progress has been noted on tariffs, unbundling of the power sector, fees in the education sector, and charges in the irrigation sector.

12. **Reform of Sales Tax.** The Government initially was not fully committed to VAT, and the consultants were asked to calculate the revenue impact of VAT and analyze the administrative

⁴ Government of Gujarat. 2000. *State Public Finance Reforms Committee: Report on Fiscal Consolidation in Gujarat, A Medium-Term Plan*. Gujarat.

implications. Due to the lack of communication and the short duration of the consulting services, these tasks received insufficient attention. Recommendations made regarding changes in legislation, administration, computerization, and training also were regarded as unhelpful. The Government, meanwhile, had gone ahead at its own pace with reforming sales tax, and all the reforms are compatible with the later introduction of VAT. Progress is being seen booked particularly with computerization and databases.

13. **The Action Plan for VAT.** The action plan produced by the TA was deemed of little use. The Government, meanwhile, prepared itself fully for the introduction of VAT through a VAT implementation committee, which included some 16 nongovernment organizations. Although the drafting of legislation, rules, and regulations was completed 14 months ahead of the scheduled introduction (in January 2002), implementation was not started in April 2003 due to the withholding of approval for the new VAT legislation by the President of India. The government had negotiated compensation by the central Government for initial losses in tax collection (estimated at Rs6 billion), but this did not materialize due to the postponement of VAT. However, a new industrial policy was approved in February 2003, which promotes the introduction of VAT in the State of Gujarat to industrialists. Given that industrial inputs will not be taxed under this law, the introduction of VAT is now seen as a selling point for the state.

14. **Reform of Stamp and Registration Duty and Other Minor Taxes.** The consultants submitted good proposals on stamp and registration duty, entertainment tax, motor vehicle tax, and some other minor taxes. A number of changes have been implemented as a result. These reforms, however, do not have the capacity to address the fiscal deficit seriously.

15. **Municipal Taxes Including Octroi Tax and Property Tax.** As recommended by the consultants, octroi tax was abolished in all local bodies, except in six large cities where the revenue from octroi is substantial. Efforts are being made to develop some new source of revenue to substitute for octroi. The property tax system was changed from one based on rental values to one based on area, location, nature, use, and age of property. The consultants' reports were helpful in executing this change, although another study preceding the one by the TA was the basis for the change of the property tax system. The system proposed by the consultants did not use the concept of valuation cells, such as under TA 2943 in Madhya Pradesh. The State Public Finance Reforms Committee took over the proposals on user charges. The Government felt that the TA could have had more interaction regarding taxation issues with local bodies, which are being given more public responsibilities.

16. **Expenditure Management and Budgetary Planning.** The consultants' central recommendation was the creation of a budget team to prepare a core investment program. However, this was not implemented due to disagreements over the proposed constitution of the team. The recommendations were deemed not to address the main problem of expenditure management and budget planning: the frequent transfer of staff. Effective budget and expenditure management requires specialists who stay in the job longer than 2 years, which is often not the case now. The final report also did not address the important subject of budget restructuring. The required identification of hidden and explicit subsidies in the budget was addressed, but did not provide new perspectives. The consultants did not find time to work on the requested worksheet-based fiscal simulation model for conducting counterfactual simulations during budget making. In an assessment of the program loan conducted for ADB, the National Applied Economic Research Council concluded in December 2001 (footnote 3) that the TA and the Program were less successful in expenditure management. The Operations Evaluation Mission agreed.

b. Training and Technology Transfer

17. **Human Resource Development Strategy.** The TA completion report and the Government viewed this strategy as weak.

18. **Training of Staff.** Training conducted by the TA was seen as unrelated to the training organized by the Finance Department, and therefore less useful. Many planned workshops and seminars were not held.

19. **Computerization of the Budget, Tax, and Expenditure Wings of the Finance and Taxation Departments, Including the Sales Tax Administration.** The consultant developed programs that were not used due to their perceived incompatibility in hardware, software, and substance. The Sales Tax Department regarded the sales tax module as not useful. The Finance Department also felt that security aspects of the software had not been sufficiently addressed. Budgets are being computerized with the assistance of other consulting services, financed by the Finance Department. All government departments are using this software. Similarly, the Sales Tax Department has gone ahead with computerization using its own sources, and several modules have become operational. Some 300,000 dealers have been registered and data has been entered in the computer. Of the 136 unit offices, 103 have been computerized.

20. The large equipment component was not utilized on the recommendation of the TA team. The Government accepted this recommendation since the TA team had been unable to prepare workable modules.

2. Institution Building

21. The intended institutional strengthening of the Finance Department through computerization and related training of staff was not achieved, due to the failure of the programs developed. The consultant systems analyst's lack of familiarity with the procedures in the Finance Department was partly to blame.

3. Performance of Consultants

22. The Government feels that the consultants selected by the consulting firm lacked credibility. This was realized at the time the consulting firm was selected. However, given the lack of interest expressed by firms, the proposals were given the benefit of the doubt. With one exception, the experts were considered of insufficient stature and produced mediocre work. In spite of this, some consultants did useful work, albeit in areas somewhat peripheral to the main reforms needed.

D. Overall Assessment

23. Gujarat has undergone significant reforms, though these are seen for the most part as unrelated to the TA. The State Public Finance Reforms Committee took up the TA's good points, but many of these were not in areas where reform counted most. The TA was rated partly successful.⁵

⁵ On a scale of four categories: highly successful, successful, partly successful, and unsuccessful.

E. Conclusions

1. Key Issues

24. The Government and consultants seem to have misunderstood what was to be expected from the TA. The Government clearly expected too much from the TA, perhaps encouraged by the consultants' wide-ranging terms of reference. As demonstrated by reform processes in the other states, TA consultants often can do little more than validate and expand on reform initiatives already contemplated by the Finance Department or other government departments. Such TA then provides a stronger justification for such reforms. Perhaps partly due to the absence of international consultants, national institutes, and consultants of national stature, the Finance Department found it difficult to widen the constituency for its reforms.

25. Overall, progress was seen in revenue reforms, revenue collection, and divestment and reforms of state-owned enterprises.⁶ Budget preparation and expenditure management pose the biggest challenges in Gujarat. For example, better application of budget and expenditure classification systems would improve the analytical potential of the budget. Computerization along the lines of the Finance Department in Madhya Pradesh needs to be pursued vigorously.

2. Lessons Learned

26. Domestic consultants with experience in fiscal management beyond working in Finance Departments are hard to find. A more systematic survey of national or state-based institutes with knowledge and experience in this field should be developed. When available, these institutes should be involved to the maximum. Such institutes generally are perceived to be more intrinsically objective than private domestic consultants.

3. Follow-Up Actions and Recommendations

27. The Government should pursue further computerization of the Finance Department. The study of systems, such as those being developed in the Finance Department of the Madhya Pradesh government, is recommended.

⁶ These reforms included the 300% increase in the electricity tariff for agriculture, the unbundling of the electricity sector and the creation of a regulatory committee, and the raising of the fees for high schools and colleges.

TA 2943-IND: SUPPORT FOR THE GOVERNMENT OF MADHYA PRADESH PUBLIC FINANCE REFORM AND INSTITUTIONAL STRENGTHENING

A. Background

1. Rationale

1. Madhya Pradesh was the second of the six focal states the Asian Development Bank (ADB) supported. The state, one of India's poorest and most backward, was highly committed to fiscal and state enterprise reform. Underlying structural weaknesses included (i) a tax structure characterized by a narrow tax base, multiple rates, and low buoyancy; (ii) low cost recovery; and (iii) continuous growth in revenue expenditures. On the revenue side, the Government's reform measures needed to be widened. On the expenditure side, resource constraints had limited the state's ability to expand public investment and maintain assets.

2. Technical assistance (TA) 2943, funded by the Japan Special Fund and administered by ADB, was provided in parallel with TA 2944: *Strengthening Local Government in Madhya Pradesh*.¹ Their aim was to improve governance through decentralization. They were part of ADB's comprehensive support for the preparation and implementation of Loan 1717-IND: *Madhya Pradesh Public Resource Management Program*.²

2. Objectives and Scope of the TA

3. TA 2943 sought to improve development management by supporting the state government's public finance reform and institutional strengthening. The TA focused on (i) institutional strengthening of the sales tax administration, including staff training to facilitate the transformation to value-added tax (VAT); (ii) strengthening the Stamp and Registration Duty Directorate, setting up a state-level central cell and district cells for the valuation of assets, and training staff on the new valuation system; (iii) conducting an assessment of the institutional, policy, and regulatory frameworks to improve social services, particularly in health and education; (iv) setting up the State Budgeting and Fiscal Analysis Unit (SBFAU), and training staff to strengthen the analytical capability for budget planning and monitoring, as well as revenue and expenditure analysis and projection; and (v) training the staff of the Finance Department and key infrastructure in the methodology of expenditure prioritization and core investment program.

3. TA Completion Report

4. The TA began on 10 August 1998 and closed on 15 August 2001. ADB issued the TA completion report by 25 November 2002. The report found that the TA was effectively undertaken and successfully completed. The TA also was effectively linked to the follow-up program loan (footnote 2), which released its first tranche by 15 December 1999.³ The report said the Government generally accepted the recommendations of the TA's wide-ranging final report. In particular, the TA created considerable ownership in the state of formulating a road

¹ For \$700,000, approved on 15 December 1997.

² For \$250 million, approved on 14 December 1999.

³ The second tranche was released on 27 February 2002 with a delay of 17 months. The third tranche was released by 17 March 2003, with a delay of almost 2.5 years based on the original plan. Delays were due to (i) late Board approval due to sanctions on India following nuclear tests, and the need to have the loan assessed as basic human needs; (ii) the policy matrix time schedule was not shifted commensurately to avoid impacting on the momentum of policy implementation; and (iii) the bifurcation of Madhya Pradesh.

map for VAT implementation. The report noted some delays in implementation, changes in team members, and weak interaction between the consultants and Executing Agency in the early stages. The results of the TA were disseminated through workshops, although some of the planned training and workshops related to VAT could not be held because of the delay in the introduction of VAT. Partly as a consequence of the TA, the Madhya Pradesh State Assembly was the first in India to pass the VAT Bill on 7 August 2002. The SBFAU, implemented in September 1998, was strengthened and valuation cells were set up as planned. The report concluded that the Government's financing and provision of an economic advisor had enhanced government ownership of the TA. Furthermore, the report said the TA's findings and recommendations were reflected in the design of TA 3576 for ADB's third focal state, Kerala. A new TA on VAT reform (TA 3856) also included additional work on VAT training in Madhya Pradesh.

B. Assessment of Implementation Performance

1. Design of the TA

5. Like TA 2668, this TA included activities on the revenue and expenditure side. A broad interpretation was made of the consultants' terms of reference, which diluted its focus and led to a number of disparate—if often successful—small interventions. The public finance domain was divided into three areas: (i) public revenue, (ii) public expenditure, and (iii) allocation and control. Under public revenue, the TA covered the Commercial Tax Department, including the Stamp and Registration Duty Department (SRDD), and the Mineral Resources Department (MRD) as the major non-tax source of revenue (mainly royalties on limestone and coal). Included under public expenditure were health, education, and other key expenditure departments, such as the Public Works Department, Water Resources Department, and the Tribal Welfare Department. Under allocation and control, the Finance Department and the Accountant General's Office were included. The disparate nature of the activities was justified, given the need to prepare a wide-ranging public resource management program.

2. Engagement of Consultants

6. A Canadian organization, in association with a local firm, was awarded the consulting contract. Nine person-months of international consultants, and 35 of the available 44 person-months of domestic consultants, were used. An international consultant was hired for 4 weeks for advisory services on the VAT system. In addition, the government provided 9 person-months for an economic advisor to guide the newly created SBFAU. The consultants worked closely with the Government and delivered the expected results on time, and within budget. The performance of the consultants as a team was satisfactory. The consultants' activities saved \$43,000 from the original contract, which was used in recruiting an international consultant to do more work on VAT issues.

3. Organization and Management

7. The TA used steering committees and working groups very effectively. The Economic Reform Committee, chaired by the chief minister, advised and oversaw the implementation of the TA, with support of two empowered committees on public finance reform and public enterprises restructuring. The committees met several times during the implementation of the TA. Various working groups also met. A number of workshops contributed to a relatively high degree of participation by the Government in the TA, which in turn led to effective follow up in many cases.

4. Implementation Schedule and Financing Arrangements

8. The consultants began on schedule in August 1998, and advisory work was completed in September 1999. Due to the slow implementation of the equipment procurement component, the TA was formally closed 2 years later than anticipated, on 15 August 2001. The estimated cost for the TA was \$879,000, which included the costs of the services of an economic advisor to run the SBFAU. The Government would contribute \$99,000 equivalent for the TA. ADB was to contribute \$780,000, though its final expenditure came to \$725,681.

5. Supervision

9. Supervision, conducted from ADB's headquarters, was adequate. ADB's resident mission also contributed substantially to the supervision. ADB participated in a few of the steering committee meetings. The TA benefited from ADB's attention to the preparation and administration of the program loan.

C. Evaluation of Outputs

1. Outputs

a. Adequacy and Quality of Reports and/or Services Provided

10. The consulting firm submitted an inception report in the third week of September 1998, an interim report in November 1998, a draft final report in April 1999, and the final report in September 1999. The final report consisted of five volumes including an executive summary, a main report, a VAT binder, and a manual on property valuation. The final report was well-written and provided a comprehensive analysis and review of Madhya Pradesh's public finances. The report provided background analysis on which the subsequent program was based. It also provided several recommendations that were included in the policy matrix of the program loan.

b. Training and Technology Transfer

11. Staff training focused on (i) the introduction of VAT; (ii) computerization in the Finance Department; (iii) to a lesser extent, building analytical capability for budget planning and monitoring; and (iv) revenue and expenditure analysis. Workshops were held on VAT and the expenditure reviews on health.

12. In January 1999, the TA submitted a detailed proposal for networking the treasury with some 52 district treasury offices. It included the development and installation of software to implement the networking, which was started immediately. The cost of the proposal was estimated at \$266,332, of which \$124,235 was intended for equipment and hardware. The proposal was accepted in August 1999. ADB contributed \$110,000 to the purchase of the software and networking. A company contracted by the Finance Department later redesigned the system. The system is based on Oracle databases, servers, and Pentium II computers, which were purchased by the Government. The bifurcation of the state in 2000–2001 delayed the implementation. By April 2004, all district treasuries were to be linked to the system, enabling for the first time "real time" statements on the budget, expenditure, and accounts positions. That should lead to more efficient use of funds. The system will allow time slicing of budgets and expenditures on a monthly basis.

13. The TA also submitted computerization proposals for the Commercial Tax Department at Indore, SRDD, the Motor Vehicle Department, MRD in Raipur, and some key expenditure departments. The proposals concentrated on systems analysis and some system design, including an initial cost estimate. In most cases, the departments took over these proposals and incorporated them into the start of subsequent computerization works, with some interesting benefits. Positive results were achieved, particularly in SRDD, Budget Directorate, and the Motor Vehicle Department. The contribution to MRD, which was based in Raipur, might have been lost due to the bifurcation. The new MRD in Bhopal has not benefited from the designs due to a lack of communication between the two departments.

2. Institution Building

14. **Institutional Strengthening of the Sales Tax Administration, Including Staff Training to Facilitate Transformation of the Sales Tax System to VAT.** An international consultant provided advisory services to the state government on the design and implementation of the VAT system. Madhya Pradesh is one of the few states in India that has had its VAT legislation approved by the President. However, since the Government of India decided to postpone the introduction of VAT from April 2002 to April 2003, the expected outcome of the TA in this area was not fully achieved. After June 2003, VAT was indefinitely postponed. Although individual states were at liberty to start VAT at the state level, only Haryana implemented VAT, probably due to concerns about initial losses in sales tax revenues without the compensation the Government of India offered earlier.

15. **Strengthening SRDD, Setting Up State-Level Central Valuation Cell and District Valuation Cells for Valuation of Assets, and Staff Training on the New Valuation System.** Surveys of land and immovable property were carried out. Some 313 valuation cells—known as valuation committees—were created, and the new valuation system is largely in place. Courts accept the values established. Computerization was initiated under the TA, and continued by another company contracted by the Finance Department. The focus is on indexing documents of the past 13 years. New rates for stamp and registration duty (3% lower than before) have been established. The TA estimated a cost of Rs9.7 million, but the design was found to have some deficiencies. The subsequent detailed design came to Rs15 million. Latest estimates of the total cost are over Rs26 million.

16. **Assessment of the Institutional, Policy, and Regulatory Frameworks for Improvement of Social Services, Particularly Underfunded Health and Education Services.** Working groups prepared incisive analyses that led to tranche release conditions for the program loans. The budgets for health and education were increased recently as a consequence. The Government expressed reservations, given that investment and operation and maintenance in sectors such as roads and irrigation have been affected. A supplementary loan would have been welcomed to complete the restructuring agenda. Meanwhile, the TA's efforts to increase cost recovery in the health sector has had a minor impact of around Rs100 million per year.

17. **Setting Up the SBFAU.** With the guidance of the government-financed economic advisor, the SBFAU became operational in September 1998. The Government issued a formal order setting up the SBFAU and detailing its functions. The TA helped strengthen the SBFAU, which is still in existence. It is managed by a director, an additional director, and four programmers. Staff to fill eight more positions were being recruited at the time of the Operations Evaluation Mission. The Government also has continued to fund an economic adviser from the Indian Economic Service. The SBFAU is supervising computerization within the finance

secretariat. Its economic analysis is expected to improve as soon as all district treasuries are connected and deliver real time budgets, expenditures, and accounts. The TA was the basis for proposals on the prioritization of expenditures, initially through the development of a core investment program. This has not been fully implemented, though its three-category prioritization system—A (vital), B (essential), and C (desirable)—is now central to the treasury system and covers investment and recurring expenditure.

3. Performance of Consultants

18. Overall, the performance of the consultants was satisfactory.

D. Overall Assessment

19. The Operations Evaluation Mission rated the TA as successful. The most successful interventions were in tax, SBFAU, and computerization of treasury functions. The outcomes of interventions in key expenditure departments, such as in health, education, public works, and water resources, were relatively less visible.

E. Conclusions

1. Key Issues

20. The gap between expenditures and revenue is still widening, expanding revenue and fiscal deficits. The restructuring program could not be completed with resources disbursed under the program loan. The Government stated that a supplementary loan could have achieved this.

2. Lessons Learned

21. The active engagement of the two steering committees, along with regular presentations of the TA team to senior management, optimized the TA's contribution in the important areas of VAT and expenditure management.

22. A mix of expenditure- and revenue-related activities in a fiscal reform-oriented TA has definite benefits, but not too many activities should be undertaken outside the Finance Department.

3. Follow-Up Actions and Recommendations

23. The new ADB TAs should take an interest in the computerization program in the ongoing Finance Department of the Madhya Pradesh government.

TA 3576-IND: SUPPORTING FISCAL REFORMS IN KERALA

A. Background

1. Rationale

1. Kerala is the third of six focal states the Asian Development Bank (ADB) has supported with assistance for public resource management. Measured by human development indicators, such as literacy, life expectancy, and infant mortality, Kerala is the most advanced state in India. However, economic problems, combined with the state's inability to sustain the expenditures for social and economic services, increasingly have threatened this achievement in the social sector. The public finances of Kerala deteriorated considerably during the second half of the 1990s, as the current account deficit rose sharply from 1.4% of state domestic product in 1995–1996 to 5.2% in 1999–2000. The fiscal deficit grew from 4.8% to 7.5% of state domestic product during the same period. As in Gujarat and Madhya Pradesh, the implementation of a salary increase for the state's civil servants in 1998, and the payment of arrears in 1999, contributed to the sharp deterioration in public finances. A cut in central Government grants, a cash crop recession, and a decline in revenues from stamp and registration duty fees, state excise and non-tax revenues of the state government accentuated the problem. The Kerala state government (the government) asked ADB for technical assistance (TA) to study ways of reducing its debt burden and raising its financial capacity for capital expenditure. In July 2000, an ADB fact-finding mission reached an understanding on the TA.

2. Objectives and Scope of the TA

2. TA 3576 aimed to conduct an even wider range of activities than its two predecessors, in preparation for program Loan 1974-IND: *Modernizing Government and Fiscal Reform in Kerala (Subprogram I)*.¹ The goal of the TA was to help the Kerala government design effective measures to improve the state's public finances and build the necessary capacity within the state government to carry them out. The detailed objectives were to (i) help the state government formulate tax and non-tax reform measures to enhance its revenue-raising capacity; (ii) upgrade the institutional capacity of the Finance Department to manage and control public spending, and introduce greater accountability and transparency in budget making; (iii) prepare a consensus-based legal and administrative framework to promote fiscal responsibility to ensure the sustainability of public finances; and (iv) strengthen the capabilities of local bodies to assume greater responsibility for social spending, and make their functioning transparent and accountable.

3. TA Completion Report

3. ADB recently issued a TA completion report (TCR). The ADB-supported public resource management program is still ongoing. The TCR rated the TA as successful, given that many of the TA's recommendations were sound and accepted by the Finance Department. The TCR noted the attack and vandalization of the project office at the end of April 2002, which prompted ADB to close it in May 2002. The TCR argued that a more active government communication policy regarding reforms could have helped avoid the incident.

¹ For \$200 million, approved on 16 December 2002.

B. Assessment of Implementation Performance

1. Design of the TA

4. As with the preparatory TA for the program loans in Madhya Pradesh, the TA included international and domestic consultants. The international consulting services focused mainly on the preparation of value-added tax (VAT) implementation and expenditure management. They were allocated a much larger budget than the international consultants under the predecessor TAs 2668 and 2943. Given their experiences, this was appropriate.

5. The TA's terms of reference included activities directed at health and education services, and local bodies. Local bodies received less attention after the focus of the TA shifted towards the evolving Modernizing Government Program (MGP).

2. Engagement of Consultants

6. The main contract was awarded to an Australian consulting firm. This firm's subsequent negotiations with an Indian subcontractor from outside Kerala were not successful, and on short notice domestic consultants from Kerala state were hired on an individual basis. Despite the delays and the requests for much time from the TA's team leader, this generally worked out well. A good mix of international and domestic consultants was beneficial.

7. The international consultants included a team leader and public finance specialist, public expenditure management and control specialists, and a VAT expert. The domestic consultants included an assistant team leader and experts in budgeting, accountancy and audit, health systems, water sector, utilities pricing, and computer systems. The state government was to finance 16 person-months of domestic consulting services, covering the budget and accounting experts as well as the legal experts. However, this did not take place. Instead, one officer in the Finance Department was made available to the TA full time. The international and domestic consultants would be supported by 30 person-months of consulting services from research associates, and 10 person-months from computer analysts recruited in Kerala.

3. Organization and Management

8. The State Public Finance Reforms Committee, chaired by the vice chairman of the State Planning Board, was created to oversee implementation of the TA. As planned, a tripartite meeting was held to discuss the draft final report. The committee examined the draft report and formulated comments, which were integrated into the final version published in September 2002. The report was presented to the Government, which has not approved it yet. As a result, some of the recommendations have not been implemented.

9. The international consultants had close interaction with senior management of the Finance Department. However, a government employee strike in February–March 2002 hampered that interaction, and led to the temporary demobilization of the team. The TA came to be perceived as promoting an “ADB agenda” for downsizing government. Local groups opposed to the TA, including government staff, affected the working conditions for many of the domestic consultants assigned to departments other than Finance.

4. Implementation Schedule and Financing Arrangements

10. The cost of the TA was estimated at \$1,285,000 equivalent. ADB provided \$1 million from the ADB-funded TA program. Nearly 80% of the funding was for contracting consulting services, including 21 person-months for internationally recruited consultants and 42 person-months of domestic consultants. Compared to the other state-based TAs reviewed, modest amounts were planned for equipment (\$30,000), workshops (\$30,000), and technical support (\$40,000). Contingencies were estimated at \$103,000. The Government would contribute the equivalent of \$285,000 in local currency costs, mainly for consultants and counterpart staff (\$160,000), and office accommodation (\$40,000). Actual costs were much below the estimate, with 50 person-months claimed, and \$716,409 reimbursed by ADB. The Government did not employ consulting services as had been agreed, but assigned one officer full time to the TA. ADB extended the implementation period from 8 months to 12 months. However, the events at the project office at the end of May 2002 prompted ADB to halt the fielding of the consultants after 8 months. The consultants submitted their draft final report in June 2002, and the final report in September 2002.

5. Supervision

11. ADB headquarters staff preparing for the program loan, and ADB's resident mission in Delhi, monitored the TA closely. However, ADB's messages regarding the course of the TA were not always consistent. The fact that a team of staff involved in the preparation of a program loan had different views on the role of the TA added to the miscommunication. Informal scope changes were requested, particularly regarding the inclusion of the MGP agenda in the TA's work. Senior staff of the Finance Department also might have given conflicting messages regarding the TA's attention to the MGP (of which fiscal reform became a part). Encouraged by ADB, the TA moved beyond the fiscal consolidation agenda and adapted its activities to focus more on MGP. ADB decided that only the staff in the resident mission were to address the media regarding the TA and the loan. The consultants were not allowed to respond directly to concerns regarding the nature of the impending loan and the role of the TA in its preparation, fueling negative public perceptions. Given the distance from Kerala, the resident mission was not always able to reduce tensions by addressing misconceptions immediately. The lack of response added to the highly charged atmosphere, which led to demonstrations and a strike by government staff in February–March 2002. The Government, which changed during the TA, was not always clear with the media regarding its ownership of the reform program. As a result, ADB was the principal owner of the fiscal reform program in the eyes of the media. Only after the incident at the end of April 2002, the Government released documents regarding the MGP to the media, which changed the mood somewhat.

C. Evaluation of Outputs

1. Outputs

a. Adequacy and Quality of Reports and/or Services Provided

12. The soft copies of some materials were lost in the damage to the project office, which was said to have affected the quality of the final report. Nevertheless, the final report contained 16 volumes with detailed recommendations on (i) improving the management of public sector finances, (ii) budget preparation and planning, (iii) enhancing fiscal transparency, (iv) VAT implementation, (v) non-tax revenue, (vi) minor taxes, and (vii) debt management. It also covered sectoral issues, such as health services, water resources, pricing and management in

irrigation, regulation of public service vehicles, the role of information technology in governance, accounting systems in local self-government, and the MGP. Due to the removal of the TA team from the scene, some of these recommendations have not been disseminated optimally or discussed, so that a consensus could be created. However, some of the more important recommendations have been translated into detailed implementation plans to be executed under the MGP. On the fiscal side—one of the five components of the MGP—7 of the 25 initially proposals are being implemented. The TA was connected with most of these.

13. **A Detailed Plan to Introduce VAT in Kerala.** The plan, produced with the Sales Tax Department, was implemented. Assistance was provided for drafting legislation, training, making required changes in administration, and computerization. Some public awareness campaigns also were aided by the TA. As a consequence of these activities, VAT legislation smoothly passed the Assembly in February 2003, 2 months before its intended (and ultimately postponed) implementation. The state government confirmed that it is fully prepared for the implementation of VAT. However, the government is waiting for the Government of India to approve the legislation and compensate states for the initial losses connected with the transfer to the new system. The Government expects structurally enlarged revenues compared to the revenues from sales tax, as VAT will enable more efficient taxation of the large services sector in Kerala.

14. **Proposal for Strengthening the Capacity of the Non-Tax Revenue Cells in the Finance Department to Levy Adequate User Charges on Social Services.** This part of the terms of reference was not implemented. The non-tax revenue cell was abolished, and its functions transferred to other departments. User charges are a very sensitive issue in the political climate of Kerala.

15. **Identification of the Institutional Requirements for Promoting Fiscal Responsibility, Introducing Multiyear Budgeting.** The Government has taken many steps since the TA to instill more discipline in the budgeting and expenditure process. Improvements to the Government's Medium-Term Fiscal Reforms Program, which was first prepared for FY2000–2001, were among the most important. Promoted by the TA, a new budget law was approved, with budget cycle changes, the approval of the budget in March, the introduction of a 3-year cycle of budgeting from 2004, and a midyear review of the Medium-Term Fiscal Reforms Program. Supplementary Demands of Grants, which approve additional expenditure, have been reduced from three to a maximum of two per financial year. Regarding expenditure management, the Government issued additional economy orders in January 2002 to reduce spending. Initially recommended by the TA, a plan is underway as part of the MGP to institute a liability management system to deal with (i) the large unreported and unaccounted commitments accumulated by departments, which have to be honored by the Government; and (ii) contingent liabilities, mainly in the form of government guarantees, which are likely to be translated into unforeseen expenditure if invoked. The state government has issued a policy paper to introduce a payroll and personnel management information system for government employees. This system is expected to improve data, information management, and human resource management, as well as provide significant efficiency gains in the preparation of the payroll. Some of the TA's proposals were rejected, such as the creation of a ministerial committee on resources.

16. **Promoting Greater Output-Linked Accountability in Budget Formulation and Implementation for the State Government and Local Bodies.** The TA prepared a planning manual, which incorporates project performance management methodologies. The State Planning Board is using the manual. The midyear budget review will include outcomes. The TA

introduced the Canadian concept of resource envelopes to the Government. Following a functional review recommended by the TA and carried out by another TA funded by the Netherlands, the Finance Department is to be reorganized, with greater integration of the expenditure and budget wings. A paper was prepared regarding the accounts of local bodies, but the recommendations were based on actions the State Planning Board and Accountant General's Office had already formulated and undertaken. The MGP included a detailed implementation plan regarding prompt action on audit reports by the Accountant General.

17. Preparation of a Legal and Administrative Framework to Implement Fiscal Responsibility to Ensure the Sustainability of Public Finances. The TA helped in preparing the Fiscal Responsibility Act 2003, as well as the Kerala Ceiling on Government Guarantees Act 2003. The State Legislature and the Governor passed both, albeit in a somewhat diluted form compared to the TA's recommendations. The TA also helped with other changes. An Asset Renewal Fund was created, and a committee was constituted under the chairmanship of the finance minister to administer it. A Surplus Staff Redeployment Committee was constituted for identifying surplus staff in Government. This resulted in a net attrition rate higher than the Government's target of 1% per year. Importantly, the practice of transferring funds to the Treasury Public Account to circumvent lapsing funds at the end of the financial year was stopped.

18. Simple, Transparent, Accountable Expenditure Monitoring and Control System Based on Information Technology for Local Bodies. With support from the TA, the Government took steps to produce more transparent and user-friendly budget documents, such as the modified *Budget in Brief* and the *Budget Summary*. On 17 September 2003, a public expenditure review committee was notified.

19. Preparation of an Action Plan to Transfer Health Care Facilities and Water Supply Schemes to Local Bodies in Phases. This target was too optimistic, given the short duration of the TA and its limited resources for promoting this initiative. The TA provided good general reports, but some planned workshops could not take place, in part due to delays related to a strike in February–March and the premature closure of the project office in May. The TA did not make much progress in the health sector in terms of promoting decentralization of services and greater financial autonomy for health units. Since these are highly charged issues, more extended involvement would be necessary. The action plans were not drawn up as intended, though a health policy is in the making. This process needs to be completed before an action plan can be prepared. The TA prepared a paper on social insurance, which helped in clarifying thinking on this issue. However, the Health Department had simultaneously requested the World Bank to look into social insurance. In addition, the European Union funded a project that was looking into the standardization of services. Thus, the TA was not very well coordinated with TA from other external agencies. On 10 October 2002, the Government approved an Asset Renewal Policy, particularly geared to the social sectors. It set up an Asset Renewal Fund to ensure that adequate investments are made for the maintenance of institutions that were transferred to local governments and render services predominantly to the poor. So far, however, only limited resources have been transferred to the fund.

20. Review of the Tax Structure and Revenue Buoyancy of Stamp and Registration Duty Fees, Motor Vehicle Taxes, State Excise Duty, and Other Minor Taxes, and Provision of Recommendations. A report prepared on minor taxes has been acted on to some extent. The Government recently issued a notification reducing stamp and registration duty. Computerization, meanwhile, is going ahead in the registration offices.

21. **Examination of Kerala's Expenditure Priorities in Key Social Sectors Against Changes in the Socioeconomic Environment and Recommend Suitable Changes.** This was carried out for the health and water supply sectors. Reports were submitted, but not fully acted upon, due to the untimely end of the TA. However, some of the TA's work was carried forward by the MGP. One of the MGP's detailed implementation plans deals with setting up district level sector plans for health and education.

22. The TA made a series of proposals for further TA, such as a functional review of the department and a study on contingent liabilities. The Government is implementing several of these, some with assistance from the Netherlands and some without foreign assistance.

b. Training and Technology Transfer

23. Training was done mainly on the job through collaboration between consultants and government staff. However, an atmosphere that was unsympathetic to the TA hampered training in some departments. Several planned workshops were not held, and some consultants had to work largely in isolation from the staff of the departments. That affected the quality and acceptance of the recommendations.

24. Some work was done on proposals for computerization in various departments, such as the Institute of Management in Government. A consultant assisted in the creation of a treasury management system, which is an ongoing activity in the Finance Department.

2. Institution Building

25. Institution building took place mainly through the preparation of legal and procedural instruments. The TA ultimately supported work on the MGP, which now has its own government secretary and secretariat. The MGP has a program consisting of five components: (i) Minimum Needs Program; (ii) Enabling Environment for Economic Growth and Employment Generation; (iii) Fiscal Sustainability; (iv) Core Government Functions; and (v) Effective, Efficient, and Accessible Local Self Government. Under these components, 93 initiatives are planned, with 33 detailed implementation plans approved for FY2003 (seven in the field of fiscal sustainability). Institution building also took place through improvements in office automation and computerization. The TA had an information technology-related component. In the Finance Department, a Treasury Information System is being developed, which was assisted by the TA. This system will link all district treasuries on real time basis, so that an up-to-date picture of budgets, expenditures, and accounts can be generated at any time. It will result in better prioritization and "time sliced" cash management. The output expected is the issue of monthly cash ceilings to all departments, based on realistic timings of cash inflows.

3. Performance of Consultants

26. The Government found the performance of consultants to be satisfactory. In most cases, there was not a one-to-one relationship between the advice of the consultants and the achievements. The situation was more complex than that.

4. Outcomes and Impacts of the TA

27. Kerala has had the best tax–state gross domestic product ratio in India for the past 15 years. However, this has not saved the government from a severe fiscal crisis in the 1990s and early 2000s. The main problems include the accumulation of old debts and a growing lack

of budgetary discipline, which the Finance Department has found difficult to stem. Line departments, backed up by politicians and buttressed by disparate government decisions, entered into budgetary commitments virtually without recourse to the Finance Department. By the early 2000s, the escalating fiscal crisis necessitated draconian measures. These are now being taken, causing major public discussion and reaction. The TA certainly played a role in creating acceptance for the need of these measures.² It also introduced or backed up new budgetary and expenditure management systems to improve efficiency. Although it is still too early to say, the worst of the crisis seems to have passed. This is indicated from the analysis in Appendix 10.

D. Overall Assessment

28. Although the TA encountered problems due to negative public attention for the preparation of the public resource management program, the Operations Evaluation Mission rated it successful. This was also the general assessment of the Finance Department.

E. Conclusions

1. Key Issues

29. The management of public awareness regarding the nature of, and need for, fiscal reforms is critical to their success. The Government needs to continue to take full ownership of these reforms.

2. Lessons Learned

30. TAs in support of fiscal and governance reforms might need a component to address public awareness and consensus creation at different levels. Consultants associated with ADB cannot always be kept out of the limelight. They need to be carefully instructed regarding their response to queries from the media and concerns raised by civil society stakeholder groups. Consultants can play a useful role in the dissemination of ADB messages to the media and general public, especially with issues which are highly charged, and in locations far from resident missions.

31. TA in support of fiscal and governance reforms should not take on too many issues in a period. Each issue needs to be coordinated and digested for it to have effect. Final reports, consisting of many volumes and covering a plethora of subjects, easily run the risk of not being fully acted upon.

3. Follow-Up Actions and Recommendations

32. None.

² Good measures taken were, for instance, a ban on recruitment, the redeployment of excess staff, and a reduced computation value for pensions.

**TA 3856-IND: VALUE-ADDED TAX REFORM:
CAPACITY BUILDING AT THE POST-IMPLEMENTATION STAGE**

A. Background

1. Rationale

1. The sales tax system in India depends primarily on taxation of goods by the Sales Tax Department at the first point of sale. In that system, the department administers only the dealers who sell at first point, which is about one third of all registered dealers. When a value-added tax (VAT) is introduced, all registered dealers—estimated at 5 million in India—will be required to pay tax over the value they add to the goods sold. As with VAT systems all over the world, the sales tax departments of all the states in India would need to shift to a different kind of administration, relying on the assessment of a guided sample of dealers. The constitution of this sample (i.e., the selection of dealers for VAT audit) would be of crucial importance to the effective collection of VAT in the long run. Since VAT is a self-assessed tax based on voluntary compliance, VAT audit is the principal mechanism to deter tax evasion and promote compliance. The Asian Development Bank (ADB) provided technical assistance (TA) to (i) help design an appropriate audit manual, (ii) develop criteria for the selection of dealers, and (iii) create a database for efficient VAT administration. The implementation period of the TA was to precede the introduction of VAT in India, then scheduled for April 2003.

2. Objectives and Scope of the TA

2. The objective of the TA was to strengthen the combined efforts of the central and state governments to introduce VAT in an efficient manner. The TA was to address a number of unresolved post-implementation administrative arrangements, which are crucial for an efficient VAT. The TA consisted of two parts. Part A would deal with the issues related to VAT for all the states. In this context, the TA was to help develop an effective audit strategy with appropriate selection of cases for audit. A VAT audit manual was to be prepared, adaptable to the specific systems in the states. Part B was to assist the six states in which ADB was active in the fiscal arena¹ in developing a database as part of a well-structured management information system. A market intelligence system also was to be established, incorporating the socioeconomic parameters of the states. The database and the market intelligence system were to be used to carry out risk analysis.

3. TA Completion Report

3. ADB has not issued a completion report for this TA. The duration of the TA, which began in September 2002, was to be only 4 months. During contract negotiations in July 2002, the participants decided to extend the TA to straddle the start of VAT implementation, so that the manuals and systems produced could be tested and adapted in the light of the early experience. However, when the introduction of VAT was postponed to June 2003, another TA extension was granted until the end of December 2003. In June 2003, the Government postponed VAT again, this time without announcing a new date of introduction. As no further extension was granted, the adaptation of the manuals and systems was dropped from the TA's schedule of activities.

¹ Assam, Chhattisgarh, Gujarat, Kerala, Madhya Pradesh, and Sikkim.

B. Assessment of Implementation Performance

1. Design of the TA

4. The purpose of the TA was crucial to the success of VAT and, therefore, highly relevant. However, the TA's design, which had a very short implementation period, did not explicitly take into account the experience of the Canadian International Development Agency (CIDA) regarding the Central Excise Audit Manual, intended for central VAT. This manual, prepared over a number of years, was issued first in 1998. By 2003, the Central Excise Department had revised the manual twice, in light of their experiences over 5 years.

5. The TA, meanwhile, appropriately followed earlier ADB TAs (also reviewed in this TA performance audit report) that had VAT capacity building components implemented at the state level.² Locating the TA at the central level, and including components to train the six states in the VAT audit strategy, was highly appropriate. This would help ensure that the VAT audit strategies in the different states were harmonized optimally. However, the Operations Evaluation Mission (OEM) viewed the TA resources as insufficient to deal with the large need for adapting the strategy to local conditions in the six states, and training needs.

6. The original design of the TA did not take into account sufficiently the need to test the VAT audit strategy. The TA was designed to be carried out before the introduction of VAT, but it became clear during contract negotiations and implementation that the audit manual would need to be fine tuned during VAT implementation. A longer duration TA, with perhaps two distinct phases, would have been more appropriate (para. 4). In the first phase, the outputs could be prepared before implementation. The second phase, which would start only a few months into the implementation of VAT, could be used to adapt, build up practical experience, and build the capacity of the VAT auditors. While the TA was implemented with some flexibility, the reason this ultimately did not help was because of a *force majeure*.

7. The audit manual suggests that the data on value of interstate sales or acquisitions is to be collected through a data exchange system. Since such a system does not exist in any of the states in India, it is important to know the *modus operandi* of the system for collecting this data. The audit manual does not discuss this, but it could have given suggestions. Also not explained is how data on income tax or union excise duty, important to cross check data on VAT, is to be collected. In many other countries, the variables are available to the department, because the same department administers all taxes. In India, this information is not available at the state level, since income tax and union excise duty are central taxes.

8. Another component of the design was to organize workshops to make officers understand the system of selection of dealers and follow the audit manual. The TA would train trainers in the state tax machinery to disseminate information, and to create a good database for the selection of dealers for audit. However, the OEM found during discussions with officers in three states visited that the training provided by the TA was too short. In retrospect, greater focus on practicability of the audit manual and better interaction with the state officials was needed.

² The other TAs included are TA 2362-IND: *Improvement of State Sales Tax Structure and Administration*, TA 2432-IND: *Capacity Building of Income Tax Administration*, TA 2668-IND: *Gujarat's Reform of Public Finances*, TA 2943-IND: *Support for the Government of Madhya Pradesh Public Finance Reform and Institutional Strengthening*, and TA 3576-IND: *Supporting Fiscal Reforms in Kerala*.

2. Engagement of Consultants

9. An international consulting firm was employed with vast experience in commercial auditing. Twelve person-months of international consultants and 8 person-months of domestic consultants were utilized. The OEM feels that the focus of the consultancy was on producing the manual, and on software to deal with the selection of VAT audit cases. Not enough time was spent interacting with officials at the state level regarding the development of local databases and training.

3. Organization and Management

10. The TA was implemented by the Department of Revenue at the central level, and the commissioners of the commercial tax departments of the concerned states at the state level. The lack of a steering committee was a lacuna. A longer involvement of the TA in each of the six ADB-assisted states should have been pursued. In retrospect, more interaction with the commercial tax departments of the states and with the Empowered Committee of State Finance Ministers would have been beneficial.

4. Implementation Schedule and Financing Arrangements

11. The draft of the audit manual was made available in November 2002. Four workshops were held in December 2002. The final VAT audit manual, which incorporated the comments, was submitted in February 2003. *A Note on Market Intelligence and Developing Risk Analysis in the ADB Project States* also was prepared in February 2003. The intended closing date of the TA was extended in April to December 2003 on the understanding that 15 states would start VAT by June 2003. However, this did not happen. Another extension is not planned.

12. The cost of the TA was estimated at \$750,000 equivalent, including \$338,000 of foreign exchange cost and \$412,000 equivalent of local currency cost. ADB's share was \$600,000. The actual cost incurred by ADB was around \$368,000. Some \$60,000 of this was spent on computer equipment: 30 computers, 6 printers, and software for 6 focal states. Savings came from larger-than-foreseen contributions by the executing agencies in terms of providing auditoriums for workshops, daily allowances for attendants, and so on. The TA had a provision for a final visit of the experts after the introduction of VAT. This did not take place due to the postponement of VAT by the Indian states.

5. Supervision

13. ADB officers from the India Resident Mission administered the TA closely.

C. Evaluation of Outputs

1. Outputs

a. Adequacy and Quality of Reports and/or Services Provided

14. The consultant team submitted a draft audit manual in early November 2002 and the final report in February 2003. On 17 March 2003, the Revenue Department of the Ministry of Finance sent three copies of the VAT audit manual to all state governments. This TA performance audit report regards the final version as a first step on the road to a user-friendly manual adapted to the realities of the commercial tax departments in the states. The approach

taken assumes the existence of databases on dealers, which is not the case in most states, and attempts to gradually improve these. An intermediate strategy of VAT audit in the absence of such databases should have been worked out. The Empowered Committee on VAT approved the draft at one of its meetings in early 2003, but the minutes were not made public. Moreover, the Revenue Department did not provide clear instructions on the use of the manual. As a result, the current status of the manual is very unclear.

15. A computer program to systematically use data for the selection of dealers for VAT audit was provided, along with the VAT audit manual. Based on discussions in Delhi and Ahmedabad, further work on the computer program would be useful. A system manual also was prepared for the audit planning and selection system. No work was done on building a dealer database suitable for computerization in the focal states, although in retrospect, some funds were available.

16. The TA envisaged a manual for risk analysis, and proposed that it be submitted 2 weeks before the end of the consulting services. The consultant team submitted a note on the subject in February 2003, but a risk analysis was not suitably elaborated due to the postponement of VAT.

b. Training and Technology Transfer

17. After the submission of the draft audit manual, the consultants organized four 2-day workshops—one each in Delhi, Kolkata, Hyderabad, and Pune (with 2–3 persons participating from smaller states, 6 from medium-sized states, and 10–12 from eight bigger states). Many of the participating commercial tax administrators felt that the time was short, and more case studies on Indian conditions needed to be considered during the workshops. Participants from the Delhi Sales Tax Administration and from the Kerala Tax Administration were generally more satisfied with the training and the quality of the VAT audit manual presented. Those of Madhya Pradesh and Gujarat were less so. (Participants from other states were not checked.) All regretted that the third module of the training, intended after the implementation of VAT, could not take place. All tax departments visited by the OEM had reviewed the VAT audit manual, and were preparing their own manual.

18. A training workshop for six computer staff of the six focal states was held to familiarize them with the audit selection software. The training was less effective, since only a few of the states (notably Madhya Pradesh) had a database of sufficient quality to try out the new software.

19. ADB delivered 30 computers to the Executing Agency, the Empowered Committee, and to some states as well. These are being used, although not always for the creation of databases of dealers, as VAT has not been introduced.

2. Institution Building

20. The intended institutional strengthening of the taxation departments by making the audit manual available to the tax officers was not fully achieved due to the postponement of VAT and the lack of opportunity for fine tuning the manual. The departments visited are in the process of adapting the manual for their use.

3. Performance of Consultants

21. The consultants produced a VAT audit manual that is in line with most such manuals in the world. They also organized workshops in four places. However, the TA did not include local experts with substantial experience in the sales tax departments. Consequently, the manual is not fully geared to the local realities in these departments. The consultants also did not take enough time to interact with tax officials of the states, to understand local practices of tax evasion and the variable quality of dealer data available.

D. Overall Assessment

22. The TA was rated partly successful. It was relevant, but less effective and efficient, with modest institutional impacts, and little expected sustainability once VAT is introduced, unless much more work is done. Due to the unforeseen postponements in the introduction of VAT, the TA could not complete its activities. The resources needed for the TA were significantly underestimated. The objective of improving databases in six selected states was not pursued. The software for the selection of the dealers for audit could not be finalized and tested.

E. Conclusions

1. Key Issues

23. The TA was part of ADB's efforts to change the system of revenue collection in India, a process some other external agencies contributed to over the years. Given that CIDA worked on a central VAT audit manual for years, the TA for VAT audit in the 28 states (or even 6 states) was designed with insufficient resources to build capacity significantly in this area. ADB's limited TA resources clearly are not sufficient to address these needs. Perhaps external agencies with a capability to assign more resources over several years would have been better suited to address these issues. The ADB TA in the three states discussed in this TA performance audit report was generally more effective and appropriate in terms of creating capacity.

2. Lessons Learned

24. TA that aims to build capacity in several states needs to be carefully considered, given the likely high requirements of resources in a country the size of India. The presence of consultants in each of these states for several months would be essential to generate an understanding of the local circumstances and a meaningful working relationship with the clients. Training of at least 10% of the tax offices from the smaller states, and 5% from the developed states (the numbers of officers range from 50 to 1,000 per state), would be needed to create a minimal impact.

25. A suitable expert with ample local experience in the administration of sales tax must be included on a TA team of this nature.

26. If a series of workshops is organized in various states, then it is wise to hold a pilot workshop first with the objective of obtaining suggestions on the nature of the subsequent workshops.

3. Follow-Up Actions and Recommendations

27. The current version of the VAT audit manual needs to be posted on the internet for public scrutiny and comments. The VAT audit manual needs to be finalized upon introduction of VAT at the state level. A number of iterations are expected, in light of growing experience with VAT implementation. The selection of variables that determine the sample of dealers to be audited needs to be reviewed. Similarly, further work is needed on the development of suitable computer databases, the testing and fine tuning of the computer program already developed, and training of trainers. This requires considerable resources and a timeframe of several years. If a suitable external agency cannot be found to fund such a TA, then ADB should consider finishing what it started with a new TA in this field. The Government needs to conduct further training of tax officers, and particularly train a number of master trainers. The Government also needs to start a public information campaign regarding VAT audits.

FISCAL MANAGEMENT ASSISTANCE PROGRAMS OF OTHER EXTERNAL AGENCIES IN INDIA

1. The main multilateral agencies providing assistance for fiscal management and tax administration in India are the Asian Development Bank (ADB), United Nations Development Programme (UNDP), and World Bank. Among bilateral agencies, the Department for International Development (DFID), Royal Netherlands Embassy, and Canadian International Development Agency (CIDA) have provided much of the assistance. At the request of the Government of India, the Royal Netherlands Embassy and CIDA will withdraw their assistance within the next years. Several other agencies have provided sectoral assistance that could translate into budgetary assistance by making redundant explicit or implicit public subsidies, such as in the power sector.

A. World Bank

2. The country assistance strategy of the World Bank emphasizes the role of subnational governments in the growth of India. Assistance has been limited to the World Bank's focal states—Andhra Pradesh, Karnataka, Orissa, and Uttar Pradesh—with much of the support targeted at fiscal and governance reforms.

3. **Andhra Pradesh.** The World Bank's first program loan was under the Andhra Pradesh Economic Restructuring Project, a multisectoral program with fiscal reform as one of the objectives. Started in 1998, this 5-year program received loan assistance of \$532.2 million. It had five sectoral components: nutrition, primary education, irrigation, roads, and public enterprise reform. DFID provided a parallel technical assistance (TA) grant of \$3.8 million, while another grant of \$4.1 million focused on the introduction of the value-added tax (VAT). The World Bank provided a second loan of \$250 million in 2002, again under a multisectoral reform program. A third loan of \$160 million for structural adjustment is under approval. The World Bank also granted TA in this field for Andhra Pradesh.

4. **Uttar Pradesh.** The Fiscal Reform and Public Sector Restructuring Program was approved in 2000 with a commitment of \$251.3 million. It has also received assistance under an umbrella program covering state and central governments.

5. **Karnataka.** The first program loan started in 2001, with a commitment of \$150 million. This was a single tranche loan for a program that included fiscal and public expenditure reforms, administrative reforms, private sector development, and poverty and human development monitoring system. The second Karnataka Economic Restructuring Loan/Credit, with the same components, was for \$100 million. The Karnataka Economic Restructuring Loan 3, a proposed loan program of \$200 million, is in the pipeline. The World Bank also granted TA in this field for Karnataka.

6. **Orissa.** This was one of the first states that the World Bank studied in detail. It followed earlier studies and loans for power, irrigation, and public enterprise reform. The state's first structural adjustment loan for \$100 million was approved recently.

7. In addition to these state-oriented programs, the Department of Economic Affairs of the Ministry of Finance implemented a broader TA for economic reform. Started in 2000, the TA's objective was to improve access to technical expertise and advisory services over a 5-year term. It has a budget of \$45 million. The states that benefited from this project include Gujarat, Karnataka, and Uttar Pradesh. A proposal to provide a loan for the state of Tamil Nadu has not

been finalized. Maharashtra and Rajasthan have been studied and considered, but no program loans have been approved outside of sectoral programs. Earlier, the World Bank provided assistance to implement VAT at the center and the states. A TA program for capacity building for budgetary analysis at the state level is in progress, as is one for pension reforms.

B. Department for International Development

8. Poverty reduction has been the main focus of DFID's operations in India. In the 1990s, however, DFID chose Andhra Pradesh and Orissa for funding a multisectoral program in collaboration with the World Bank. The main objectives in these states were good governance and economic restructuring. Three programs in Andhra Pradesh fall in the category of fiscal management: (i) TA for economic restructuring (introduction of VAT and public enterprise reform) with an allocation of \$6.6 million, (ii) contribution to the World Bank Trust Fund to support TA activities of the World Bank with an allocation of \$2.2 million in 2003–2004, and (iii) budgetary support of about \$50 million every year for 3 years. In Orissa, DFID allocated \$19 million to the Public Sector Reform Program. Additional projects are under design for Orissa with a budget of \$62.3 million, most of which are in budgetary support and public enterprise reform.

C. Canadian International Development Agency

9. CIDA's TA for Capacity Development in Revenue Administration, which encompassed central government and selected states (1997–2003, C\$8.5 million), was notable for its fiscal management focus. This covered direct and indirect taxes at the central level, and advisory services on the introduction of state-level VAT. In early 2003, state level interventions were planned for Chhattisgarh, Madhya Pradesh, and Uttaranchal.

D. Royal Netherlands Embassy

10. The Royal Netherlands Embassy has concentrated primarily on sectoral assistance and supplementing broader programs of multilateral agencies in specific areas. For example, its support for decentralization and state public enterprise reform in Kerala dovetailed with ADB's program of assistance to Kerala. Similarly, the Royal Netherlands Embassy supplemented the World Bank-ADB joint emergency relief program in Gujarat after the earthquake.

E. United Nations Development Programme

11. UNDP funded a TA program for capacity building for tax administration, which included research studies on tax administration (central and states), assistance for computerization, study tours, and facilitating the use of international expertise. The Department of Economic Affairs implemented the program. UNDP also started a TA to create an enabling environment for the private sector and capacity building for public administration at the state and local levels.

F. Australian Agency for International Development

12. The Australian Agency for International Development's program in this area was confined to public expenditure reform in Karnataka, under the umbrella India-Australia Training and Capacity Building Project. Future assistance to some states was planned for fiscal and governance reform, which the Government of India approved earlier this year. However, the Government of Australia decided to withdraw from implementing a new phase of the facility.

G. United States Agency for International Development

13. The United States Agency for International Development recently began a program of assistance to various states to improve governance, manage public expenditure, advise on tax collection methods and treasury operations, develop a long-term debt market, and improve local government functioning. The program has six focal states—Andhra Pradesh, Jharkhand, Karnataka, Rajasthan, Uttar Pradesh, and Uttaranchal. In 2003, a \$21 million program of fiscal reform was initiated in Karnataka, Jharkhand, and Uttaranchal.

H. Assessment

14. External assistance for fiscal reforms has been small compared to assistance in other fields. However, it has been growing in recent years, particularly assistance to individual states. The coverage of states by externally-assisted fiscal reform programs has been extensive. Most of the larger states already have been covered by the external agencies. A notable exception has been Bihar, perhaps due mostly to the perception that it is not reform friendly. States such as Haryana, Maharashtra, and Rajasthan have not received assistance for fiscal reform, but studies on fiscal reforms have been conducted and they have received sectoral assistance. Many of the smaller or special category states have not been covered, but attention is now shifting to these states (Assam and Sikkim).

FISCAL DEVELOPMENTS IN ASIAN DEVELOPMENT BANK-ASSISTED STATES¹

A. Introduction

1. This appendix examines recent trends in the public finances of the three states that received Asian Development Bank (ADB) assistance for the improvement in their public financial management: Gujarat, Kerala, and Madhya Pradesh.² This examination is done against the backdrop of fiscal developments of the states in general from FY1999–2000 onwards.

B. General Trends

2. Since the Government of India (the Government) announced a general increase in the salaries of its employees in 1999, state finances in India have been under severe stress. The employees of the state governments demanded a similar rise in their salaries and parity with the pay scales of the central Government. All state governments eventually gave in to these demands. Further, salary arrears needed to be paid. Despite impounding these arrears into the provident fund accounts of the employees, which the state governments maintained (to avoid cash depletion), several states faced rising deficits and serious cash flow problems. The pay revisions caused a permanent increase in the expenditures.

3. Although the pay revision immediately contributed to the destabilization of state finances at the end of the 1990s, it was not the only cause. State finances were in bad shape before the pay revision. Other reasons were the (i) limited buoyancy of tax revenues, (ii) archaic tax administration, (iii) reluctance to price public services rationally, (iv) leaks from public expenditures, (v) badly performing state enterprises that received subsidies, and (vi) sharp decline in central transfers relative to the state expenditures (as the low buoyancy of central taxes lead to only small increases in shared taxes). Added to all this was a tendency to adjust spending priorities to gain electoral mileage in times of relatively insecure and unstable governments. For all states together, the debt-gross domestic product (GDP) ratio rose from 17.9% in 1995–1996, to more than 25% by the end of 2002–2003. The gross fiscal deficit has been around 4.5% of the GDP for the past 3 fiscal years, with small fluctuations. Table A10.1 provides the recent trends in broad fiscal variables for all states together.

4. The figures show fluctuating trends over the 5-year period. Mainly through a compression of capital expenditures, the fiscal deficit was reduced in 2000–2001 as compared to 1999–2000. Revenue deficits also dropped a little, thanks to strong revenue performance. The situation, however, worsened over the next 2 years, with all deficits shooting up. The deficits situation is expected to improve somewhat in 2003–2004.

5. Despite tax revenue growth averaging around 13% annually, the deficits are determined mainly by the trends in revenues, as the expenditure figures rise slowly and predictably. The prospects for 2003–2004 most likely the state governments depend again on the transmission of overall growth into tax collections.

¹ Prepared by Tapas Kumar Sen, direct tax consultant.

² At the time the ADB program started, it was undivided. Subsequently in 2001, the state was bifurcated into Chhattisgarh and Madhya Pradesh.

Table A10.1: Recent Fiscal Trends in All States Combined
(Rs million)

Item	1999–2000	2000–2001	2001–2002	2002–2003 (Revised Estimates)	2003–2004 (Budget Estimates)
Own Tax Revenue	1,025,819	1,179,810	1,317,104	1,493,581	1,690,214
of which: Sales Tax	623,013	733,639	798,606	866,338	984,236
Shared Taxes	441,211	507,337	485,648	531,602	580,730
Total Tax Revenue	1,467,030	1,687,147	1,802,752	2,025,182	2,270,943
Non-Tax Revenue	298,747	314,545	322,765	359,540	415,638
Grants	306,235	377,838	430,477	554,009	642,610
Revenue Expenditure	2,609,982	2,915,215	3,148,328	3,551,752	3,819,273
of which: Interest Payments	451,717	517,020	624,890	741,466	822,873
Capital Expenditure ^a	376,833	359,635	367,529	554,282	598,525
Revenue Deficit	537,970	535,685	592,334	613,021	490,082
Fiscal Deficit	914,803	895,320	959,863	1,167,303	1,088,607
Primary Deficit	463,086	378,300	334,973	425,837	265,734

Note: The average rupee-dollar exchange rates are as follows:

FY1999–2000	43.33
FY2000–2001	45.68
FY2001–2002	47.69
FY2002–2003	48.40
FY2003–2004	46.30 (April–November 2003 average).

^a Including net loans advanced.

1. Gujarat

6. Gujarat was devastated by a major earthquake, communal riots, and drought in the last 5 years. The impact of the earthquake on the state finances was not very large, but the law and order situation probably had a greater impact on the state's finances. This was partly because the natural disaster brought in considerable assistance from other parts of the country and the international community to help the state mount relief operations. This was not the case with respect to the riots, however. The riots also affected mainstream trade and business activity, while the earthquake did not. Given that the main strength of Gujarat is its entrepreneurship, anything that damages business strikes at the root of the state's prosperity. The end-result has been a clear trend of bad performance by the state's finances since 1999–2000. Table A10.2 provides the summary of the budgetary trends of the state.

7. The figures show low buoyancy of its own tax revenue and negative buoyancy of shared taxes (a result of the award of the Eleventh Finance Commission that reduced the share of Gujarat). Despite small increases only in revenue expenditures, revenue deficits rose until 2001–2002. The fiscal deficit in 2001–2002 dropped, but would have dropped more except for a large-scale, one-time recall of loans given to state-owned power utilities. The fiscal deficit rose substantially the next year, despite a drop in revenue deficit. In FY2003–2004, revenue and fiscal deficits are expected to drop, if the trends hold for the entire fiscal year in the state. However, the deficits are at such high levels that substantial improvement will be needed before fiscal stability returns to Gujarat. Revenue expenditures have been held reasonably steady with only small increases, despite upward surges in the interest payment component. Continuing this strategy over the longer term might be difficult without affecting public service delivery. If the

state suffers no more serious reversals, its revenue performance should improve. Today, Gujarat's finances are clearly in much worse shape than they were 5 years ago.

Table A10.2: Recent Fiscal Trends in Gujarat
(Rs million)

Item	1999–2000	2000–2001	2001–2002	2002–2003 (Revised Estimates)	2003–2004 (Budget Estimates)
Own Tax Revenue	81,617	90,468	91,997	92,690	101,103
of which: Sales Tax	51,345	59,427	58,574	59,400	65,000
Shared Taxes	16,650	15,738	15,352	16,723	17,405
Total Tax Revenue	98,268	106,206	107,349	109,413	118,408
Non-Tax Revenue	29,193	33,492	37,609	39,003	45,138
Grants	11,543	17,689	14,903	23,198	23,903
Revenue Expenditure	175,172	220,409	227,176	233,620	240,622
of which: Interest Payments	28,082	31,314	42,060	51,532	55,422
Capital Expenditure	31,752	16,854	(2,208) ^a	44,858	41,948
Revenue Deficit	36,168	63,022	67,315	62,006	53,174
Fiscal Deficit	67,920	79,876	65,108	106,863	95,122
Primary Deficit	39,838	48,562	23,048	55,331	39,700

^a The large scale recall of power sector loans caused the negative figure. Capital expenditure includes net loans advanced, so large scale loan repayment causes a negative value.

2. Kerala

8. The strength of Kerala is its high level of human development. However, in the absence of adequate industrial development, the state's educated unemployed traditionally have put pressure on the Government to provide jobs. Kerala is one of the states with relatively low levels of poverty, but heavy dependence on the Government for basic social and economic services. In this context, reforms are relatively more difficult to achieve, especially if these envisage a smaller role of the public sector. Still, some reforms have been carried out in Kerala, and the results in terms of improvement in its financial position are clearly visible in Table A10.3.

9. The average annual growth of own tax revenues during the period was around 13%, which allowed the total tax revenues to grow at about 11%, despite very slow growth in shared taxes. The non-tax revenues also have grown substantially, although this is partly due to the inclusion of a one-time receipt of Rs500 crore in 2000–2001 from privatization. Moreover, the Kerala government managed to maintain tight control on growth of expenditures (revenue and capital)—not allowing them to grow by much more than 5% per annum. These broad trends cut the primary deficit substantially. Even though interest payments grew at about 10% per year, the reduction in the primary deficit was large enough to translate into an average annual reduction of about 20% per year. These averages hide the fact that much of this took place in 1 year (2002–2003), and that the budget estimates show a rise in the revenue deficit in 2003–2004.

10. All the same, the fiscal performance of Kerala in recent years seems to be in the direction of fiscal consolidation. Some of the off-budget liabilities, not fully reflected in the above figures, have been brought into the budget. However, the look of future deficits will depend considerably on how the rest is handled.

Table A10.3: Recent Fiscal Trends in Kerala
(Rs million)

Item	1999–2000	2000–2001	2001–2002	2002–2003 (Revised Estimates)	2003–2004 (Budget Estimates)
Own Tax Revenue	51,935	58,703	58,394	73,602	86,342
of which: Sales Tax	38,535	43,443	44,409	54,000	64,180
Shared Taxes	15,352	15,856	16,983	17,648	19,998
Total Tax Revenue	67,287	74,559	75,377	91,250	106,339
Non-Tax Revenue	5,307	12,750	5,434	7,370	7,679
Grants	6,823	6,159	9,753	15,894	12,978
Revenue Expenditure	115,659	124,939	116,620	133,500	153,646
of which: Interest Payments	19,523	22,576	24,895	26,631	27,381
Capital Expenditure	9,124	7,307	6,638	9,464	6,419
Revenue Deficit	36,242	31,471	26,056	18,987	26,650
Fiscal Deficit	45,366	38,778	32,694	28,450	33,069
Primary Deficit	25,843	16,202	7,799	1,820	5,688

3. Madhya Pradesh

11. Among the five low-income states of Bihar, Madhya Pradesh, Orissa, Rajasthan, and Uttar Pradesh, two states—Madhya Pradesh and Rajasthan—have enjoyed relatively high growth in state domestic product over the past 10 years. This allowed for some fiscal adjustments, although the advantage was probably lost for Madhya Pradesh with the bifurcation of the state in 2000. From all accounts, the part of Madhya Pradesh that is now Chhattisgarh contributed most to that growth. Also, the division of assets and liabilities has affected the truncated state's finances. With most of the assets of the (undivided) state being in the form of physical assets, the division was practically based on location. But the liabilities, which were mostly financial, were divided primarily by population. This worked against the truncated Madhya Pradesh, as it has a much higher population density than Chhattisgarh. The physical assets, on the other hand, were more evenly distributed across the pre-bifurcation Madhya Pradesh. Further, Chhattisgarh has most of the mineral bearing areas of Madhya Pradesh, as well as those with the highest agricultural production (the "rice bowl" of Madhya Pradesh). All these factors affected the finances of the truncated Madhya Pradesh. The figures in Table A10.4 indicate an initial impact, but the trend is in an unexpected direction. The table provides the relevant data for Madhya Pradesh, including and excluding those for Chhattisgarh for the post-split years. Some insights into the trends, as well as the effect of the split on Madhya Pradesh finances, can be gleaned from considering both sets. What it appears to show is the strong initial negative impact, tapering off gradually until 2003–2004, when the smaller Madhya Pradesh is beginning to shake off the negative impact.

Table A10.4: Recent Fiscal Trends in Madhya Pradesh
(Rs million)

Item	1999– 2000	2000– 2001	2000– 2001 C ^a	2001– 2002	2001– 2002 C ^a	2002– 2003 (Revised Estimates)	2002– 2003 C ^a (Revised Estimates)	2003– 2004 (Budget Estimates)	2003– 2004 C ^a (Budget Estimates)
Own Tax Revenue	57,952	56,396	63,867	47,023	66,955	60,082	82,972	70,464	96,991
of which: Sales Tax	25,551	27,666	31,202	23,607	33,008	29,040	39,568	33,400	46,078
Shared Taxes	32,616	47,833	52,932	34,059	46,297	39,565	51,322	39,565	54,283
Total Tax Revenue	90,569	104,229	116,799	81,082	113,252	99,647	134,295	110,028	151,274
Non-Tax Revenue	24,690	32,442	35,324	16,017	23,242	14,393	23,316	15,989	27,135
Grants	16,779	15,199	18,550	14,911	19,754	27,742	39,416	32,618	51,658
Revenue Expenditure	161,361	165,063	180,676	143,688	192,829	156,917	220,171	164,791	241,488
of which: Interest Payments	21,387	24,108	26,988	22,537	29,557	26,244	35,240	30,011	39,986
Capital Expenditure	9,791	13,928	16,221	4,816	9,977	30,560	40,776	35,047	50,857
Revenue Deficit	29,323	13,193	10,003	31,678	36,581	15,135	23,145	6,156	11,421
Fiscal Deficit	39,114	27,121	26,224	36,494	46,557	45,694	63,921	41,203	62,277
Primary Deficit	17,727	3,013	(763)	13,957	17,001	19,450	28,680	11,192	22,291

Note: Madhya Pradesh was bifurcated in 2000. Thus, figures for 2000–2001 show partly those of the larger state and partly those of the truncated Madhya Pradesh. Those for 2001–2002 to 2003–2004 refer to the truncated Madhya Pradesh only.

^a Year C implies combined figures for Madhya Pradesh and Chhattisgarh.

12. **Impact of the Bifurcation Effect.** In FY2000–2001, the combined figures show a primary surplus, as compared to a deficit for the truncated state and a revenue surplus figure lower than that of Madhya Pradesh alone. The initial impact of the bifurcation, therefore, was negative. But the share of the truncated Madhya Pradesh in the combined figures of the fiscal deficit has dropped continuously from 78% in 2001–2002 to 66% in 2003–2004 (budget estimate). The drop is much sharper in primary deficit shares, substantiating the point that Madhya Pradesh has the larger share of financial liabilities (and hence interest payment responsibilities). The conclusion is that the relative performance of bifurcated Madhya Pradesh is better than that of Chhattisgarh, except in the first year after the split.

13. **Combined Madhya Pradesh.** The trends indicate rising fiscal deficits, although there is a small reduction in the budget estimates for 2003–2004. The growth in revenues is reasonable. Although non-tax revenues grew sluggishly, the sharp rise in grants more than made up for it. The revenue expenditures did not grow too fast. As a result, the revenue deficits decreased in the past 2 years. A spurt in capital expenditures, including net lending, accounts for the large jump in fiscal deficits in 2002–2003, with the resulting high level maintained in 2003–2004 budget estimates.

14. **Truncated Madhya Pradesh.** In the truncated Madhya Pradesh, the tax performance has been excellent, despite a relatively slow increase in shared taxes. Since the split in 2000, own tax revenues have grown more than 20%. Own non-tax revenues have grown little, but grants have spurted. The growth in revenue expenditures has been contained at just above 7%, leading to a substantial reduction in revenue deficit between 2001–2002 and 2003–2004 (budget estimates). The jump in capital expenditures and net lending has been as pronounced in this case as for the combined Madhya Pradesh, leading to a neutralization of the drop in revenue deficits. In 2001–2002 and 2002–2003, the revenue deficit actually shows a sharp rise, leveling off somewhat thereafter. Thus, for the combined and truncated Madhya Pradesh, the verdict on fiscal performance apparently depends largely on how wisely the capital expenditures (and net lending) were incurred.

C. A Comparison

15. Table A10.5 compares the fiscal performance of the three ADB-assisted states with that of all states taken together, in terms of some main fiscal variables. For this purpose, annual average growth for 1999–2004 is considered, including the budget estimates for 2003–2004.³

16. Gujarat has performed the worst of the three, with its revenue deficit and fiscal deficit rising substantially over the 4-year period. Deficits in the areas of pre-bifurcation Madhya Pradesh also have risen, but this was due to a sharp rise in capital expenditures. The rise in Gujarat came despite a sharp fall in such expenditures in 1 year. The reason is the poor growth in revenue from Gujarat's own taxes and shared taxes. Kerala also had a relatively low growth in tax revenues, but raised its non-tax revenues significantly and contained its expenditure growth well below that of others. Further, it has managed to contain interest payments, allowing a drop in the revenue and fiscal deficits despite a rise in primary deficits. The general drop in revenue deficits is not seen in Gujarat and Madhya Pradesh, but the figure of the latter is somewhat distorted by a sharp rise in only 1 year.

³ A qualitative difference exists between budget estimates and the rest of the figures, which should be taken into account. Furthermore, budget estimates are not always based on expectations about policy and other economic determinants; there is some amount of "strategizing" built into them that make them different from the actual and revised estimates.

**Table A10.5: Average % Annual Increase
(1999–2004)**

Item	All States	Gujarat	Kerala	Madhya Pradesh and Chhattisgarh
Own Tax Revenue	13.30	5.59	13.96	13.97
of which: Sales Tax	12.18	6.29	13.85	16.06
Shared Taxes	7.35	1.27	6.90	16.59
Total Tax Revenue	11.58	4.82	12.37	14.29
Non-Tax Revenue	8.72	11.61	30.67	6.39
Grants	20.50	24.05	23.31	36.91
Revenue Expenditure	10.01	8.68	7.73	10.64
of which: Interest Payments	16.24	18.97	8.93	17.10
Capital Expenditure ^a	14.11	(574.64)	(4.67)	90.15
Revenue Deficit	(1.60)	14.73	(4.28)	28.11
Fiscal Deficit	4.99	13.06	(6.74)	19.83
Primary Deficit	(10.06)	20.30	11.68	(596.36)

Note: In Gujarat, the large scale recall of power sector loans has caused the negative growth rate. Capital expenditure includes net loans advanced, so large scale loan repayments cause the negative value. In Madhya Pradesh and Chhattisgarh, the large primary deficit value was due to the state's bifurcation, and the consequent need to step up capital expenditure.

^a Including net loans advanced.

17. Overall, the fiscal performance of Kerala appears to be above average, while that of Gujarat is clearly below average. The case of Madhya Pradesh is difficult to judge due to the sharp fluctuation in the figures. However, leaving aside the sharp rise in capital expenditures and net lending, it is roughly similar to that of all states taken together. Also, the drop in primary deficits improves its debt sustainability. Better debt management to slow down growth of interest payments can pay rich dividends in reducing revenue and fiscal deficits. In general, the states in India show a trend towards higher fiscal sustainability, with reductions in primary and revenue deficits. Paying greater attention to the financial viability of the capital expenditures and better loan recovery should improve this further.